



TRADE AND DEVELOPMENT REPORT, 2015

Making the international
financial architecture work
for development



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GENEVA**

TRADE AND DEVELOPMENT REPORT, 2015

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Explanatory notes

Classification by country or commodity group

The classification of countries in this *Report* has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area.

There is no established convention for the designation of “developing”, “transition” and “developed” countries or areas in the United Nations system. This *Report* follows the classification as defined in the *UNCTAD Handbook of Statistics 2014* (United Nations publication, sales no. B.14.II.D.6) for these three major country groupings (see http://unctad.org/en/PublicationsLibrary/tdstat39_en.pdf).

For statistical purposes, regional groupings and classifications by commodity group used in this *Report* follow generally those employed in the *UNCTAD Handbook of Statistics 2014* unless otherwise stated. The data for China do not include those for Hong Kong Special Administrative Region (Hong Kong SAR), Macao Special Administrative Region (Macao SAR) and Taiwan Province of China.

The terms “country” / “economy” refer, as appropriate, also to territories or areas.

References to “Latin America” in the text or tables include the Caribbean countries unless otherwise indicated.

References to “sub-Saharan Africa” in the text or tables include South Africa unless otherwise indicated.

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 2014* refers to *Trade and Development Report, 2014* (United Nations publication, sales no. E.14.II.D.4).

References in the text to the United States are to the United States of America and those to the United Kingdom are to the United Kingdom of Great Britain and Northern Ireland.

The term “dollar” (\$) refers to United States dollars, unless otherwise stated.

The term “billion” signifies 1,000 million.

The term “tons” refers to metric tons.

Annual rates of growth and change refer to compound rates.

Exports are valued FOB and imports CIF, unless otherwise specified.

Use of a dash (–) between dates representing years, e.g. 1988–1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 2000/01, signifies a fiscal or crop year.

A dot (.) in a table indicates that the item is not applicable.

Two dots (..) in a table indicate that the data are not available, or are not separately reported.

A dash (-) or a zero (0) in a table indicates that the amount is nil or negligible.

Decimals and percentages do not necessarily add up to totals because of rounding.

Abbreviations

ADB	Asian Development Bank
AfDB	African Development Bank
AIIB	Asian Infrastructure Investment Bank
ASEAN	Association of South-East Asian Nations
AUM	assets under management
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BNDES	Banco Nacional de Desenvolvimento Econômico e Social (National Bank for Economic and Social Development, Brazil)
BRICS	Brazil, the Russian Federation, India, China and South Africa (group of countries)
CAC	collective action clause
CAF	Corporación Andina de Fomento (Andean Development Corporation)
CDB	China Development Bank
CMI	Chiang Mai Initiative
CMIM	Chiang Mai Initiative Multilateralization
CRA	credit rating agency
DAC	Development Assistance Committee (of the OECD)
DTE	developing and transition economies
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
EU	European Union
FCL	flexible credit line
FDI	foreign direct investment
FSB	Financial Stability Board
G20	Group of Twenty
G8	Group of Eight
GDP	gross domestic product
GINI	gross national income
HIPC	heavily indebted poor country (also HIPC initiative)
IADB	Inter-American Development Bank
ICMA	International Capital Management Association

ICSID	International Centre for Settlement of Investment Disputes
ICT	information and communications technology
IDS	International Debt Statistics (World Bank)
IMF	International Monetary Fund
IMS	international monetary system
LAIA	Latin American Integration Association
LDC	least developed country
MDRI	Multilateral Debt Relief Initiative
MMMF	money market mutual fund
NDB	New Development Bank
NSFR	net stable funding ratio
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PBOC	People's Bank of China
PLL	Precautionary and Liquidity Line (of IMF)
PPI	Private Participation in Infrastructure (database)
PPP	public-private partnership
QE	quantitative easing
Repo	repurchase agreement
SDR	special drawing right (of the IMF)
SDRM	sovereign debt restructuring mechanism
SME	small and medium-sized enterprise
SML	Sistema de Pagos en Monedas Locales (Local Currency Payment System)
SUCRE	Sistema Unitario de Compensación Regional (Unitary System of Regional Payments Compensation)
SWF	sovereign wealth fund
TDR	Trade and Development Report
TNC	transnational corporation
UNCTAD	United Nations Conference on Trade and Development
UN-DESA	United Nations Department of Economic and Social Affairs

OVERVIEW

Money makes the world go round, or so the song goes. It can also send it spinning out of control, as witnessed during the 2008 global financial crisis. In response to the soaring economic and social costs that followed, the international community called for a new financial songbook. Gordon Brown, chief conductor of the G20 choir at the time, placed the blame firmly on inadequately regulated financial institutions that had become less “stewards of people’s money” and more “speculators with people’s futures”; what was needed, he insisted, was new global rules underpinned by shared global values. Shortly after, the leaders of the BRIC countries, at their first summit in the Russian Federation, called for more democratic international financial institutions, along with a stable, predictable and more diversified international monetary system. The United Nations General Assembly added its universal voice with a blueprint for reforming the international financial system, noting, in particular, as an urgent priority, “comprehensive and fast-tracked reform of the IMF”.

A number of national legislators joined the chorus with a string of parliamentary hearings and expert commissions, many of which criticized the short-term bias of financial markets, their addiction to toxic and opaque financial instruments, and their failure to adequately service the financial needs of businesses and households. Serious reform, it seemed, was just a matter of time.

Seven years on, and against a backdrop of sluggish global aggregate demand, increasing income inequality and persistent financial fragility, the world economy remains vulnerable to the vagaries of money and finance. It would be wrong to suggest that the reform agenda never got beyond the drawing board; various measures have been adopted, at both the national and international levels, including some with real bite. But so far these have failed to get to grips with the systemic frailties and fragilities of a financialized world. Rather, to date we have, in the words of the Financial Times journalist Martin Wolf, little more than a “chastened version” of the previously unbalanced system.

The persistent short-term and speculative biases of global financial markets, and the inadequate measures to mitigate the risks of future crises, raise important questions about whether the heightened ambition of the international community with respect to a range of new developmental, social and environmental goals can be achieved within the desired time frame. On paper, this new agenda anticipates the biggest investment push in history, but in order to succeed it will require a supportive financial system. Accordingly, this year’s Trade and Development Report examines a series of interconnected challenges facing the international monetary and financial system, from liquidity provision, through banking regulation, to debt restructuring and long-term public financing. Solutions are available, but dedicated action by the international community will be needed if finance is to become the servant of a more dignified, stable and inclusive world.

From global financialization to global financial crisis

Following the collapse of the Bretton Woods system, finance became more prominent, powerful and interconnected; it also grew steadily more distant from the real economy. From the 1980s, most major developed economies rapidly opened up their capital accounts, followed a decade later by many emerging developing economies. As a result, capital began flowing across borders on an unprecedented scale. In 1980, global trade had been at a level relatively close to that of global finance, at around a quarter of world GDP, but by 2008, just prior to the financial crisis, global finance had grown to become nine times greater than global trade; by that time, the global stock of financial assets exceeded \$200 trillion. At the same time new financial institutions emerged and more traditional intermediaries increasingly diversified their range of financial products, in both cases with fewer regulations and less oversight. In the process, finance became much more interconnected, with standard measures of financial integration hitting historical highs and global asset prices moving in ever closer tandem.

In a very short period of time, these developments overwhelmed the institutional checks and balances that had ensured a remarkable period of financial stability during the three decades after the end of the Second World War, and which had, in turn, underpinned a steady rise in international trade and an unprecedented drive in capital formation. A new generation of policymakers responded with calls for the rapid dismantling of remaining financial regulations, extolling, instead, the virtues of self-regulating markets as the best, and on some accounts the only, approach for combining efficiency and stability in a globalizing world.

The resulting financial system became far more generous in creating credit, more innovative in managing risk and more skilled in absorbing small shocks to the system (the so-called Great Moderation). However, it turned out to be much less capable of identifying systemic stresses and weaknesses and anticipating bigger shocks (from the Mexican peso crisis to the Great Recession) or mitigating the resultant damage. The burden of such crises has, instead, fallen squarely on the balance sheet of the public sector, and indeed, on citizens at large.

The scale of the 2008 crisis has left many governments struggling to offset the effects of financial retrenchments in banks, businesses and households as they seek to repair their balance sheets. This is partly because a singular focus on price stability has led policymakers to abandon the art of managing multiple macroeconomic goals; but also because financialization has blunted or removed a range of policy instruments that are needed for effective management of a complex modern economy.

Since the crisis, many developed economies have turned to “unconventional” monetary policy instruments in efforts at recovery. Essentially, key central banks have been buying up the securities held by leading banks in the hope that increased reserves would generate new lending and stimulate new spending in the real economy. The results have been underwhelming: in many developed economies, recovery from the 2008 crisis has been amongst the weakest on record. Job growth has been slack, real wages have stagnated or fallen, investment has struggled to pick up, and productivity growth has been stuck in second gear. By contrast, stock markets have recovered, property markets have rebounded – in some instances booming again – and profits are up, in many cases beyond the highs reached before the crisis. Meanwhile, debt levels have continued to rise, with an estimated \$57 trillion added to global debt since 2007.

Tepid recovery in developed countries

Back in mid-2014, following a prolonged period of crisis management, there seemed to be a sense of “business as usual” returning to policy circles. Projected growth rates for the coming years were edging up, the eurozone was back in positive territory and Japan seemed poised to pull itself out of years of economic stagnation. Meanwhile, unemployment in the United States was heading lower, and the Federal Reserve was progressively ending quantitative easing; oil prices were falling and business confidence was on the mend.

However, by the end of the year, some doubts had emerged and, if anything, the clouds on the horizon have since darkened.

Following the 2008–2009 crisis and the rebound in 2010, the global economy has been growing at around 2.5 per cent, below the conservatively estimated benchmark of a 3 per cent potential growth rate, and significantly below the 4 per cent average of the pre-crisis years. The growth rate for 2015 is expected to remain more or less unchanged from last year, at 2.5 per cent – the combined result of a slight acceleration of growth in developed economies, a moderate deceleration in developing economies, and a more severe decline in transition economies.

Developed countries are expected to grow at around 1.9 per cent, compared with 1.6 per cent in 2014, as growth in the eurozone and Japan is experiencing a moderate acceleration, although from very low rates. Recent improvements are due to stronger domestic demand as a result of increased household consumption and a less stringent fiscal stance. The former stems from a reduction of energy prices, wealth effects from rising equity market valuations and employment growth in a number of countries, notably Germany, Japan, the United Kingdom and the United States. Inflation has remained significantly below targeted rates in most developed countries.

Monetary policies remain expansionary, with very low interest rates in all developed regions and additional “quantitative easing” programmes launched in the eurozone and Japan. However, credit expansion has not followed, wages remain subdued and banks are showing signs of weakness. There is also renewed uncertainty regarding the future of Greece in the eurozone and the ongoing talk of a possible “Grexit”, which represents the most immediate threat to the sovereign yields of Portugal, Spain and other European countries that have recently started to recover from the depth of the crisis. Doubts have also crept back concerning the strength of the Japanese recovery. The United States is expected to continue its post-crisis growth trajectory with an estimated growth rate of 2–2.5 per cent, which is below previous recoveries; nevertheless, this allows steady – if unspectacular – job creation, although still without a significant improvement in nominal wage growth. Moreover, household balance sheets remain fragile and the appreciating dollar is hurting the contribution of net exports to GDP growth.

Stagnation: Secular or seasonal?

Over and above these conjunctural movements, a much bigger concern is that developed countries could be stuck in a holding pattern of slow growth. Secular stagnation is an old idea with a modern twist. The idea of a vanishing growth frontier was first raised in the late 1930s and was linked to unfavourable technological and demographic trends that could only be offset by large government deficits. At present, the observation that the growth path in many developed countries has remained at substantially lower levels than before the crisis, despite several years of accommodative monetary policy, has created a sense of a “new normal”. In today’s financialized world, the main stimuli used are mounting private debts and asset bubbles. Thus countries may be facing a trade-off between prolonged subdued growth on the one hand and financial instability on the other.

So far there is no consensus on whether or not there actually is secular stagnation, and if there is, why. Some observers hold that the decline in growth has been due to a combination of supply-side factors: weak investment propensities, a lack of technological dynamism and unfavourable demographic shifts. Others see it more as the inevitable, prolonged, but ultimately reversible downside of a debt super cycle. In either case, there has been insufficient acknowledgment of the decline in the wage share in developed countries by about 10 percentage points since the 1980s, which has considerably constrained income-based consumer demand, with attendant negative effects on private investment. These adverse demand effects from worsening functional income distribution have been reinforced by widening inequality in personal income distribution,

as the share in total income of the richest households has strongly increased and these households tend to spend less and save more of their incomes than other households. They have also been reinforced by the singular reliance on expansionary monetary policies to address the demand shortfall. This has led firms to use their profits for dividend distribution and investment in financial assets, rather than in production facilities. These spur asset prices and exacerbate the inequalities in wealth distribution, thereby perpetuating income stagnation for the majority of the population.

The attendant policy debate has mainly been on whether and which structural reforms might best spur private investment and entrepreneurial dynamism. Some proposals focus on measures which would correct perceived rigidities in product and labour markets. Others have placed greater emphasis on ways to reduce the size of the public debt. But while these are presented with a good deal of conviction, there is little indication of where the growth impulses will actually come from. In this view, much seems to rest on a mutually supporting combination of rising business confidence and improving international competitiveness. However, world trade remains in the doldrums. Between 2012 and 2014, world merchandise trade grew between 2 and 2.5 per cent (very similar to the rates of global output). These growth rates are significantly below the average annual rate of 7.2 per cent recorded during the 2003–2007 pre-crisis period. In 2014, world merchandise trade, at current prices, remained almost stagnant (growing only by 0.3 per cent) due to the significant fall in the prices of the main commodities. Preliminary estimates for 2015 indicate a mild increase in the volume of merchandise trade, which could grow at a rate close to that of global output. But these improved trade prospects are largely due to increased trade among developed countries, and probably reflect moderate gains in their growth performance. In any case, this improvement does not provide a significant stimulus to global economic growth.

Indeed, to the extent that secular stagnation is mostly a demand-side phenomenon, policy approaches that seek to contain labour income and public spending will tend to worsen rather than solve the problem. An alternative approach gives a prominent role to incomes policy (e.g. minimum wage legislation, strengthening of collective bargaining institutions and social transfers) and to public expenditure to address weaknesses on both the demand and supply sides. The fact that an increase in public expenditure, such as on infrastructure, has been shown to have very substantial positive multiplier effects in stagnating economies suggests that enhancing public investment should be a key instrument for addressing secular stagnation. Moreover, a progressive incomes policy increases demand as well, creating outlets for private investment and resulting in wider benefits: higher wage incomes reduce the financial pressure on pension schemes and allow households to increase their consumption spending without adding to household debt. There is also substantial evidence of a positive impact on labour productivity. Indeed, increased levels of activity and employment are known to foster productivity, creating a virtuous circle of demand and supply expansion. Thus, fiscal expansion and income growth would increase actual output and at the same time accelerate potential output growth, thereby animating a virtuous feedback relationship that provides the basis for future sustained, non-inflationary growth.

Financial spillovers to developing and transition economies

Whatever the future course of the stagnation debate, the combination of an easy monetary policy and a sluggish real economy has, to date, encouraged excess liquidity in developed economies to spill over to emerging economies. This was already observed after the dot-com bubble burst, but it has escalated considerably since the 2008 crisis.

Since the turn of the millennium, the rate of private capital inflows into developing and transition economies (DTEs) has accelerated substantially. As a proportion of gross national income (GNI), net external inflows into DTEs increased from 2.8 per cent in 2002 to 5 per cent in 2013, after having reached two historical records of 6.6 per cent in 2007 and 6.2 per cent in 2010. At the same time, many DTEs experienced strong growth and improving current accounts, accumulating, as a group, considerable external reserve assets.

Mainstream proponents of financial integration were enthusiastic about these trends, emphasizing the positive interaction between open capital accounts, increased private capital flows, sound policy frameworks and efficiency gains. However, the links have proved elusive to researchers, and the integration of most DTEs into global financial markets appears to have been only weakly connected to their long-term development goals. While foreign capital can play a useful role in closing domestic savings gaps and foreign direct investment (FDI) can help promote domestic productive capacity, particularly when invested in greenfield projects, part of the challenge is that an increasing proportion of the inflows are of a short-term, more risky and speculative nature, exhibiting the type of volatility reminiscent of inflows that preceded previous financial crises in the 1980s and 1990s. As a result, increasingly large and volatile international capital flows, even if they give a short-term boost to growth, can increase vulnerabilities to external shocks, while also limiting the effectiveness of policy tools tasked with managing them. Therefore, these flows may compromise the macroeconomic conditions necessary for supporting productivity growth, structural transformation and inclusive development in the long term.

After the crisis erupted in 2008, many developed-country policies of quantitative easing, coupled – after a brief expansionary interlude – with fiscal austerity, have continued this pattern of generating more liquidity in the private sector but with limited growth returns. In this context, the promise of higher returns on investments in DTEs, and perceptions that they posed lower risks than before, made them an attractive alternative for international investors.

Since these capital inflows occurred at the same time that most DTEs experienced current account surpluses or lower deficits, it is unlikely that financing to meet development needs was the main driver of the boom in private capital. DTEs as a whole, particularly the larger economies, accumulated considerable amounts of reserve assets during this period, indicating that the amount of inflows exceeded what was broadly consistent with domestic spending and investment requirements. It was not only deficit countries that received gross capital inflows, but also countries with large trade surpluses, indicating that often capital movements became the major drivers of the balance of payments, and were largely unrelated to real economic activities. Since the rates of return paid by DTEs on their international liabilities have been higher than those earned on their assets, these capital inflows have tended to reduce balances in the income account leading to a deterioration of the current account. This could prompt the adoption of restrictive policies and result in increased financial fragility in the deficit countries. An important question is therefore whether these patterns are consistent with financial stability and sustained demand, at both the national and global levels.

Managing capital flows: New vulnerabilities, old challenges

At the policy level, external financial flows, and in particular excessive short-term speculative flows, can alter prices and influence policy in ways that could compromise the potential for sustainable growth and development. Large capital inflows can generate pressures for currency appreciation. These effects are exacerbated by a widespread commitment to maintaining extremely low rates of inflation as a goal in itself. The resulting macroeconomic environment, characterized by high and volatile interest rates, combined with the appreciated currency, run the risk of discouraging both robust aggregate demand and the types of investment that deepen productive capacity. The possibility to use fiscal policy can similarly be constrained by a compulsion to maintain a finance-friendly public stance, which requires a light touch on both the expenditure and revenue sides. Less government activity directly reduces national income by limiting public spending; it also indirectly lowers productive capacity by restricting the types of public investment in physical and human capital that support private investment and productivity growth. In some cases, particularly in Latin America and sub-Saharan Africa, these price and policy effects have reinforced the trend towards premature deindustrialization and informalization of work.

Since the 1980s, most financial crises in DTEs have been preceded by a surge in capital inflows. The consequent build-up of financial fragility, mainly in the form of excessive private debt, often culminates

in a crisis, with substantial negative real effects and a soaring public debt. Although fiscal profligacy is a frequent refrain in many accounts of financial crises, it is typically the lower growth resulting from the crisis and the clearing up of the private bust and all the costs associated with it (e.g. nationalizing private debt, recapitalizing banks, and the impact of currency devaluation on the value of foreign-currency liabilities) that run up public debt. Such boom-bust cycles have continued to be heavily influenced by circumstances external to the economies that host them, for example changes in global commodity prices or in United States interest rates, or by the contagion effects of crises elsewhere.

In this context, domestic macroeconomic and structural weaknesses are exacerbated by a larger global financial system characterized by too much liquidity and not enough macroprudential regulation, giving rise to a process of optimism, excessive private risk-taking and overborrowing.

In light of these systemic vulnerabilities, there are a number of policy responses that DTEs – especially those countries susceptible to excessive short-term capital flows – can consider, not only for better managing the amount and composition of private capital flows and their macroeconomic effects, but also for strengthening the links between fiscal and monetary policies and development goals. Instead of relying solely on interest rates and very low inflation targets to manage capital inflows and the balance of payments, what is needed is a judicious combination of appropriate capital account and exchange-rate management that maintains access to productive external finance, including trade finance and FDI that builds local productive capacity, while also encouraging domestic investment. In addition, central banks can and should do more than just maintain price stability or competitive exchange rates to support development. For instance, they could use credit allocation and interest rate policies to facilitate industrial upgrading and provide key support to development banks and fiscal policy, as has been done by central banks in many of the newly industrializing countries. However, as evidenced by the challenges faced by developed countries in emerging from the recent crisis, monetary policy alone is not enough; proactive fiscal and industrial policies are also essential for generating the structures and conditions that support domestic productivity growth and the expansion of aggregate demand.

Given the sheer size of global capital flows, however, macroeconomic management at the national level must be supplemented by global measures that discourage the proliferation of speculative financial flows and provide more substantial mechanisms for credit support, including through shared reserve funds at the regional level.

Slowdown and diversity in the developing world

The new vulnerabilities linked to financialization dropped off the policy radar screen at the turn of the millennium, when DTEs entered a period of strong growth that seemed to decouple from economic trends in developed countries. In response to the initial shock in 2008–2009, many of them applied more ambitious countercyclical policies, including increased fiscal spending and income support measures that were sustained long enough to encourage a continuing rise of household expenditure and, by extension, of private investment. Some of these countries are now scaling back or even reversing the policy stimulus as they face capital outflows or lower export prices. Oil importers, by contrast, have greater room for manoeuvre as a result of the recent improvement in their terms of trade.

Developing countries as a whole will continue to expand at a rate of more than 4 per cent, thanks, in particular, to the resilience of most of the countries in the Asian region. However, other regions are experiencing a significant slowdown due to lower commodity prices and capital outflows, which, in some countries, have prompted tighter macroeconomic policies. Latin America, West Asia and the transition economies are among the worst affected, while African subregions present a mixed picture.

In 2014, most trade figures were bleaker than those of the previous years. In particular, Africa's real exports showed a contraction on account of shrinking oil exports in both North and sub-Saharan African

economies. External trade in Latin America and the Caribbean slowed down in volume (and even more in value terms), partly because regional economic stagnation negatively affected intraregional trade. East Asian trade continued to grow in volume, but at unusually low rates for the region (less than 4 per cent in 2014). To a large extent, this reflects the slowdown of China's international trade, where the real exports growth rate became slower than its GDP growth rate, while real imports decelerated even more markedly. These trends may reflect a structural change in the Chinese economy, with growth drivers shifting from exports to domestic demand and imports being used more for final use within the country rather than as inputs in export-processing industries.

Commodity markets witnessed particularly turbulent times in 2014 and the first half of 2015. Most commodity prices fell significantly in the course of 2014, continuing the declining trend that started after the peaks of 2011–2012, with a particularly notable slump in crude oil prices. The pace of the price decline accelerated in comparison with 2013, noticeably for the commodity groups for which demand is more closely linked to global economic activity, such as minerals, ores and metals, agricultural raw materials and oil. Market fundamentals appeared to be the major driver of commodity price movements, although financialization of commodity markets continued to play a role, as financial investors reduced their commodity positions in conjunction with the downturn in prices and returns. Hedge funds appear to have been particularly active in oil markets, where they amplified price movements. Furthermore, the strong appreciation of the dollar over the past year has been an important factor in the declining prices of commodities.

The plunge in oil prices resulted mainly from greater global production, especially shale oil in the United States, and OPEC's abandonment of its price-targeting policy, presumably to defend its market share by attempting to undercut higher cost producers in order to drive them out of the market. Global oil demand continued to grow in 2014, but its slower rates of growth could not absorb the larger supply. The resulting lower oil prices have had an impact on other commodity prices through different channels. Lower oil prices provide incentives to increase commodity production as a result of reductions in some production costs. They may also discourage demand for agricultural products used in biofuels and reduce the prices of synthetic substitutes for agricultural raw materials. This exerted downward pressure on the prices of commodities such as cotton and natural rubber. However, most of the price evolution in agricultural markets was determined by their own supply, which was affected, in particular, by meteorological conditions. The declining prices of most minerals, ores and metals were also due mainly to larger supplies, as investments of the last decade matured in response to demand, which, although still growing, has lost steam.

Prospects for commodity prices are uncertain. Lower commodity prices caused by oversupply are already leading to some downward adjustments in investment and production capacities, while future demand would appear to hinge on the pace and pattern of recovery in the developed economies and on growth prospects in the larger emerging economies. Still, recent trends are a reminder of the challenges that many commodity-dependent developing countries still face and how crucial it is for them to properly use their resource rents to implement diversification and industrial policies for achieving structural change and sustained growth.

The transition economies have been among the regions most affected by lower commodity prices and capital outflows, and their GDP is expected to decline in 2015. In the Russian Federation and Ukraine, balance-of-payments restrictions were aggravated by political conflicts. Steep currency depreciation and inflation dampened domestic demand and deepened economic recession. This, in turn, affected neighbouring countries for which the Russian Federation is an important market and source of worker remittances. Ukraine is currently grappling with a dangerous combination of declining incomes, a collapsed currency and an unsustainable debt level, with a real possibility of default.

The slowdown in the Latin American and Caribbean region which started in 2011 is likely to continue in 2015. In particular, South America and Mexico have been affected by losses in their terms of trade and by the volatility of capital flows. A harsher external environment and difficulties in pursuing countercyclical policies, including credit expansion, have weakened the capacity to provide supportive policies; some countries

have even adopted contractionary policies. By contrast, most Central American and Caribbean countries are likely to grow at rates well above the regional average. They have benefited from lower oil prices, and have been less vulnerable to speculative capital outflows.

The African region has displayed divergent developments. While armed conflicts are adversely affecting national incomes in countries in Central Africa and others such as Libya, West Africa is likely to continue suffering from the impact of the recent outbreak of Ebola. Growth remains strong in East African countries, whose terms of trade have improved. It is to remain subdued in South Africa, while some large and medium-sized sub-Saharan economies such as Angola and Nigeria are affected by the decline in commodity prices, particularly oil.

Asia has again been the most dynamic region, as in previous years. East, South and South-East Asia are continuing to experience relatively strong growth, estimated for all three subregions at 5.5–6 per cent in 2015. Growth is essentially being driven by domestic demand, with an increasing contribution of consumption, both public and private. Hence, even if investment rates remain very high compared with other regions (and are likely to remain so, particularly given the needs for infrastructure development), most Asian countries, especially China, seem to be rebalancing the structure of demand so as to make it more sustainable in the long run. The bursting of the stock market bubble in China has increased economic uncertainty, as it could affect domestic demand. However, private consumption growth is essentially based on expanding incomes rather than on credit, which is also an important element for growth sustainability. Furthermore, expansionary fiscal and monetary policies seem set to compensate for these negative financial shocks. Meanwhile, lower oil prices have eased current account deficits in several countries, such as India and Pakistan, whose economies are forecast to maintain or slightly improve their growth rates. In West Asia, Turkey also benefited from this development, even though most of the oil-exporting economies in the subregion have faced deteriorated terms of trade. In addition, military conflicts have reduced growth prospects in part of the subregion.

Developing economies' rapid rebound from the global financial crisis seemed to confirm their escape from the gravitational pull of the developed countries and the establishment of their own independent economic orbit. But this decoupling thesis looks less convincing now, as there are some worrying signs that are already making headlines across the developing world: some currencies have depreciated sharply, stock markets are wobbling, and in some cases collapsing, some large emerging economies are in recession, and in a number of countries deficits are widening and debt levels climbing.

This is the difficult environment in which the multilateral financial institutions have to fulfil their mandated tasks: to chart a stable course for the global economy, and to quickly extinguish any financial fires that threaten to fan the flames of a wider financial conflagration. But one thing that has become clear since the global financial crisis is that the international financial architecture lacks the fire-fighting equipment needed to tackle larger blazes. Moreover, the present international monetary system has acquired its own pyromanic tendencies, by promoting policy interventions that have frequently exacerbated recessions, instead of softening them, and by placing all the burden of adjustment too heavily on the debtors and deficit countries.

The liquidity conundrum: Too much and too little

The breakdown of the post-war international monetary system (IMS) in the early 1970s, and the open door policy with respect to large-scale private international capital flows have meant that the provision of global liquidity is no longer limited to “official” sources from accumulated foreign-exchange reserves, swap lines between central banks and from allocations of special drawing rights (SDR) or loan agreements by the International Monetary Fund (IMF). It can be, and has increasingly been, supplemented by “private liquidity” resulting from cross-border operations of financial institutions, such as banks, and non-financial institutions, such as enterprises that provide cross-border credits and/or foreign-currency-denominated loans. This has effectively meant the merging of the international monetary and financial systems.

The surge of privately created global liquidity has lifted one potential constraint on growth, but it has also added to the procyclical and unstable nature of the IMS. Many developing countries have responded by accumulating official liquidity in the form of foreign-exchange reserves as a type of self-insurance. Those reserves serve as an insurance against eventual liquidity shortages arising from a sudden stop or reversal of capital flows. They are also a by-product of intervention in foreign-exchange markets designed to avoid currency appreciation resulting from capital inflows that are unrelated to the financing of imports. This has the added advantage of avoiding the need to resort to IMF assistance in crisis situations, and the policy constraints associated with its lending.

The total holdings of foreign-exchange reserves have grown noticeably since the beginning of the millennium, with developing countries accounting for most of the increase. While some of these reserves have been generated by current account surpluses, others have been borrowed on international capital markets. These holdings have sometimes been judged “excessive” based on conventional measures, such as the levels needed to counter fluctuations in export earnings or to roll over short-term (up to one year) external debt. However, financial openness, desired exchange-rate stability and the size of the domestic banking system are additional considerations in determining what should be the level of reserves. The accumulation of substantial reserves implies a transfer of resources to reserve-currency countries, as those reserves are typically held in the form of “safe” but low-yielding assets from these countries. This is one of the factors that make the IMS highly inequitable.

This combination of inadequacy and unfairness indicates the need for globally more diversified and efficient forms of foreign-currency-denominated liquidity provision, especially in crisis situations, to reduce – and eventually replace – large holdings of foreign-exchange reserves held for precautionary purposes. Ideally, new multilateral arrangements are the best way to correct the system’s weaknesses and biases. Steps towards a more diversified IMS would entail the current dollar standard being replaced by a multi-currency system comprising a range of international currencies, such as the dollar, the euro, the renminbi and possibly other currencies. Scaling up SDR allocations might offer an alternative arrangement.

Either option would help cut the cost of holding borrowed reserves and reduce the current system’s bias in favour of the reserve-currency country. What is more, an SDR-based system would delink the provision of official international liquidity from any national issuer. And the creation of a real alternative to national currencies as reserve assets would allay the concerns of holders of large foreign-exchange reserves about maintaining the purchasing power of their reserves. Also, since SDRs are based on a currency basket, diversification out of dollar-denominated assets would involve much smaller exchange-rate fluctuations than a multi-currency system, thereby minimizing the threat to global financial stability. Several advantages would follow, especially in terms of more elastic liquidity provisioning and more discipline in reserve-currency countries, which would prevent them from abusing the “exorbitant privilege” of issuing a reserve currency to bolster narrow national concerns at the expense of broader global interests.

Possible steps towards the reform of the international monetary system

Effective multilateral arrangements should remain the long-term objective of any comprehensive reform agenda. However, they imply wide-ranging institutional changes, from a new agreement on rules for multilateral exchange-rate management, to the creation of a global central bank and even a new global currency. Even with a less ambitious agenda, their effective functioning would require comprehensive macroeconomic policy coordination. In addition, the IMF’s resources would need to be augmented and its governance reformed to better meet the needs of developing countries, and to strengthen its ability to survey the actions of systemically important countries. Even these changes appear to be out of reach in the immediate future, for a number of economic and political reasons.

This means that despite all its deficiencies, the IMS is likely to maintain the dollar standard for the foreseeable future. The challenge, therefore, is how to reform a system that relies on national currencies,

widespread floating and sizeable private international capital flows so that it is able to secure a reasonable level of global macroeconomic and financial stability. This will require attenuating the role of private international capital flows as a source of international liquidity and ensuring that institutional mechanisms can effectively provide sufficient official international liquidity, thereby reducing the need for the large-scale accumulation of foreign-exchange reserves as self-insurance, and ensuring that surplus countries share the burden of adjustment.

One way the international community has reacted to the challenge is through the wider use of central bank foreign-currency swap arrangements for addressing emergency liquidity problems, and making the United States Federal Reserve the de facto international lender of last resort. This has relied on three main premises: first, central banks can act swiftly; second, they face virtually no limit on their money-creating capacities; and third, swap arrangements with the central bank that issues the currency in which the liquidity shortage occurs does not have any adverse exchange-rate effects. The existing swap arrangements extended by developed-country central banks mainly cater to the needs of developed countries and risk being driven by political expediency or bias. Recently, the People's Bank of China (PBOC) has established currency swap arrangements with a wide range of other central banks, mostly from developing countries.

Difficulties in the design and implementation of the various reform proposals have reinforced the perception that self-insurance in the form of large foreign-exchange holdings is the only tool available to developing countries to foster exchange-rate stability and ensure the predictable and orderly availability of emergency finance. However, maintaining the status quo poses serious risks, particularly where the accumulation of foreign-exchange reserves is the result of borrowing in international credit markets or portfolio capital inflows. A possible solution is to try and achieve current account surpluses. However, this option would not be available to all countries, and to the extent that it requires devaluation, it runs the serious risk of triggering a currency war or threatening debt sustainability. Moreover, the increase in the IMS' contractionary bias associated with widespread attempts to accumulate foreign-exchange reserves would have the effect of further holding back already weak global demand and economic recovery.

A preferred option for developing countries may be to proactively build on a series of regional and interregional initiatives with the aims of fostering regional macroeconomic and financial stability, reducing the need for foreign-exchange accumulation, and strengthening resilience and capabilities to deal with balance-of-payments crises. While regional arrangements have suffered from some institutional shortcomings, the greatest problem is probably their limited size, especially in situations when all their members are subject to external shocks simultaneously. As a way to address the size problem, interregional swap arrangements would be particularly useful. Another possibility might be the creation of a common fund with a periodic increase of paid-in capital, which could be used by a regional clearing union or reserve pool to increase its liquidity provision capabilities by borrowing on its own. This could even be an effective tool for preventing intraregional contagion in the event of external shocks with different intensities or varying time lags. Furthermore, in a heterogeneous international community, strong regional initiatives could combine with global, other regional and national institutions to create a better governance system than an arrangement based solely on global financial institutions. Such a combination of initiatives at various levels could provide, at least partially, an alternative to reserve accumulation, and could help deal with the contractionary bias of the IMS, thereby serving as a stepping stone to more comprehensive reform in the future.

International financial regulation: A work in progress

The crisis confirmed the growing disconnect between the real and financial economies; speculative capital trumped entrepreneurial capital, while household savings were no longer protected. Banks have been singled out – not unfairly – for attention, as their international presence made them too big to fail before the crisis and too big to bail after it hit. Stronger oversight of systemically important financial institutions is needed, together with a greater degree of management of capital accounts. To date, the IMF has been reluctant to take on this task, even though the monitoring of adverse spillovers is now an accepted part of its work.

The international reform agenda, under the guidance of the Financial Stability Board (FSB), has pursued a number of regulatory and supervisory initiatives, including the revised Basel III accords and specific provisions for “globally systemic important banks”. Although portrayed as a great leap forward, these reforms are unlikely to make banks significantly more resilient. While Basel III requires banks to maintain higher capital adequacy ratios compared with Basel II, its risk-weighting methodology allows banks to maintain very high leverage ratios, while discouraging lending to small and medium-sized enterprises (SMEs) and to start-ups and innovators. More regrettably perhaps, prudential regulations still allow the banks’ own evaluations or credit rating agencies’ assessments for calculating their risk-weighted assets and therefore the level of capital they need to cope with unexpected losses.

A particular concern for developing countries that have been voluntarily adopting the Basel rules is that Basel guidelines for credit-risk measurement may increase the capital requirements for financing SMEs and for investments in long-term projects. Moreover, policymakers in developing countries should bear in mind that the Basel framework was not conceived to meet their particular needs; it aims to harmonize national regulations and avoid regulatory arbitrage across countries hosting large and complex, internationally-active financial institutions.

In parallel to the adoption of these regulatory reforms at the international level, several developed countries drafted new national legislation to address systemic risks in their financial systems. The most far-reaching includes provisions to “ring-fence” or separate commercial activities from investment activities so as to insulate – and thus protect – depositors’ assets from risky bank activities and limit the probability of a bank run in case of insolvency. However, even though these initiatives are addressing key weaknesses in the banking system, they have met with strong resistance from the banking industry lobby, which has (with some success) sought to postpone and downgrade their implementation.

Outstanding issues: Shadow banking and credit rating agencies

The focus on traditional banking has meant that inadequate attention has been paid to the risks inherent in an expanding shadow banking sector – an activity which has emerged over several decades of liberalization and deregulation of the financial system. Innovative forms of market intermediation for the provision of credit and a new breed of asset managers (such as hedge funds) and broker-dealers (often in financial conglomerates) have taken leveraging within the financial system to new heights, with dangerous consequences for financial stability. One of the concerns is the quality of the financial products that have been created and traded. Measuring toxicity is difficult, but there is a clear need to do so, and credit rating agencies (CRAs) have proved they are not up to the task. Another concern is that shadow banking may amplify financial cycles by facilitating leveraging when asset prices are buoyant and triggering rapid and deep deleveraging when confidence is lost.

Despite the crisis, shadow banking remains a very large activity and is continuing to grow, including in several developing countries. In these countries, it generally does not involve long, complex, opaque chains of intermediation; however, it can still pose systemic risks, both directly, as its importance in the overall financial system grows, and indirectly through its interlinkages with the regulated banking system. Indeed, the focus of reforms on the regulated financial sector might even be inducing a migration of banking activities towards the shadow banking system.

In a world of mounting debt, CRAs play a pivotal role in the governance of the financial system. A handful of companies (the “Big Three”) which dominate this business have a poor track record. They have been accused of conflicts of interest and of defrauding investors by offering overly favourable evaluations of some financial instruments (often for the benefit of their paying clients), including extremely risky mortgage-related securities. They also strongly influence investors’ perceptions of the creditworthiness of sovereign issuers. The 2008 crisis exposed how ratings are generally based on predisposed views, rather

than on macroeconomic fundamentals, with potentially detrimental impacts on development strategies due to increased and unjustified borrowing costs for a number of governments that have been given lower ratings. The wide use of CRA ratings is now being recognized as a threat to financial stability and a source of systemic risk. Indeed, under FSB guidance, countries are being required to reduce mechanistic reliance on credit rating agencies. However, CRA assessments still have a strong impact on asset allocation and the interest rate the borrower must pay for obtaining financing. Their ratings are extensively used by banks for prudential regulation, as both the Basel II and III frameworks allow banks to determine the risk weights for capital requirements on the basis of CRAs' evaluations. Credit ratings are also used for open market operations conducted by central banks, and provide a guideline for investment funds' strategies.

The challenge of tackling financial instability at the international level also has implications for many developing countries which have a growing commercial presence of foreign-owned banks. Such banks may be systemically important in the host country, even though their activities may represent only a small proportion of their global business. This creates regulatory challenges for host supervisors, especially when there is a lack of home-host country coordination in the supervision of the transnational banks' activities. Also, while these banks can facilitate access to foreign capital, by the same token they can also contribute to swings in capital flows and to the build-up of different types of fragilities, including asset bubbles. This requires particular regulatory responses.

Towards a bolder agenda

Post-crisis regulatory reforms have been more likely to preserve than to transform the financial system. A more ambitious reform agenda is necessary if finance is to become less fragile and better serve the needs of the real economy and of society. Ongoing efforts to strengthen prudential regulation by raising capital and liquidity requirements will not suffice; it will also be necessary to introduce structural reforms that focus both on financial stability and on development and social objectives.

Such reforms should include ring-fencing of financial activities that requires a strict separation of retail and investment banking, including at the international level, and regulation of the activities now performed by the shadow banking system. However, ring-fencing alone will not ensure that the financial system will allocate enough resources to meet broad developmental goals. As risks involved in development finance are beyond the acceptance limits of commercial banks, various measures should be undertaken by the State to help shape a more diversified system, both in terms of institutions and functions.

Rating creditworthiness remains of essential relevance for a healthy financial sector. However, the existing agencies have demonstrated a poor record, particularly when it comes to anticipating serious crises. Following the widespread recognition that concentration of the sector in the three biggest international CRAs has created an uncompetitive environment, substantial changes are needed to curb conflicts of interest, for instance by shifting from an "issuer pays" to a "subscriber pays" business model. But this new model would still require some kind of public sector involvement to avoid free-rider issues. More radical measures include completely eliminating the use of ratings for regulatory purposes, or transforming the CRAs into public institutions, since they provide a public good. Also, banks could pay fees to a public entity that assigns raters for grading securities. Alternatively, banks could revert to what has historically been one of their most important tasks, namely assessing the creditworthiness of their potential borrowers and the economic viability of the projects they intend to finance.

Regulation should no longer discourage the financing of long-term investment or of innovation and SMEs just because they seem more risky from a narrowly prudential point of view. Indeed, with effective regulation such lending would spur growth, and actually improve the overall quality of banks' assets.

The recurrent problem of external debt crises

From Accra to Kiev and from Athens to San Juan, external debt difficulties have been making financial headlines in recent months. External debt is not a problem in itself; indeed, debt instruments are an important element of any financing strategy, and to the extent that they are used to expand production capacities, they contribute to boosting income and export earnings which are required to service that debt. However, where external debt primarily results from large surges in private capital inflows that are mostly unrelated to the financing of trade and investment in the real economy, they can lead to asset bubbles, currency overvaluation, superfluous imports and macroeconomic instability. Under these circumstances, the claims on the debtor can quickly exceed its capacity to generate the required resources to service its debts.

Over the past decade or so, the external debt position of most developing countries improved due to a combination of strong economic growth, a favourable interest rate environment and international debt relief. As a percentage of GNI, the stock of external debt fell markedly from its peak levels in the 1990s, in most regions to below 30 per cent. Similarly, interest payments on this debt amounted to between 1 and 6 per cent of exports in 2013, compared with 15 per cent (on average) in the 1980s and 1990s. The composition of this debt also changed from predominantly syndicated bank lending to bond financing, with the recent first-time entry into international bond markets of some countries, notably from sub-Saharan Africa. Meanwhile, a growing number of emerging developing countries have been able to attract foreign investors to local-currency-denominated debt.

It would, however, be premature to take these trends as a guarantee of future economic robustness. Global debt levels have been rising again since 2011, led by public sector borrowing in some developed economies, but also sharp increases in public sector borrowing in low-income developing countries, as well as predominantly private sector borrowing in some emerging developing economies. Foreign asset managers can quickly unload entire positions in a country's domestic debt and exit the market for reasons which have little to do with fundamentals, causing severe impacts on that country's domestic interest rates and exchange rate. Consequently, a number of DTEs could encounter growing difficulties in servicing their debts over the coming years, as historically low interest rates in the United States are likely to be gradually increased over the next few years, while export opportunities to developed countries remain subdued and commodity prices are stagnating or continuing to fall. The rapid rise of external private debt runs the danger of repeating a pattern seen prior to the Latin American crisis of the 1980s and the Asian crisis of the 1990s, with private liabilities ending up on public sector balance sheets. While these countries' significantly higher levels of foreign-exchange earnings could postpone crises, and smooth their impact if they occur, current high debt levels nonetheless present significant vulnerability to a sudden drying up of foreign borrowing possibilities.

In truth, serious debt problems are likely to reflect irresponsible behaviour by both creditors and borrowers. However, with the advent of rapid financial liberalization and financial openness, key factors causing serious repayment difficulties in developing countries are the changing economic conditions and risk perceptions in developed countries. The experience of the last few decades shows that capital movements can reverse suddenly, sometimes as a result of contagion, and trigger external debt crises. Steep currency depreciations, banking difficulties, corporate bankruptcies and job losses can quickly follow, prompting public sector interventions to contain the crises, such as bailouts, emergency financing and countercyclical measures. It is from this sequence that external debt crises often turn into crises in public finances.

So long as private debt defaults do not affect the wider economy, managing them essentially involves the application of commercial law in the jurisdiction where the debt was issued. However, sovereign external debt poses a different set of challenges. Foremost amongst these is, of course, the fact that the macroeconomic management of sovereign debt has far-reaching social, economic and political impacts on whole populations, particularly through the provision of public goods. In addition, sovereigns are both more and less vulnerable than private debtors. On the one hand, unlike private debtors, sovereigns that are

unable to service their debt cannot seek the protection of bankruptcy laws to restructure or delay payments. On the other hand, creditors cannot easily seize non-commercial public assets in payment for a defaulted sovereign debt. Thus, historically, sovereign debt issues have been addressed through direct negotiations between sovereign debtors and their creditors.

The contemporary system of sovereign debt restructuring is highly fragmented and based on a number of ad hoc arrangements. This system has given rise to numerous inefficiencies. First, sovereign external debt problems tend to be addressed too late with too little. Debtor governments have been reluctant to acknowledge solvency problems for fear of triggering capital outflows, financial distress and economic crisis, while private creditors have an obvious interest in delaying explicit recognition of a solvency crisis, as this is likely to entail haircuts. Procrastination is frequently endorsed by official creditors who provide emergency support to bridge presumed liquidity shortages. These are often used to repay private creditors rather than to support economic recovery. Second, the current system places most of the burden of adjustment on the debtor economies through conditionalities attached to lending, which demand austerity policies and structural reforms with a strong recessionary bias. And finally, with the fast-growing promotion of creditor rights and the rapid rise of bond financing in external debt markets, sovereign debt restructuring has become enormously complex. In addition to the involvement of often thousands of bondholders with diverging interests and multiple jurisdictions, this has also facilitated the emergence of highly speculative funds run by non-cooperative bondholders, including so-called vulture funds. These funds purchase defaulted sovereign bonds at a significant discount with the sole intention of suing governments for repayment at face value plus interest, arrears and litigation costs, resulting in profits of up to 2,000 per cent.

Alternative approaches to sovereign debt restructuring

There is growing recognition that a more efficient, more equitable approach to sovereign debt restructuring is urgently needed. Three mutually supportive approaches are under discussion. The first seeks to strengthen the existing market-based approach to debt restructuring by clarifying and adapting its legal underpinnings. This includes, for example, improvements to so-called collective action clauses (CACs) in bond contracts. These allow a (super-) majority of bondholders to vote in favour of a debt restructuring that then becomes legally binding on all bondholders. Other examples include clarifications of the pari passu (equal treatment of bondholders) provision in debt contracts and contingent payment provisions. The latter make future payments by sovereign debtors contingent on observable economic conditions, for instance through the use of GDP-indexed bonds or contingent-convertible bonds (so-called CoCos). The main advantage of this approach is that it remains voluntary and consensual. However, it does not address potential problems with outstanding debt contracts, often remains limited to particular types of debt (such as bond debt in the case of CACs), and provides little in the way of debt crisis prevention and sovereign debt resolution aimed at fast macroeconomic recovery and return to growth.

A second approach focuses on soft-law principles contained in international public law. Its aim is to develop an internationally accepted solution to sovereign debt restructuring, with a higher degree of coordination – and possibly centralization – than the market-based contractual approach. Such general principles of law usually reflect unwritten rules of behaviour or customary practice that are recognized in most domestic legal systems and should be applicable in the context of existing international law. Core principles currently under discussion include sovereignty, legitimacy, impartiality, transparency, good faith and sustainability.

A principles-based approach can be promoted in a variety of ways. One option focuses on their institutionalization and implementation based on general guidelines agreed at the international level, either at already established forums or through new, independent bodies. Another compatible option is through domestic legislation, such as the United Kingdom Debt Relief (Developing Countries) Act of 2010 or the recent Belgian law “in relation to the fight against the activities of vulture funds”. While such principles largely

build on existing mechanisms of negotiation and restructuring, using these flexibly, their core limitation is their non-binding nature, with no guarantee of the willingness of a critical mass of parties to adhere to them.

This is a problem that can be resolved only through a fully fledged multilateral and statutory approach. The core feature of this third approach to sovereign debt restructuring is that legal decision-making in restructuring cases would be governed by a body of international law agreed in advance as part of an international debt workout mechanism. The core purpose of any sovereign debt restructuring facility or tribunal would be to provide transparent, predictable, fair and effective debt resolution, and its decisions would be binding on all parties as well as universally enforceable.

Advocates of multilateral debt workout mechanisms and procedures have often drawn attention to the asymmetry between strong national bankruptcy laws, as an integral part of a healthy market economy, and the absence of any counterpart to deal with sovereign debt restructuring. Debt workout arrangements should meet two core objectives. First, they should help prevent financial meltdown in countries facing difficulties servicing their external obligations. Such a meltdown often results in a loss of market confidence, currency collapse and drastic interest rate hikes, seriously damaging public and private balance sheets, and leading to large losses in output and employment and a sharp increase in poverty. Second, they should provide mechanisms to facilitate an equitable restructuring of debt that can no longer be serviced according to the original contract. Meeting these goals implies the application of a few simple steps: a temporary standstill on all due payments, whether private or public; an automatic stay on creditor litigation; temporary exchange-rate and capital controls; the provision of debtor-in-possession and interim financing for vital current account transactions; and, eventually, debt restructuring and relief.

Establishing such a statutory solution for debt restructuring has met with considerable resistance. But its core advantage is precisely that, if successfully established, it promotes a set of regulations and practices that embody long-term objectives and principles over and above particular interests. Building momentum on all three fronts would appear to be a constructive approach to forging a consensus on effective debt restructuring.

Restating the case for additional official development assistance

One of the limitations of the current international financial system is its relative inability to provide the desired levels of international finance for development and for long-term investments. As discussed extensively in previous *Trade and Development Reports*, domestic resources (both private and public) will remain the most relevant sources of long-term investment in most developing countries. However, international financing – especially of a longer term nature – can play an important role when domestic finance is limited or is missing altogether in key areas. A basic challenge is that, while international public finance can be unduly influenced by political calculations, private international financial markets tend to underinvest in key projects in developing countries, because these are often associated with lengthy gestation periods, significant externalities and complementarities across interrelated investments, as well as uncertainty about eventual outcomes, or because they lack the information about the special needs of SMEs or start-ups.

The resulting disconnect between private and social rates of return is a long-standing policy challenge at all levels of development, and necessitates greater State involvement to provide the right kind of finance, particularly for development purposes. Most successful big investment pushes have managed to effectively mix public and private initiatives in some way or another, and so in a very basic sense, all development finance is blended. The big issues are who is doing the blending, how and to what end?

Official development assistance (ODA) continues to play a critical role in resource mobilization, particularly for the poorer and more vulnerable developing countries, including through budget support. This form of financing tends to be more stable than other forms of external capital, and while the empirical evidence remains ambiguous, successful projects with large-scale ODA indicate that it can play a catalytic role

in growth and development. However, the trends in ODA are not encouraging: even though it has increased in the past decade, and in absolute terms has reached record levels, it was, on average, just 0.29 per cent of donor GNI in 2014 – well below the desired and committed level of 0.7 per cent of GNI and even lower than in the early 1990s. Moreover, partly as a result of efforts to achieve the Millennium Development Goals, ODA has been focusing increasingly on the social sectors, and only a small and declining share (less than 40 per cent of the total) has been directed towards economic infrastructure development, productive sectors and related services.

Cooperation amongst developing countries is growing. South-South development assistance increased to account for around 10 per cent, or higher (depending on which measurements are used) of total development cooperation in 2011. These flows are also typically more oriented towards infrastructure development and economic activities compared with traditional North-South flows, although they involve a greater degree of tied and bilateral aid.

Overall, however, the scale of current official flows remains well short of what is needed, and even, as should be the case, if donor countries were to meet the ODA target of 0.7 per cent of their GNI, it would still be insufficient to fill infrastructure and other financing gaps. Such challenges are compounded by the need to finance global public goods related to climate change mitigation and adaptation. For instance, between 2010 and 2012, \$35 billion was mobilized for that purpose. This is well below the \$100 billion a year by 2020 pledged under the Copenhagen Accord. Moreover, most of these resources have also been counted as ODA, meaning that they do not clearly consist of “additional” financing.

In this context, the idea of “blended finance” is being mooted as a way for development assistance to be used to leverage private capital. However, discussions appear to ignore the long history of blended finance, and have therefore avoided asking the questions, “by whom, how and for what purposes?” The international community needs to explore further how these processes would work in practice, taking into account the possible pitfalls alongside their advantages. ODA is already a mixture of grants and (subsidized) loans, with a shift towards the latter in recent years. The OECD reports that the amount of “aid” provided as loans doubled from \$9 billion in 2006 to \$18 billion by 2013. An immediate concern is that such aid should not result in risks being transferred from the private to the public sector.

Public-private partnerships

Recently, and in the wake of heightened financialization, the idea of leveraging public resources for long-term financing has been linked specifically to public-private partnerships (PPPs).

The use of PPPs has increased sharply in developing countries over recent decades, and is being strongly promoted in the post-2015 context amid hopes that harnessing the private sector will help multiply millions of dollars into billions and even trillions. However, while PPPs have shown some successes in some countries and activities, the most needy areas and services tend to be neglected, such as in least developed countries or in water services. Moreover, even where PPPs have grown in number, the historical experience in many settings suggests they do not succeed in creating “additional” finance in a real economic sense; indeed, their use still tends to be just an accounting exercise to get project debt off the government budget. Even in countries or regions with a long history of PPPs, governments frequently provide the lion’s share of finance. Particular caution is needed in assessing the long-term fiscal costs to governments, as the scale of obligations and liabilities that governments have incurred through the use of PPPs has often been much greater than anticipated.

Where international investors have been involved as partners in the PPP, contingent liabilities of governments may be related to exchange-rate volatility or macroeconomic shocks; other liabilities can occur because of overoptimistic expectations of consumer demand, or higher-than-expected operating costs

that threaten the survival of a project. Even if a project goes according to plan, the fiscal burden during the entire life span of the project, as opposed to just the construction phase, has prompted some governments to review all PPPs and issue new guidelines. Some governments insist on the use of accrual accounting that makes explicit all contingent and future liabilities, rather than just the short-term exposure during the construction phase. In other cases, unsatisfactory outcomes with PPPs have resulted in some schemes being abandoned early and not revived. More than 180 cities and communities in 35 countries have taken back control of their water services, for example, even in cities that have been internationally renowned for their PPP-based water supply projects.

Blending the new with the old: Sovereign wealth funds and development banks

A major challenge for long-term investment sources relates to productive activities that are potentially profitable but which private investors avoid because of market failures. Such classical market failures may be best addressed by specialized public financial institutions.

One such institution is the sovereign wealth fund (SWF). These special purpose vehicles are owned by national or regional authorities with large amounts of foreign assets to invest rather than hold as international reserves. SWFs are gaining increasing attention, not only because of the immense scale of their combined assets (currently estimated at some \$7 trillion), but also because more than 40 developing and transition economies own almost \$6 trillion of those assets. Fund holdings are highly concentrated, with almost 90 per cent of total developing-country funds being held by just 7 countries, but even in the remaining countries, where asset values are relatively small, the amounts are still sufficiently large to make a development impact. At present, however, only in relatively rare cases are SWFs designated directly to invest in development-oriented activities; most of them make the same portfolio decisions as traditional private investors.

This is not the case for development banks, which are designed specifically to compensate for the short-termism of private capital flows and markets. They have a clear mandate to support development-oriented projects, and for their funding base they can seek low-cost, long-term capital from international markets. Such banks can provide low-income countries with loans for development projects at subsidized interest rates; their concessional lending represents about 30 per cent of their total loan portfolios. They also play an important countercyclical role, providing project finance to fill the gaps left when private lenders withdraw during times of downturn or crisis.

However, despite their important role, without further capital injections, the traditional multilateral and regional development banks can make only a limited contribution towards essential development finance needs, given their small loan capacity. South-South cooperation is helping to fill the gap through subregional development banks that have emerged in the developing world. These can be significant players: in Latin America, for instance, loans approved by the Andean Development Corporation stood at \$12 billion in 2014, roughly the same amount as the total loans of the Inter-American Development Bank. Some of the new developing-country regional banks plan to be active far beyond their region, such as the new Asian Infrastructure Investment Bank established in 2014, which includes developing and developed countries from outside Asia as founding members. Some national banks are similarly showing a willingness to invest at the regional or international level, providing external finance as part of their operations. In 2014, the stock of loans disbursed by the China Development Bank, the Export and Import Bank of China and Brazil's national bank for economic and social development (known by its acronym as BNDES) totalled \$1,762 billion, or more than 5 times the World Bank's total outstanding loans of \$328 billion. Thus the landscape of development banking is changing considerably, both in response to new investment needs and as a reflection of the wider trend of South-South cooperation and global engagement.

In summary, there remains a critical need for government support for long-term development finance, at both the international and domestic levels. This need has not been met, even by the emergence of innovative

mechanisms for harnessing finance or by ODA. In part this relates to the intrinsic characteristics of some of the activities that need to be financed: infrastructure development will always involve large, long-term and lumpy financing needs; SMEs and start-ups will always present more risk than many other borrowers; and markets will never finance positive social externalities that cannot be captured by the profit mechanism. However it also reflects the current state of the global economy, in which, ironically, private investors appear willing to accept very low returns on government bonds rather than assume the risk of investing in private productive enterprises.



Mukhisa Kituyi
Secretary-General of UNCTAD

CURRENT TRENDS AND CHALLENGES IN THE WORLD ECONOMY

A. Recent trends in the world economy

1. Global growth

Following the 2008–2009 financial crisis and the rebound in 2010, the global economy has been growing at an average annual rate of 2.5 per cent. Growth is expected to remain at around the same level in 2015 (table 1.1). This will result from a slight acceleration of growth in developed economies, a moderate deceleration in developing economies and a contraction of gross domestic product (GDP) in transition economies. Therefore, global output growth will remain significantly below the 4 per cent rate posted in the pre-crisis years.

Developed countries are expected to grow at around 1.9 per cent in 2015 compared with 1.6 per cent in 2014. The eurozone and Japan, in particular, are experiencing a moderate acceleration of growth, although from very low rates in 2014. Developing countries as a whole will continue to expand at a rate of more than 4 per cent, mainly owing to the resilience of most countries in the Asian region. However, other regions are experiencing a significant slowdown due to lower commodity prices and capital outflows, which have prompted tighter macroeconomic policies in some countries. The worst hit by all these developments are Latin America, the transition economies

and West Asia, while the African subregions present a more mixed picture.

In developed countries, recent improvements in economic activity reflect a pick-up of domestic demand, owing to greater household consumption and to a less stringent fiscal stance. The increase in household consumption is largely due to lower energy prices and improvements in some labour markets, with lower unemployment rates in countries such as Germany, Japan, the United Kingdom and the United States. Monetary policies remain expansionary, with very low interest rates in all developed regions and “quantitative easing” (QE) programmes in the eurozone and Japan.

In Europe, the QE programme of the European Central Bank (ECB) helped to further reduce yields on sovereign debt, but so far this has had little impact on credit flows to the private sector. Nevertheless, household deleveraging has already eased in recent months, fiscal austerity has been moderated or slightly reversed, and real wages have improved on account of the fall in commodity prices. However, fragilities persist: in many countries higher rates of employment have not been matched by better quality jobs, and some banks are showing signs of weakness, while downside risks have increased with the

Table 1.1

Region/country	WORLD OUTPUT GROWTH, 2007–2015 (Annual percentage change)								
	2007	2008	2009	2010	2011	2012	2013	2014	2015 ^a
World	4.0	1.5	-2.1	4.1	2.8	2.2	2.4	2.5	2.5
Developed countries	2.5	0.1	-3.7	2.6	1.5	1.1	1.3	1.6	1.9
<i>of which:</i>									
Japan	2.2	-1.0	-5.5	4.7	-0.5	1.7	1.6	-0.1	0.9
United States	1.8	-0.3	-2.8	2.5	1.6	2.3	2.2	2.4	2.3
European Union (EU-28)	3.0	0.5	-4.4	2.1	1.8	-0.5	0.1	1.3	1.7
<i>of which:</i>									
Eurozone ^b	3.0	0.5	-4.5	2.0	1.8	-0.8	-0.4	0.8	1.5
France	2.4	0.2	-2.9	2.0	2.1	0.2	0.7	0.2	1.2
Germany	3.3	1.1	-5.6	4.1	3.6	0.4	0.1	1.6	1.5
Italy	1.5	-1.0	-5.5	1.7	0.6	-2.8	-1.7	-0.4	0.7
United Kingdom	2.6	-0.3	-4.3	1.9	1.6	0.7	1.7	3.0	2.3
EU member States after 2004	6.2	3.5	-3.5	2.0	3.1	0.6	1.2	2.6	3.0
South-East Europe and CIS	8.7	5.4	-6.6	4.7	4.6	3.3	2.0	0.9	-2.6
South-East Europe ^c	6.2	5.8	-1.8	1.5	1.7	-0.6	2.4	0.7	1.5
CIS, incl. Georgia	8.9	5.3	-6.8	4.9	4.7	3.5	2.0	0.9	-2.8
<i>of which:</i>									
Russian Federation	8.5	5.2	-7.8	4.5	4.3	3.4	1.3	0.6	-3.5
Developing countries	8.0	5.3	2.6	7.8	5.8	4.7	4.8	4.5	4.1
Africa	6.1	5.5	3.0	5.1	0.9	5.1	3.8	3.4	3.2
North Africa, excl. Sudan	4.8	6.2	2.9	4.1	-6.8	8.9	1.0	1.3	2.0
Sub-Saharan Africa, excl. South Africa	7.4	6.1	5.3	6.7	4.6	4.3	6.0	5.4	4.3
South Africa	5.4	3.2	-1.5	3.0	3.2	2.2	2.2	1.5	1.9
Latin America and the Caribbean	5.6	3.6	-1.6	5.8	4.7	3.2	2.8	1.4	0.8
Caribbean	7.1	2.5	-1.0	2.7	1.9	2.0	2.7	3.0	3.3
Central America, excl. Mexico	7.0	3.9	-0.3	3.7	5.2	5.0	4.3	4.2	3.7
Mexico	3.2	1.4	-4.7	5.2	3.9	4.0	1.4	2.1	2.1
South America	6.6	4.8	-0.2	6.5	5.2	2.8	3.3	0.8	-0.2
<i>of which:</i>									
Brazil	6.0	5.0	-0.2	7.6	3.9	1.8	2.7	0.1	-1.5
Asia	9.2	5.9	4.1	8.8	6.9	5.1	5.6	5.6	5.2
East Asia	11.1	7.0	6.0	9.5	7.6	6.0	6.3	6.3	5.7
<i>of which:</i>									
China	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.4	6.9
South Asia	9.1	5.1	4.8	9.0	5.5	3.0	5.2	6.2	6.7
<i>of which:</i>									
India	10.1	6.2	5.0	11.0	6.2	4.4	6.4	7.1	7.5
South-East Asia	6.7	4.2	1.6	8.1	4.7	5.8	4.9	4.3	3.9
West Asia	5.5	4.6	-1.0	6.7	7.5	4.0	4.1	3.3	2.5
Oceania	4.1	2.1	1.0	3.5	4.4	3.2	2.8	3.3	5.3

Source: UNCTAD secretariat calculations, based on United Nations, Department of Economic and Social Affairs (UN-DESA), *National Accounts Main Aggregates* database, and *World Economic Situation and Prospects (WESP): Update as of mid-2015*; ECLAC, 2015; Organisation for Economic Co-operation and Development (OECD), 2015; International Monetary Fund (IMF), *World Economic Outlook*, April 2015; Economist Intelligence Unit, *EIU CountryData* database; JP Morgan, *Global Data Watch*; and national sources.

Note: Calculations for country aggregates are based on GDP at constant 2005 dollars.

^a Forecasts.

^b Excluding Lithuania.

^c Albania, Bosnia and Herzegovina, Montenegro, Serbia and the former Yugoslav Republic of Macedonia.

uncertainty over the sustainability of debt in Greece. The latter represents the most immediate threat to the sovereign debt yields of Portugal, Spain and other European countries which had recently started to recover from the depths of the crisis (see box 1.1).

In Japan, following the recession in 2014, economic activity is starting to improve, aided by consumer and investment spending. Lower energy prices will have a positive influence on the balance of trade and on consumption expenditure, as will exports to the United States which rose in the first months of 2015. The United States is expected to continue its post-crisis growth trajectory with a 2–2.5 per cent growth rate, which is below previous recoveries but allows steady job creation. Fiscal austerity is easing at the federal and state levels, and residential investment is recovering from a low base. However, with scant evidence of nominal wage increases, there are concerns that households' balance sheets will remain fragile. Even if the expected very gradual increases in the policy interest rate do not represent a significant tightening of monetary conditions, they have already impacted international capital movements and led to a dollar appreciation. This in turn may result in net exports having a negative impact on GDP growth.

Growth in Australia and especially in Canada is slowing down on account of their deteriorating terms of trade and lower investments in the extractive industries. Fiscal austerity policies in Canada have also affected its economic activity, although higher exports to the United States may attenuate their negative impact.

Economic trends in developing economies have followed a different pattern since the crisis. In response to the initial shock in 2008–2009, many of them applied ambitious countercyclical policies, including increased fiscal spending and incomes policy measures that were sustained long enough to encourage a continuing rise of household expenditure and, by extension, private investment. Some of these countries are now scaling back or even reversing their policy stimuli as they face capital outflows or lower export prices. By contrast, for oil importers, the recent improvements in their terms of trade enlarge the room for manoeuvre.

Among those most affected by lower commodity prices and capital outflows have been the transition economies, whose GDP is expected to decline

in 2015. In the Russian Federation and Ukraine, balance-of-payments problems were aggravated by political conflicts. Steep currency depreciation and inflation damped domestic demand and deepened economic recession. This in turn affected neighbouring countries for which the Russian Federation is a major market and source of remittances.

In Latin America and the Caribbean, the economic slowdown which started in 2011 is forecast to continue, with an estimated growth rate of less than 1 per cent in 2015. In particular, South America and Mexico have continued to experience losses in their terms of trade and reversals of portfolio investment inflows since the second half of 2014. Lower export prices have affected tax receipts and have also led to the paralysis of several investment projects, particularly some linked to oil exploitation and mining, and to a fall in gross fixed capital formation. Governments have generally sought to sustain real wages and keep unemployment in check despite the slowdown of economic growth. As a result, private consumption is still the main engine of growth for the region, though its rate of expansion was less dynamic in 2014 and early 2015 (ECLAC, 2015). The more stringent external environment, and in some cases the inability to maintain countercyclical policies and credit expansion resulted in less supportive policies in the first months of 2015, and even austerity measures in the case of Brazil. By contrast, most Central American and Caribbean countries benefited from lower oil prices and were also less vulnerable to speculative capital outflows. The linkages of their manufacturing sector with United States markets, together with the increase in remittances from abroad, should contribute to significant growth of these subregions, which is likely to be well above the regional average.

The picture in the African region is also varied. In the last decade, growth in sub-Saharan countries has been mostly driven by rising private consumption and infrastructure spending, linked in many countries to commodity production, with a positive impact mainly on the construction and service sectors. Recently, however, some large oil-exporting countries such as Angola and Nigeria have announced cuts in public spending, notably capital investment and subsidies. The Nigerian naira has been subject to speculative attacks that led to the adoption of tighter monetary and fiscal policies, which will have a further negative impact on growth prospects. Meanwhile, growth in most East African countries, whose terms

Box 1.1**THE EURO ZONE CRISIS, A CASE OF DÉJÀ VU**

The eurozone crisis resembles earlier balance-of-payments crises in developing countries in terms of the origins and policy responses; but it also reveals some specific and in part unique problems in the design of eurozone rules, institutions and adjustment mechanisms.

The origins of the eurozone crisis do not reflect fiscal mismanagement, but rather lie in macroeconomic imbalances generated by excessive foreign capital inflows into the so-called periphery countries of the eurozone, as was highlighted in *TDR 2011*. Essentially, in the years prior to the 2008 global financial crisis, the recycling through the banking system of the growing surpluses in the eurozone centre to the periphery (and which in part were due to the asymmetric impact on relative prices of traded goods in the core and periphery following the introduction of a common currency), helped finance a massive surge in private sector consumption and housing investment in the latter, at historically low interest rates, but at the expense of growing financial fragilities. However, there were no major policy reactions on either side to stop rising imbalances. As the slowdown in the eurozone persisted after 2010, capital flight forced deficit countries to cut domestic spending to bring it in line with domestic incomes. This resulted in a severe recessionary adjustment and, ultimately, a rise of public sector debt.

The traditional response to balance-of-payments crises is to devalue the currency. But within the eurozone, nominal devaluation is not an option. Therefore, policies in the deficit countries sought an internal devaluation through wage compression and reduced government spending, but without any adjustment on the part of the surplus countries through faster wage increases and a more expansionary fiscal stance. However, such an approach to achieving a real depreciation is likely to involve high economic and social costs and, even if feasible, would take considerable time, especially when the productivity gap with trade partners is high and inflation is very low. Moreover, deflationary policies dampen domestic consumption and investment, adding to unemployment and increasing the debt burden. In addition, declining prices and falling domestic activity reduce tax revenues, forcing governments to seek liquidity from external sources in order to service their debt in the short term.

Lacking the institutional arrangements to provide financial assistance, the eurozone designed a series of bilateral loans in 2010, coupled with IMF assistance to Greece to enable that country to cope with its debt repayments. This saved the original private creditors from incurring major losses, despite their irresponsible lending practices. Bailing in creditors was ruled out as an option until major lenders (or bondholders) had removed substantial portions of their troubled assets from the balance sheet. Those assets were acquired by supranational bodies (such as the Securities Markets Programme established by the ECB in 2010, the coordinated lending by the eurozone countries to Greece and the eurozone rescue programmes for Portugal and Ireland) or by other financial institutions in the countries involved (such as Italian and Spanish banks, which increased their holdings of national government debt). The Spanish and Portuguese governments also borrowed from European funds in order to recapitalize some of their domestic banks, making good the losses caused by bubble-induced lending.

From late 2009, lending to peripheral eurozone countries (Greece, Ireland, Portugal and Spain) was suddenly reversed as “core” eurozone banks sought to reduce their exposure without incurring significant losses (see chart). The first restructuring of Greece’s external debt was only implemented in March 2012, while a voluntary debt buyback was introduced in December of that same year.

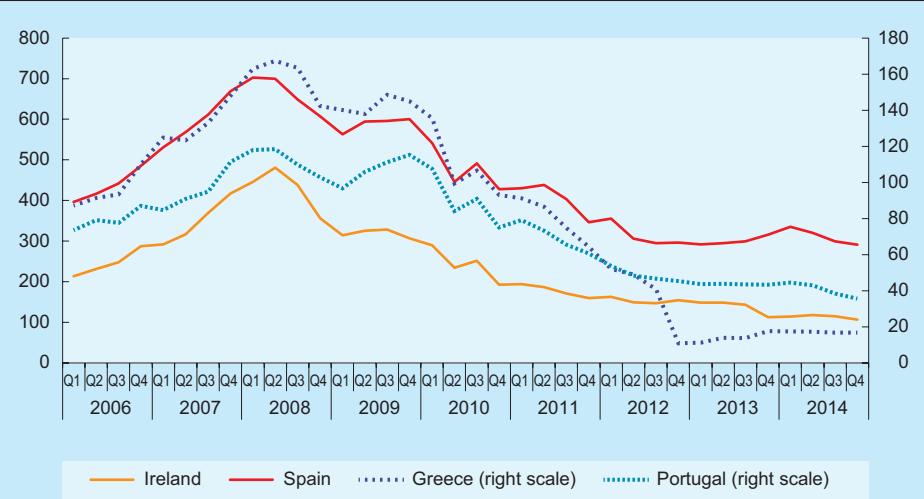
Eventually, the eurozone established a number of funds – initially the European Financial Stability Facility in June 2010, which was later absorbed by the European Stability Mechanism in 2012 – in order to provide financial assistance not only to Greece, but also to Ireland and Portugal. Such assistance was, however, often attached to unrealistic growth predictions and came with excessive policy conditionalities, in some cases with IMF involvement, which neither allowed for a measured recovery nor facilitated a clean-up of the private sector’s balance sheets. Meanwhile, government debt rose in all the periphery countries, with sovereign yields moving upwards until the announcement by the ECB of its Outright Monetary Transaction (OMT) Programme. The immediate effect of OMT in reducing interest spreads on sovereign debt showed that reliance on a lender of last resort is much more effective for creating confidence in financial markets than fiscal austerity.

Subdued growth in the 2010s, caused by a set of restrictive policies similar to those implemented in emerging market economies in the 1980s and 1990s, clearly demands a change in the approach to resolving financial crises triggered by private and public debt denominated in currencies over which

Box 1.1 (concluded)

**EXPOSURE OF “CORE” EUROZONE BANKS TO SELECTED PERIPHERAL
EUROZONE COUNTRIES, 2006 Q1–2014 Q4**

(Billions of dollars)



Source: UNCTAD secretariat calculations, based on BIS, *Consolidated Banking Statistics* database.

Note: Exposure of “core” eurozone banks reflects the consolidated claims of Austrian, Belgian, French, German and Dutch banks vis-à-vis the selected countries on an ultimate risk basis. This indicator excludes “other potential exposures” consisting of derivatives, credit commitments and guarantees extended.

domestic monetary authorities have no control; all the more so as the solvency of foreign creditors may be at risk. A different distribution of the costs of adjustments, shared not only by the domestic sector but also by external creditors through bail-ins, could provide the conditions for a faster and more sustainable recovery. This alternative resolution proposal is not just a matter of counterfactual thinking, but can draw on actual experiences such as that of Iceland.

In response to the dramatic financial crisis in Iceland in 2008, the IMF provided a \$2.1 billion conditional loan aimed partly at stabilizing the domestic currency, supplemented by additional loans from the Nordic countries. Iceland’s central bank, with strong IMF support, introduced “capital flow management” to stop capital flight and boost exporters’ repatriation of foreign exchange. In addition, the Government let its banks collapse rather than be bailed out by taxpayers. In short, it partially nationalized the big banks, and transferred their foreign assets and liabilities to insolvent “old” banks and their domestic assets and liabilities to solvent “new” banks. It also provided a guarantee for deposits in the new banks. Implicitly, it declined to protect depositors in branches of Icelandic banks abroad. The new banks continued to fulfil basic domestic banking functions. In parallel, the Government set up a “Welfare Watch” task force, comprised of representatives from a wide range of stakeholders and operating at arm’s length from the Ministry of Welfare. Separately, it established a debtor’s ombudsman to facilitate household debt restructuring, as a sizeable number of households were in trouble, with their mortgage debt worth much more than the sharply depreciated prices of their houses. Lastly, the Government changed the tax code so as to shift more of the burden on higher income groups and reduce it on lower income groups.

Capital controls in Iceland – which were limited to capital account transactions after the initial crash – coupled with timely bail-ins of foreign creditors were a key component of the recovery strategy. The Government and the IMF considered it more important to prevent a further decline in the value of the currency and to share the costs more equitably between non-resident capital owners and Icelandic taxpayers than to safeguard the liberal commitment to freedom of choice and the property rights of capital. In addition to capital controls and the rejection of bailouts for foreign investors, in order to provide a faster, more sustainable and broad-based recovery, there is an ongoing need for a mix of countercyclical policies that protect the weakest groups of the domestic economy together with measures aiming to solve lingering indebtedness obstacles and to revitalize productive credit (such as differentiating old loans and new loans, which would be payable in full).

of trade have improved, is expected to continue at a relatively fast pace. By contrast, West African countries are likely to continue to suffer from the consequences of the Ebola epidemic. Economic growth is forecast to remain subdued in South Africa due to supply-side constraints in the energy sector, coupled with restrictive fiscal and monetary policies. Added to this, though the widespread fall in commodity prices over the past year will have a mixed impact on the terms of trade of net oil importers, it may also delay investment spending and projects, particularly those relating to the extractive industries and construction sectors. Finally, conflicts and security concerns will have an impact on national incomes in a number of economies throughout the continent.

As in previous years, Asia is the most dynamic region, and is estimated to account for almost half of total global growth in 2015. The projected growth rate for East, South and South-East Asia combined is between 5.5 and 6 per cent in 2015. Growth is being driven essentially by domestic demand, with an increasing contribution of consumption, both public and private. Hence, even though investment rates have been very high in comparison with other regions (and should remain so, given the region's infrastructure needs), most Asian countries (particularly China) seem to be rebalancing the structure of their demand. In the past few years, the contribution of domestic demand to growth has exceeded that of net exports, and the share of consumption (private and public) in GDP has tended to increase. However, the bursting of the stock market bubble in China has created economic uncertainty, as it could affect domestic demand. Nevertheless, the growth of private consumption is essentially based on rising incomes rather than on credit or an appreciation of asset values, which should ensure sustainability. Furthermore, expansionary fiscal and monetary policies seem set to compensate for these negative shocks. Meanwhile, lower oil prices have eased current account deficits in several countries, such as India and Pakistan, and the former economy is forecast to expand by more than 7 per cent. In West Asia, Turkey also benefited from lower oil prices, but most of the oil-exporting economies in the subregion face deteriorating terms of trade. In addition, military conflicts have reduced growth prospects in parts of this subregion.

2. International trade

(a) Goods

Like global economic activity, international trade remains subdued. Between 2012 and 2014, the rate of growth of world merchandise trade (by volume) oscillated between 2 and 2.6 per cent (table 1.2). These growth rates are significantly below the average annual rate of 7.2 per cent recorded during the 2003–2007 pre-crisis period. In 2014, world merchandise trade at current prices grew at even lower rates (only 0.3 per cent, to reach \$19 trillion)¹ due to the significant fall in the prices of major commodities. Preliminary estimates for 2015 indicate that merchandise trade volume could grow at a rate close to that of global output. This remains largely insufficient to provide, by itself, a significant stimulus to economic growth.

Aggregate figures hide some diversity across countries and products. In developed countries, trade – especially imports – accelerated in 2014, albeit from a low base. Positive (although slow) GDP growth rates in the European Union (EU) and Japan helped boost their import volumes by around 2.8 per cent in 2014. But because imports of the EU-28 had contracted during the two previous years, real imports still remained below their level of 2011 at the end of 2014. In the United States, imports rose faster, by 4.7 per cent, partly due to dollar appreciation. All these factors, combined with the fact that import volume growth in developing and transition economies continued to fall short of that achieved in earlier years, made developed countries the country group with the highest annual growth of imports for the first time since the late 1990s.

Data for the first five months of 2015 indicate that growth in world merchandise trade in 2015 may be slightly weaker than in 2014. During these five months, the volume of international trade grew by a year-on-year average of less than 2 per cent (chart 1.1). Among the developed countries, import growth in the EU showed signs of deceleration, while its exports continued to pick up. In addition, bilateral monthly trade receipts indicate that EU exports to the United States kept increasing on account of faster

Table 1.2**EXPORT AND IMPORT VOLUMES OF GOODS, SELECTED REGIONS AND COUNTRIES, 2011–2014**

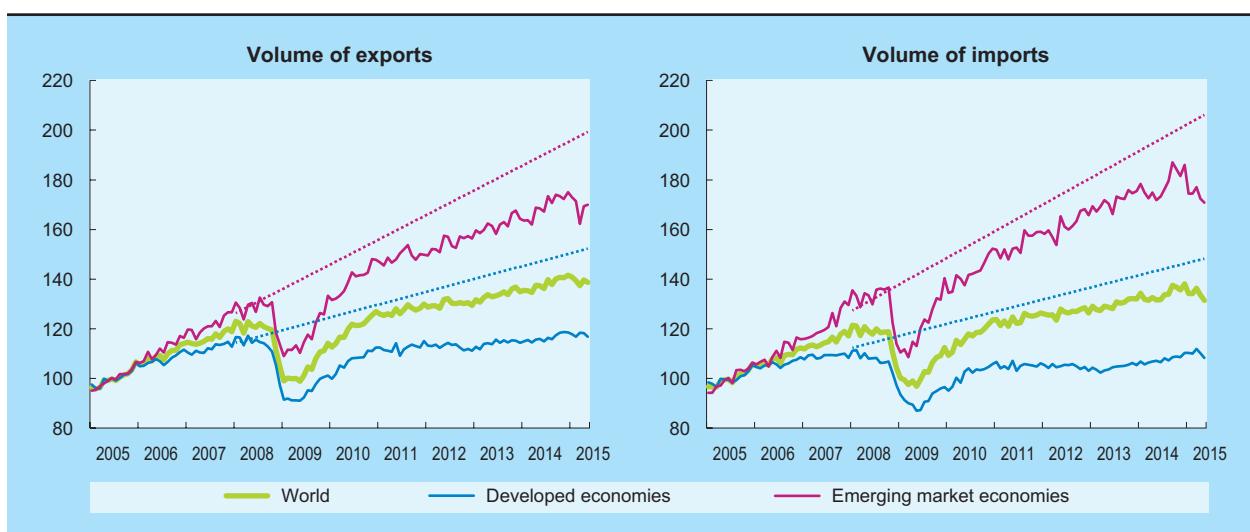
(Annual percentage change)

Region/country	Volume of exports				Volume of imports			
	2011	2012	2013	2014	2011	2012	2013	2014
World	5.1	2.0	2.6	2.3	5.4	2.0	2.3	2.3
Developed countries	4.8	0.6	1.4	2.0	3.3	-0.4	-0.3	3.2
of which:								
Japan	-0.6	-1.0	-1.9	0.6	4.2	3.8	0.5	2.8
United States	7.3	3.9	2.6	3.1	3.8	2.8	0.8	4.7
European Union	5.4	-0.1	1.7	1.5	2.6	-2.5	-0.9	2.8
Transition economies	1.8	0.7	1.8	0.2	15.9	5.6	-0.8	-8.5
of which:								
CIS	1.6	0.8	1.1	0.1	16.8	6.4	-1.4	-9.8
Developing countries	6.2	4.0	4.2	2.9	7.9	5.1	6.1	2.0
Africa	-7.2	5.5	-2.0	-3.6	4.2	13.2	5.2	3.3
Sub-Saharan Africa	0.1	0.2	2.0	-0.9	9.9	8.2	7.5	2.8
Latin America and the Caribbean	4.6	3.2	2.1	2.4	9.7	3.3	4.0	0.6
East Asia	8.7	4.7	6.6	4.7	7.8	3.5	8.3	2.7
of which:								
China	8.8	6.2	7.7	6.8	8.8	3.6	9.9	3.9
South Asia	9.4	-7.0	2.7	4.8	5.4	3.8	-0.6	4.4
of which:								
India	14.9	-1.8	8.5	3.2	9.6	5.9	-0.2	3.2
South-East Asia	7.8	1.4	4.3	3.4	9.5	5.2	3.8	1.0
West Asia	8.3	9.6	3.1	0.3	8.4	9.2	9.6	0.2

Source: UNCTAD secretariat calculations, based on *UNCTADstat*.

Chart 1.1**WORLD TRADE BY VOLUME, JANUARY 2005–MAY 2015**

(Index numbers, 2005 = 100)



Source: UNCTAD secretariat calculations, based on the CPB Netherlands Bureau of Economic Policy Analysis, *World Trade* database.

Note: Emerging market economies are those of the source, excluding Central and Eastern Europe. Line in dashes corresponds to the January 2002–December 2007 trend.

output growth in the latter country and the appreciation of the dollar. Meanwhile, Europe's exports to China showed some resilience. In the United States, imports continue to increase at a faster rate than its exports, which are showing signs of a slight deceleration, while Japan's exports are also recovering. Exports from emerging market economies plunged in early 2015 before rebounding, partly owing to a gradual output recovery in developing Asia.

More generally, the growth of exports by volume in emerging market economies has remained below their pre-crisis trend by a substantial margin, with the shortfall even increasing during the first half of 2015 (chart 1.1). This is partly due to sluggish import demand growth for their goods in developed countries, in spite of the slight acceleration in the latter's growth of imports in 2014. As discussed in some detail in *TDR 2013*, this poses a challenge to the emerging market economies that aim to revert to export-oriented growth policy used before the crisis.

Regarding the transition economies, exports were virtually stagnant in 2014, while import volumes plunged by 8.5 per cent and further contracted in early 2015, mostly on account of economic and financial difficulties in the Russian Federation and Ukraine. In developing countries, most trade figures pointed to a bleaker picture than the previous years. In particular, Africa's real exports showed a contraction as a result of shrinking oil exports in Libya and to a lesser extent in some other major oil-exporting sub-Saharan countries. Notably, Nigeria's oil exports to the United States stopped completely in 2014, as the shale revolution in the latter country reduced its need for oil imports. Nigeria was therefore forced to reorient its exports towards China, India, Japan and the Republic of Korea. Other African oil exporters may follow Nigeria's example.² Meanwhile, South Africa's exports to East, South and South-East Asia – comprising largely primary commodities – fell by 13.4 per cent in 2014. By contrast, export receipts from manufactured products of several African countries registered significant growth – in particular those with close trading connections to Europe, like some North African countries such as Morocco and Tunisia.

In Latin America and the Caribbean, international trade measured in current values practically ground to a halt, largely due to the fall in export unit values. Weaker demand from China and the

slowdown of intraregional trade affected mostly South American countries. In particular, their exports, especially machinery and transport equipment, were strongly affected by a decline of imports by Brazil, the largest regional economy. Indeed, South American exports to Brazil fell by 7.9 per cent in 2014. Plunging prices of two of its key exports, iron ore and soybeans, pushed Brazil's trade balance into negative territory, despite a significant reduction of its imports. This contrasts with Mexico, whose exports to the United States increased significantly. In addition, Mexican auto exports to most regions of the world, in particular Asia, increased markedly, with the exception of exports to Europe, which declined.

In West Asia, oil-exporting economies faced adverse terms of trade, which sharply reduced their export receipts, but also their import demand – despite some of them having large international reserves. Armed conflicts in several countries of the subregion further affected intraregional trade, with spillover effects in some North African countries' exports, including from Egypt. Meanwhile, Turkish export receipts increased by close to 4 per cent in 2014, falling short of the Government's target. This disappointing result was due to political and economic turmoil, which took a heavy toll on Turkey's exports to Iraq and the Russian Federation. Nevertheless, lower oil prices eased current account deficits in Turkey and in other oil-importing economies of the subregion.

In East Asia, the growth rate of trade, by volume, was unusually low for the region, at less than 4 per cent in 2014. To a large extent, this reflects the slowdown of China's international trade. Its exports, by volume, grew by 6.8 per cent in 2014, which was a slower rate than that of its GDP. Meanwhile, the growth of China's imports by volume decelerated even more, to 3.9 per cent. As a result, developing and transition economies which export primary commodities experienced a significant slowdown in demand from China in 2014. By contrast, developing countries' exports to China that are related to manufacturing supply chains, with the finished products ultimately ending up in developed economies, fared better. In 2014, China's exports to the eurozone and the United States saw a rebound from the declining and sometimes negative growth rates that had occurred between 2010 and 2013, but they did not return to their pre-crisis dynamism.

In South-East Asia, export growth by volume also decelerated, to 3.4 per cent in 2014, while import growth slowed even further to 1 per cent; both these rates were lower than the subregional economic growth rate. Indonesia has been consistently running monthly trade surpluses since late 2014 until mid-2015, as its import bill decreased more than its export receipts in the context of significant currency depreciation. South Asian trade departs from the downward trends registered in all other developing-country groups. Within this group, the Islamic Republic of Iran registered a significant rise in its oil export volumes in 2014, although they remained roughly half of what they had been prior to the strengthening of economic sanctions in 2011. Meanwhile, buoyant garment sectors supported exports (mainly to developed economies) from Bangladesh, the most populous of the least developed countries (LDCs), and from post-conflict Sri Lanka. By contrast, India's export growth (by volume) slowed down from 8.5 per cent in 2013 to 3.2 per cent in 2014.

Overall, global trade has displayed little dynamism. The moderate trade growth mainly reflects an improvement in North-North trade, with only limited positive effects on exports from developing to developed countries.

(b) Services

Trade in services maintained its growth, to reach \$4.9 trillion in 2014 – a year-on-year increase of 5.1 per cent (at current prices), which was higher than the growth of merchandise trade. Transport services grew by 2.7 per cent while travel and goods-related services increased by 6 and 2.8 per cent respectively. Transport and tourism represent 55 per cent of services exports from developing countries and 62 per cent from LDCs, compared with only 39 per cent from developed economies.³

International tourism remains the largest component of trade in services, with export earnings totalling \$1.4 trillion in 2014. Tourist arrivals continue to be robust: they increased by 4.3 per cent in 2014 (similar to 2012 and 2013), reaching 1.1 billion arrivals. Receipts earned from international visitors grew 3.7 per cent in real terms (taking into account exchange-rate fluctuations and inflation). Preliminary data confirm this tendency for 2015: during the first

four months of 2015, tourist arrivals grew 4 per cent year-on-year, while international air travel reservations were forecast to expand by about 5 per cent in May–August 2015 (World Tourism Organization (UNWTO), 2015a and 2015b).

At the regional level, the European Union remains the world's most visited region, and also a very dynamic one, as the growth in tourist arrivals accelerated to 4.9 per cent, compared with 3 per cent and 4 per cent in 2012 and 2013 respectively. Growth of tourist arrivals more than doubled in North America to 9.2 per cent in 2014. By contrast, tourist arrivals fell in the transition economies due to the conflict in Ukraine and the slowdown of the Russian economy. All other regions and subregions registered positive growth rates in 2014, although demand weakened in Africa after years of solid growth, affected mainly by the Ebola epidemic.

In 2015, preliminary data by region show positive figures everywhere except in Africa. In particular, tourist activities expanded rapidly in North and South America, the Caribbean and Oceania during the first four months of 2015. They also rebounded by 7 per cent in the transition economies after shrinking last year. By contrast, in Africa limited data currently available for January–April 2015 point to a 6 per cent decline, due to recent health or security concerns in a number of countries (UNWTO, 2015a).

Regarding *international transport services* – the second largest category of commercial services – preliminary estimates indicate that the volume of world seaborne shipments expanded by 3.4 per cent in 2014 – the same rate as in 2013.⁴ Dry cargo shipments, which accounted for over two thirds of total cargo shipments, increased by 5 per cent, mainly on account of the continued rapid expansion of global iron ore volumes. This was partly driven by sustained import demand from China. Containerized trade expanded by 5.6 per cent while tanker trade contracted by 1.6 per cent.

Developing countries continued to be the main source and destination for international seaborne trade: in terms of loading, they accounted for 60 per cent of world tonnage in 2014, a figure that has remained rather flat over the past decade. Their contribution to unloading continued to grow, reaching an estimated 61 per cent of the world total in 2014.

The expanding production of shale oil in the United States and the drop in oil prices since June 2014 have affected shipping and seaborne trade, particularly tanker trade. As mentioned above, the former has altered the destination of African oil, a growing share of which is reorienting from the United States to Asia. In addition, lower oil prices have contributed

to lower fuel and transport costs; for instance, the 380-centistoke bunker prices in Rotterdam fell by 46 per cent (Clarkson Research Services, 2015). Lower fuel costs reduced ship operators' expenditures and the rates paid by shippers, which in turn is expected to stimulate the demand for maritime transport services and increase seaborne cargo.

B. Recent developments in commodity markets

Commodity markets witnessed turbulent times in 2014 and the first half of 2015. Most commodity prices fell significantly during the course of 2014, continuing the downward trend from their peaks of 2011–2012. The most dramatic fall was that of crude oil prices since mid-2014 (chart 1.2), which had widespread influence. All commodity groups, except for tropical beverages,⁵ saw average prices decline in 2014 (table 1.3), with the pace accelerating in comparison with 2013 for those commodity groups whose demand is more closely linked to global economic activity, such as minerals, ores and metals, agricultural raw materials and oil. Nevertheless, on average, in 2014 and up to June 2015 commodity prices have been higher than the average of the 2003–2008 price boom.

The main reason for the recent fall in most commodity prices has been an abundant supply, as the investment response to the price boom of the 2000s has significantly increased production over the past few years. The resulting tendency towards oversupply has been reinforced by weakening demand due to sluggish growth in the world economy more generally, and the recent slowdown in a number of large developing economies in particular. Apart from supply and demand fundamentals, the financialization of commodity markets continued to influence price developments, as financial investors have been reducing their commodity positions in conjunction with the downturn in prices and returns from commodity derivatives. Another important factor in the

commodity price decline has been the strong appreciation of the dollar over the past year.

1. Evolution of main commodity prices

The market for crude oil took the lead in commodity price developments in 2014. After having remained at a relatively stable level since April 2011, with oscillations within a \$100–\$120 band, crude oil prices plummeted in the second half of 2014. For example, the price of Brent crude fell from a monthly average of \$112 in June 2014 to a low of \$48 in January 2015. This decline of 56.7 per cent pushed the price of crude oil to its lowest level since 2009 (*UNCTADstat*).

The plunge in oil prices was mainly caused by greater global production, particularly of shale oil in the United States. In 2014, global oil production increased by 2.3 per cent, while in the United States it grew by 15.9 per cent. Indeed, in the short period between 2011 and 2014, United States oil production increased by 50.6 per cent, reaching levels not achieved since the early 1970s (BP, 2015). This led to significant increases in inventories. Substantially higher oil production in the United States contributed to the relative stability of oil prices between 2011 and mid-2014, as it compensated for production disruptions in other producing countries (*TDR 2014*). When

these disruptions became less of a problem and the oversupply more evident, prices started to fall in mid-2014. However, the price decline accelerated after the November meeting of the Organization of the Petroleum Exporting Countries (OPEC) where it was decided not to change production quotas, a decision upheld at the subsequent meeting of OPEC in June 2015. This has been widely interpreted as an attempt by OPEC to defend its market share and to undercut higher cost producers, such as shale oil, tar sands and deepwater oil producers, so as to drive them out of the market.

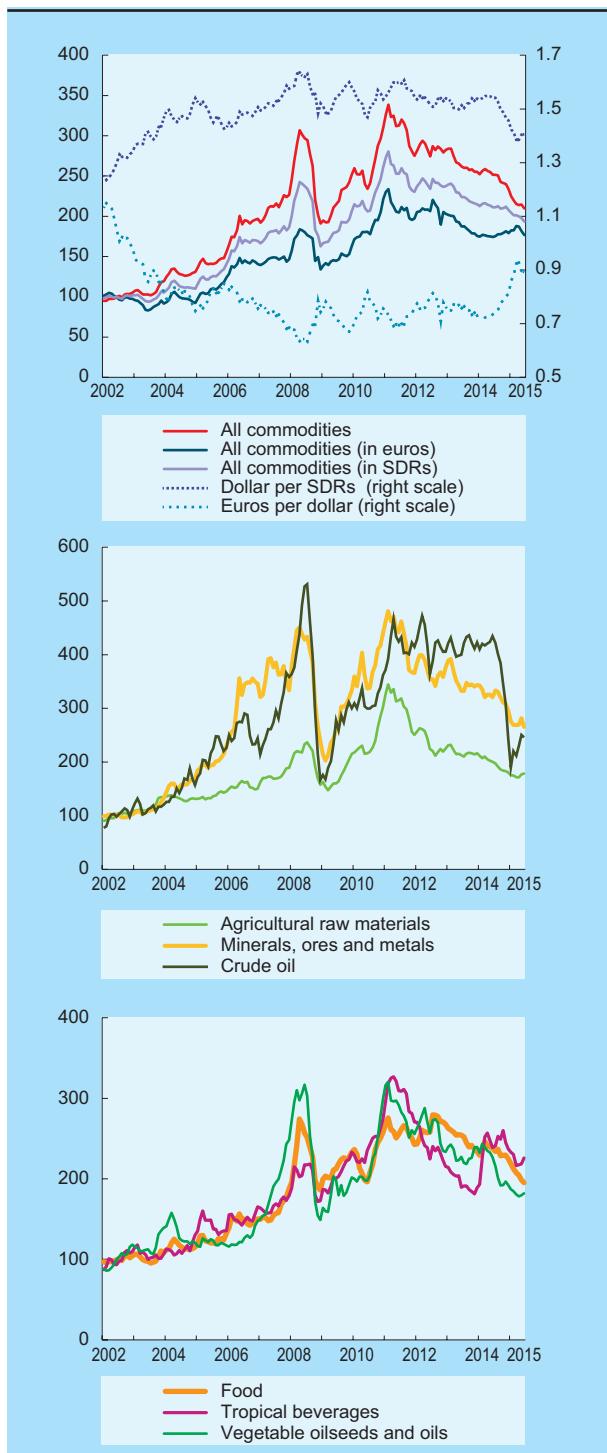
As a result of the lower prices, a number of oil-producing companies announced investment cuts, which should result in a downward supply adjustment (IMF, 2015). In July 2015, the number of oil rigs in the United States had fallen by 60 per cent compared with October 2014, to reach their lowest count in about five years (EIA, 2015). Following expectations that the decline in investment would quickly translate into lower supplies (see below), the price of Brent crude increased from under \$50 in January 2015 and stabilized at around \$65 between end April and end June.⁶ However, it fell again at the end of June and in July. This is partly attributable to the resilience of shale oil producers, who managed to increase productivity and reduce costs.⁷ The United States Energy Information Administration (EIA, 2015) estimates that in the first half of the year crude oil production in the United States increased by 0.3 million barrels per day, up from the average production of the fourth quarter of 2014. Nevertheless, the EIA notes a decline in onshore production since April 2015. The July fall in prices was also related to expectations of an agreement with the Islamic Republic of Iran on its nuclear programme, which was reached on 14 July. The consequent eventual lifting of sanctions will mean an additional source of oil entering international oil markets, which would exert downward pressure on an already oversupplied market. However, the timing of this return of Iranian oil will depend on the time required to rehabilitate that country's oil production and transport facilities. Meanwhile, by June 2015 Saudi Arabia had increased its own crude oil output to record levels.⁸

Overall, international crude oil markets present a new landscape, with the increasing importance of production in the United States and an abandonment of OPEC's price-targeting policy. As long as this persists, the United States could replace Saudi

Chart 1.2

MONTHLY COMMODITY PRICE INDICES BY COMMODITY GROUP, JAN. 2002–JUNE 2015

(Index numbers, 2002 = 100)



Source: UNCTAD secretariat calculations, based on *UNCTADstat*.

Note: All commodities exclude crude oil. Crude oil price is the average of Brent, Dubai and West Texas Intermediate, equally weighted. Index numbers are based on prices in current dollars, unless otherwise specified.

Table 1.3

WORLD PRIMARY COMMODITY PRICES, 2009–2015
(Percentage change over previous year, unless otherwise indicated)

Commodity groups	2009	2010	2011	2012	2013	2014	2015 ^a	2014–2015 versus 2003–2008 ^b
All commodities^c	-16.9	20.4	17.9	-8.3	-6.7	-6.1	-13.1	36.9
All commodities (in SDRs)^c	-14.5	21.7	14.1	-5.5	-6.0	-6.1	-5.9	39.1
All food	-8.5	7.4	17.8	-1.4	-7.4	-4.1	-12.2	51.1
Food and tropical beverages	-5.4	5.6	16.5	-0.4	-6.7	-3.8	-11.7	54.2
Tropical beverages	1.9	17.5	26.8	-21.5	-18.3	23.5	-7.5	60.7
Coffee	-6.9	27.3	42.9	-25.7	-23.6	29.9	-14.8	66.7
Cocoa	11.9	8.5	-4.9	-19.7	2.0	25.6	-2.3	66.3
Tea	16.5	-1.0	11.4	0.8	-23.9	-10.4	28.5	17.3
Food	-6.0	4.4	15.4	2.0	-5.7	-5.9	-12.1	53.6
Sugar	41.8	17.3	22.2	-17.1	-17.9	-3.9	-19.6	54.3
Beef	-1.2	27.5	20.0	2.6	-2.3	22.1	-6.4	92.2
Maize	-24.4	13.2	50.1	2.6	-12.1	-22.2	-14.2	40.1
Wheat	-31.4	3.3	35.1	-0.1	-1.9	-6.1	-18.7	32.6
Rice	-15.8	-11.5	5.9	5.1	-10.6	-17.8	-7.6	20.6
Bananas	0.7	3.7	10.8	0.9	-5.9	0.6	4.8	54.4
Vegetable oilseeds and oils	-28.4	22.7	27.2	-7.6	-12.6	-5.8	-16.0	30.2
Soybeans	-16.6	3.1	20.2	9.4	-7.9	-9.7	-18.2	37.2
Agricultural raw materials	-17.5	38.3	28.1	-23.0	-7.4	-9.9	-11.2	22.8
Hides and skins	-30.0	60.5	14.0	1.4	13.9	16.5	-8.2	58.4
Cotton	-12.2	65.3	47.5	-41.8	1.5	-8.8	-14.5	26.9
Tobacco	18.0	1.8	3.8	-3.9	6.3	9.1	-0.4	65.7
Rubber	-27.0	90.3	32.0	-30.5	-16.7	-30.0	-10.0	6.1
Tropical logs	-20.6	1.8	13.4	-7.1	2.6	0.4	-16.0	21.4
Minerals, ores and metals	-30.3	41.3	14.7	-14.1	-5.1	-8.5	-15.8	19.5
Aluminium	-35.3	30.5	10.4	-15.8	-8.6	1.1	-4.3	-14.0
Phosphate rock	-64.8	1.1	50.3	0.5	-20.3	-25.6	4.3	15.4
Iron ore	-48.7	82.4	15.0	-23.4	5.3	-28.4	-37.4	5.4
Tin	-26.7	50.4	28.0	-19.2	5.7	-1.8	-22.4	94.4
Copper	-26.3	47.0	17.1	-9.9	-7.8	-6.4	-13.5	35.0
Nickel	-30.6	48.9	5.0	-23.4	-14.3	12.3	-18.9	-21.5
Lead	-17.7	25.0	11.8	-14.2	3.9	-2.2	-10.4	45.6
Zinc	-11.7	30.5	1.5	-11.2	-1.9	13.2	-1.1	10.9
Gold	11.6	26.1	27.8	6.4	-15.4	-10.3	-4.8	120.5
Crude oil^d	-36.3	28.0	31.4	1.0	-0.9	-7.5	-41.7	41.1
Memo item:								
Manufactures^e	-5.6	1.9	10.3	-2.2	4.0	-1.8

Source: UNCTAD secretariat calculations, based on *UNCTADstat*; and United Nations Statistics Division (UNSD), *Monthly Bulletin of Statistics*, various issues.

Note: In current dollars unless otherwise specified.

^a Percentage change between the average for the period January to June 2015 and the average for 2014.

^b Percentage change between the 2003–2008 average and the 2014–2015 average.

^c Excluding crude oil. SDRs = special drawing rights.

^d Average of Brent, Dubai and West Texas Intermediate, equally weighted.

^e Unit value of exports of manufactured goods of developed countries.

Arabia as the key swing producer. This would mean that when prices fall to very low levels, investment and production in the United States could be cut, pushing prices up; and once prices reached a certain level, United States oil production could rise, thereby exerting a downward pressure on prices. Indeed, a significant characteristic of shale oil drilling is its flexibility. As a result, there would be an upper cap on oil prices which would depend on the break-even price of profitability for shale oil producers. However, there appears to be little agreement on what that price is.⁹ In sum, it is not likely that prices will approach \$100 per barrel any time soon. As shale oil production has a short life span, this will depend on how long the shale oil boom lasts. However, there is considerable uncertainty as to when shale oil production will reach its peak.

On the demand side, expectations of lower economic growth also played a role in the collapse of oil prices. Indeed, specialized agencies made continuous downward adjustments to their projections for demand growth. In 2014, global oil demand grew by a mere 0.8 per cent, down from an average growth of 1.1 per cent during the previous three years. Non-OECD countries accounted for all the demand growth, at 2.7 per cent, with oil demand in China increasing by 3.3 per cent, but these were lower rates than the averages for the previous three-year period, of 3.3 per cent and 4.8 per cent respectively. By contrast, oil demand in OECD countries declined by 1.2 per cent (BP, 2015).

A decline in crude oil prices has an influence on the price developments of other commodities. It leads to a reduction in production costs, for instance through lower transport costs, or to lower fertilizer prices in the case of agricultural production. There is also a link through the biofuel channel, as depressed oil prices make biofuels less competitive as an energy source and can reduce demand for food crops. However, some other factors can also influence biofuel production, particularly official mandates. Another channel through which oil prices influence other commodity prices is financialization, as oil prices are a large component of commodity price indices (see below). Nevertheless, prices in agricultural markets have been mainly determined by their own supply situation, which is affected in particular by meteorological conditions. In the case of *food commodities*, bumper harvests, thanks to good weather, and ample levels of inventories, were

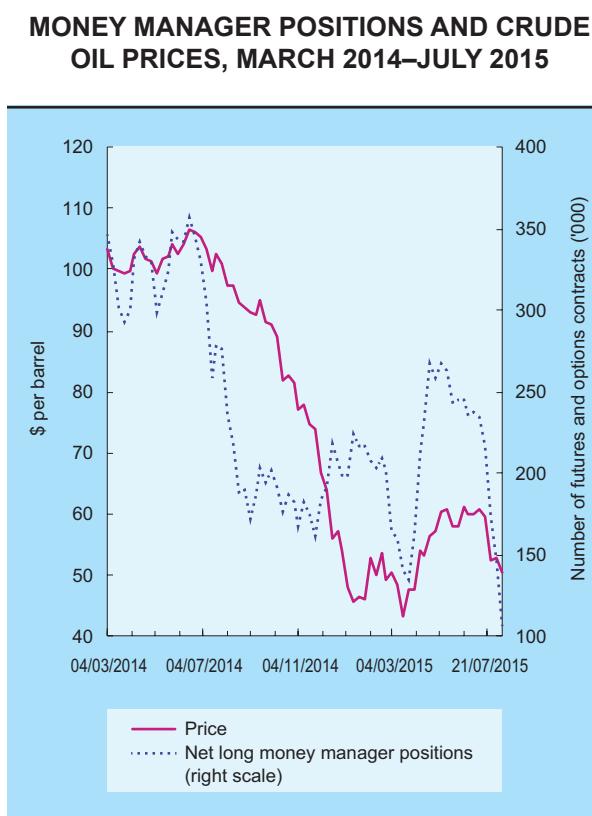
the key factors contributing to the continued fall in cereal and soybean prices in 2014 and early 2015. However, those prices saw a reversal in June and July 2015 due to adverse weather conditions in the United States, which affected planting. Wheat prices also rose in June due to the adverse impacts of the rains on harvesting in the United States and to dry weather in other producing areas in the world. Uncertainties also arose concerning the potential effects of the El Niño phenomenon.¹⁰ The sugar market was also characterized by oversupply and declining prices, as production in 2014 exceeded consumption for the fifth consecutive season (OECD-FAO, 2015).

Price developments in the *tropical beverages* markets in 2014 and early 2015 were more erratic. Prices of coffee and cocoa rose in the first half of 2014 as a result of unfavourable crop conditions for coffee in Brazil and for cocoa in West African countries. They fell later in the year following improvements in those conditions. Cocoa prices increased in the second quarter of 2015 due to a shortfall in Ghana's harvest.

In the *agricultural raw materials* markets, plentiful supply was a major issue. Global cotton production exceeded consumption, and excess stocks pushed prices downwards. Announcements by China that import quotas were to be reduced and the end of its inventory policy also had an influence on prices. Natural rubber prices experienced a substantial decrease of 30 per cent in 2014 resulting from oversupply and high stocks. Weak demand for cotton and natural rubber is also related to the slump in oil prices. This leads to lower prices of synthetic rubber and synthetic fibres, putting downward pressure on the prices of natural rubber and cotton.

Minerals, ores and metals markets also experienced a supply glut. The main example is iron ore, the oversupply of which led to a price reduction of 28.4 per cent in 2014 (table 1.3). Aluminium, nickel and zinc performed relatively better, recording price increases in 2014. For nickel, this was related to the export ban of unprocessed ores in Indonesia; for aluminium and zinc price increases were the result of production cuts. However, these rising prices saw a reversal after mid-2014.¹¹ Sluggish demand stemming from subdued global economic growth has played a role, as metal prices tend to be strongly linked to the evolution of global industrial production. In particular, prospects for growth of demand for metals in China will depend on the balance between

Chart 1.3



Source: UNCTAD secretariat calculations, based on Thomson Reuters datastream.

Note: The data shown refer to WTI and positions on NYMEX.

high investment in infrastructure and urbanization that will still be needed in the coming years, on the one hand, and its transition towards an economy with an expanding share of demand for services, on the other.¹² However, this has generally translated into reduced consumption growth rates rather than declining demand. Moreover, since the current levels of consumption are greater than in the past, lower growth rates may still mean substantial amounts of additional demand for metals. There are also some exceptions; for instance, consumption of copper increased by around 15 per cent in 2014. Since the market for this metal appeared to be balanced, or even in deficit, the sharp price drop in 2014 “looks overdone compared to the fundamentals” (AIECE, 2015). This can most probably be attributed to financial factors (see below). The decline in gold prices is also strongly linked to financial factors and monetary policy: expectations of an increase in interest rates in the United States as well as the appreciation of the dollar tend to reduce demand for gold as a safe haven.

2. The continuing influence of financial factors

Commodity prices continue to be influenced by the close linkages between commodity and financial markets, as further discussed in the annex to this chapter. These linkages may be illustrated by the recent movements in oil prices. Their decline during the second half of 2014 was accompanied by a much more rapid drop in the net long positions of money managers, such as hedge funds, which is likely to have accelerated the fall (chart 1.3). Similarly, the rebound in the price of West Texas Intermediate (WTI) crude oil from a six-year low of \$44 per barrel in March 2015 to \$61 in early May was partly stoked by a substantial increase in the net long positions of money managers who, betting that low oil prices would rapidly reduce supply, doubled their net long positions between mid-March and early May on the New York Mercantile Exchange (NYMEX); this was accompanied by similar movements on the Intercontinental Exchange (ICE). In July, they strongly reduced their positions, having realized that both the cuts in oil supply and the global economic recovery were proving to be less rapid than anticipated, which made prices plunge considerably once again.

The use of commodities as collateral constitutes another linkage between commodity and financial markets. A positive differential between domestic and foreign interest rates provides an incentive to borrow money on international financial markets using letters of credit from domestic banks to import commodities. The acquired physical commodity is placed in a warehouse, while the borrowed money is invested in high-yielding domestic assets such as real estate or financial products (Tang and Zhu, 2015).

Copper has probably been the commodity most frequently used for this type of carry trade, and the resulting increased demand for physical copper has helped boost the price of this metal. Taking the example of China, the world’s leading consumer of copper, Zhang and Balding (2015) find that copper inventory in Shanghai grew from 4 per cent of global stocks in 2009 to 38 per cent in 2014, and that during the same period the interest rate differential between China and the rest of the world averaged 358 basis points. More recently, however, the decline in China’s interest rates led to an unwinding of such copper carry trade.

According to media reports, the resulting decline in copper prices was accelerated by the substantial net short copper positions that hedge funds had built up in parallel with net long equity positions. This was based on expectations that slower growth of the Chinese economy would cause a decline in copper prices, while a subsequent loosening of monetary policy would boost equity market valuations.¹³ But in July 2015, the hedge funds needed to buy back their bearish bets in order to meet rising margin calls from China's equity markets, which experienced a sharp decline.

Furthermore, the strong appreciation of the dollar contributes significantly to falling commodity prices. Typically, as commodity prices are denominated in dollars, they tend to be inversely related to the dollar exchange rate. This factor influences prices both on the physical markets and through the financialization channel. On the one hand, as the dollar appreciates commodities become more expensive in non-dollar areas, putting downward pressure on demand. Similarly, with an appreciating dollar, producers in non-dollar areas who normally receive their revenues in dollars but pay for most of their costs in local currency have an incentive to increase supply. For example, Brazilian farmers have increased their production of coffee and sugar as a result of the depreciation of their currency, the real, against the dollar.¹⁴ On the other hand, a higher value of the dollar may provide more incentives to increase financial investment in dollars in the foreign-exchange market to the detriment of investment in commodity markets. For example, for non-oil commodities, price declines are not so pronounced in special drawing rights (SDRs), and in euros they have even increased in parallel with the appreciation of the dollar (chart 1.2).¹⁵

3. Impact and prospects

The impact of lower commodity prices on different countries varies according to their production and trade structure. Developing countries (and also some developed countries) that are highly dependent on their exports of commodities tend to be the most adversely affected. These include mostly countries in Africa, Latin America, the Commonwealth of Independent States (CIS) and West Asia. Declining commodity prices frequently translate into lower

terms of trade, pressures on the current account balance and the fiscal accounts, and eventually lead to a slowdown of economic growth. Some countries which have well-functioning commodity stabilization funds, such as Chile with copper, or which have healthy levels of foreign-exchange reserves, such as the oil-exporting countries in West Asia, may have more policy space to buffer these impacts better than others.

In any case, the reversal of the upward trend in commodity prices is a new reminder of the challenges faced by developing countries that depend on only a few commodities, as they are exposed to boom and bust cycles resulting from price changes. Therefore, to achieve and maintain sustained growth, it is crucial for them to implement policies that facilitate economic diversification and structural change. On the other hand, as the commodity price decline amounts to a transfer of income from commodity-producing to commodity-importing countries, the countries that benefit the most are many developed countries and some emerging market economies, such as China. To the extent that lower prices for commodity-consuming countries could help global economic recovery, and particularly recovery in developed countries which have been dragging down growth in the past few years, the net global effect could be positive, though unevenly distributed. However, all this remains unclear, and largely depends on the duration of the price downturn.

Prospects for commodity prices are highly uncertain. The reversal of their rising trend, which took place around 2011, has been widely considered to mark the end of the upward phase of the commodity super cycle. If this is indeed the case, then commodity prices¹⁶ could continue to fall for quite some time. However, there is another possibility. Until 2014, most of the price corrections took place by way of increasing supply, while commodity demand was growing at healthy levels. Only in 2014 and early 2015 did demand show some signs of easing, but nevertheless registered positive growth rates for most commodities. This slowdown in demand is related to disappointing economic growth in many commodity-consuming areas. However, the current lower levels of commodity prices are already leading to some downward adjustments of investment and production capacities. This is particularly the case for minerals and metals. For example, worldwide, non-ferrous metals exploration budgets fell by 26 per cent in 2014, after an even sharper reduction in 2013

(SNL Metals & Mining, 2015). This should result in lower production in the medium term.

If growth of the global economy – mainly developed countries – manages to return to reasonable levels, and the lower prices stimulate demand, this could maintain demand growth despite a declining supply outlook. Much will also depend on developments in China. Moreover, other emerging and developing countries may intensify their commodity consumption as they enter more advanced phases in

their development. In this case, it is quite possible that, after a short-term correction, commodity prices could increase again in a few years' time. However, they are unlikely to grow as rapidly as they did in the first decade of the 2000s. This would imply that the level of commodity prices is likely to stay at a higher plateau than at the beginning of the millennium. Moreover, as long as commodity markets remain financialized, price volatility could be higher and price changes more pronounced than warranted by supply and demand fundamentals.

C. Stagnation: Secular or temporary?

The observation that the growth trajectories of many developed countries have remained at substantially lower levels than before the crisis, despite several years of accommodative monetary policy, somewhat improved financial conditions and some relaxation of fiscal consolidation, has created a sense of a “new normal” that now defines the future evolution of incomes in developed countries.

The concern is that the crisis that erupted in 2008 may have had a long-lasting effect on the growth potential of these economies (Oulton and Sebastiá-Barriel, 2013). This could be for a variety of reasons. One is that a financial crisis of this magnitude has necessarily affected the balance sheets of a wide range of economic actors – including private and public agents, financial and non-financial sectors – and it has generated significant spare production capacities. Normally, these negative impacts are eventually overcome, although it may take several years, especially in the absence of appropriate countercyclical policies. However, this time there is a concern that the abnormally prolonged period of low investment and high unemployment will become self-sustaining because of their lasting repercussions in terms of reduced production capacities and productivity. Prolonged unemployment leads to the erosion of skills and specialization among some segments of the workforce; and with insufficient investment, the

diffusion of new technologies largely embodied in plant and equipment may also be affected.

Another impact of the crisis may be more subtle: to the extent that it brought to a sudden end an extraordinary period of credit expansion that had supported asset bubbles and artificially boosted consumption and growth, it may have released a number of underlying factors that tend to hamper growth in the long term. These pre-existing long-term factors, and not the financial crisis per se, would be the true cause of protracted slow growth. And rather than a cyclical downturn, developed economies could be entering into a period of “secular stagnation”.

This has revived the debate on the drivers of economic growth dating back to classical economists such as Adam Smith, David Ricardo, John Stuart Mill and Karl Marx, which received a further twist in “the secular stagnation thesis” presented in the late 1930s by Alvin Hansen. The thesis refers to “sick recoveries which die in their infancy and depressions which feed on themselves and leave a hard and seemingly immovable core of unemployment”. In his original analysis, Hansen stressed the problems of “inadequate private investment outlets” (Hansen, 1939: 4)¹⁷ in the context of declining population growth, the relative ineffectiveness of monetary policy, and technological change that failed to stimulate

substantial capital disbursement. All these factors were eventually reversed in the post-war period, not least because of massive public intervention – including deficit spending – which was a possible solution proposed by Hansen himself. However, the sluggish recovery from the 2008 crisis, in which it is possible to identify traces of those very same elements, has led to a reappearance of “stagnationist” analyses in the public debate.

The modern twist on the “secular stagnation hypothesis” suggests that, since the crisis, the traditional macroeconomic toolkit, and especially monetary policy, has lost much of its effectiveness. With the deleveraging processes after the crisis, and nominal interest rates already close to zero, monetary expansion has not translated into increasing credit to finance private sector expenditures; instead it has been directed to investment in financial assets. High levels of indebtedness that adversely affect investment demand have been identified as an explanation for the sluggish growth rates in developed countries, which would also affect future performance. Koo (2014) emphasizes that the deterioration in the balance sheets of the private sector after the bursting of a debt-financed bubble has constrained the ability to foster productive investment. Lo and Rogoff (2015) blame sluggish growth performance on the contractionary fiscal stance adopted by highly indebted governments who have pursued sustained primary budget surpluses in order to reduce public indebtedness, even though alternative policies have been available. As a further explanation of secular stagnation, Summers (2014a and 2014b) notes the limited space for further monetary easing – given that the zero lower bound rate has already been reached – in particular since its main transmission channel to real activity (affecting asset prices and relative yields of financial products) has had only indirect effects on economic agents’ propensity to invest.

In the academic debate on the secular stagnation hypothesis, agreement has yet to be reached on whether in fact secular stagnation exists, and if so, which are its long-term or structural determinants. Some hold that the deceleration of growth has been due to a combination of supply-side factors. According to them, the size of the labour force has diminished due to developed countries’ shrinking and ageing populations, and a hypothesized reduced speed of technological innovation is holding back productivity growth. Gordon (2012), in particular,

stresses the different kinds of technological innovations which were adopted at a faster speed in the last four decades than previous breakthrough technical advances (such as the steam engine, combustion engine or electricity), with an emphasis on short-lived capital equipment. From a more policy-oriented perspective, Dabla-Norris et al. (2015) have listed policy distortions as factors in developed countries that have hindered productivity growth over the past few decades, particularly in the agricultural and services sectors. The authors argue for the need for structural reform measures to reduce product market rigidities. Also, especially in most severely crisis-hit countries in Europe, some governments have taken measures to increase the flexibility of labour markets and to reduce social benefits, aimed at addressing “supply-side constraints” in order to boost competitiveness, while maintaining contractionary fiscal policies for prolonged periods.

Other observers argue that secular stagnation reflects a decade-long tendency of inadequate aggregate demand growth. They attribute the major cause of secular stagnation to the lack of growth of labour incomes. From this perspective, the decline in the wage share in developed countries by about 10 percentage points since the 1980s has considerably constrained income-based consumer demand with attendant adverse effects on private investment (*TDR 2012*). These adverse demand effects resulting from worsening functional income distribution have been reinforced by widening gaps in the distribution of personal income, as the share in total income of the richest households has strongly increased, and these households tend to spend less and save more of their incomes than other households. These trends have been strengthened by policies that seek to address the demand shortfall essentially through monetary expansion. However, instead of inducing firms to invest in productive activities, such a policy has resulted in firms investing in financial assets, which spurs asset price bubbles and worsens wealth distribution, without addressing income stagnation for the majority of the population.

The related policy debate has been mainly concerned with whether private investment and aggregate demand growth can be best spurred by supply-side-oriented structural reforms or by demand-side-oriented fiscal and incomes policies. The former approach is based on the belief that product and labour markets that are not sufficiently

flexible discourage enterprises from increasing their fixed investments.¹⁸ However, to the extent that secular stagnation results mainly from weak demand, such a policy approach will tend to worsen rather than resolve the problem. An alternative approach gives a prominent role to incomes policy (e.g. minimum wage legislation, reinforcement of collective bargaining institutions and social transfers) and to public expenditure to address weaknesses both on the demand and the supply sides.¹⁹ This is obviously the case for public investment in infrastructure.

Koo (2014) stresses that an expansionary fiscal policy in a context of high private indebtedness need not be detrimental; on the contrary, as also discussed in *TDR 2011*, the positive multiplier effects of government spending in a stagnating or recessionary economy would increase output and tax revenues, and consequently stabilize the ratio of public debt to GDP. This kind of public investment complements private investment and tends to “crowd in” the latter.

Moreover, a progressive incomes policy increases demand, as it strengthens the purchasing power of social segments with a high propensity to consume. This in turn creates outlets for private investment, with multiple benefits: higher wage incomes and improvements in formal employment reduce the financial pressure on pension schemes and allow households to increase their consumption spending without adding to household debt (Palley,

2015). And higher levels of activity and employment are known to foster productivity as well, creating virtuous circles of demand and supply expansion (McCombie et al., 2002). Thus, fiscal expansion and income growth will increase output and at the same time accelerate potential output growth, thereby animating a virtuous feedback relationship that lays the basis for future sustained, non-inflationary growth. International coordination would multiply these invigorating effects while preserving balance-of-payments sustainability (Onaran and Galanis, 2012; *TDR 2013*).

The implications of this debate for developing countries are significant (Mayer, 2015). A protracted period of stagnation in developed countries would weaken demand for exports from developing countries, affecting both output growth and productivity, and eventually generate balance-of-payments problems in these latter countries. Furthermore, the choice of monetary expansion as the main instrument for fostering demand, coupled with prevailing unregulated capital movements, generates volatile financial flows to emerging economies of magnitudes that are well above the latters’ absorptive capacities. Unless developing countries are able to apply macroeconomic and prudential policies to check such financial shocks, they will enter into a sequence of asset price bubbles and debt-fuelled consumption sprees. The subsequent financial collapse and economic retrenchment could eventually lead to secular stagnation worldwide. ■

Notes

- 1 Data from *UNCTADstat* as on July 2015.
- 2 *Financial Times*, “Victim of shale revolution, Nigeria stops exporting oil to US”, 2 October 2014.
- 3 See also *UNCTAD News*, “In 2014, world merchandise exports grew by 0.6%, while trade in services recorded a 4.2% global increase”, 14 April 2015.
- 4 Unless otherwise specified, data on seaborne trade are from UNCTAD, 2015.
- 5 The prices of tropical beverages increased sharply in early 2014, then stabilized up to October 2014 only to fall in the first months of 2015. Therefore, since 2011, prices for this group have experienced an overall downward trend.
- 6 In fact oil prices were quite volatile in the first quarter of 2015. This was most likely related to the uncertainty about how far they could fall.

- 7 Bloomberg, "U.S. oil drillers add rigs for second straight week", 10 July 2015.
- 8 See *Financial Times*, "Iran's return to oil market to weigh on crude prices", 14 July 2015; and *Financial Times*, "Saudi Arabia's crude oil output hits 10.6m b/d record in June", 13 July 2015.
- 9 See, for instance, *Forbes*, "U.S. oil production forecasts continue to increase", 7 May 2015.
- 10 See, for instance, *Financial Times*, "Grain prices rise as tighter supply looms", 30 June 2015; *Financial Times*, "El Niño hits Asian and African cereal production", 9 July 2015.
- 11 This price decline was due to increased production of aluminium and zinc in China and an increased supply of nickel from the Philippines, as well as high inventory levels of nickel (AIECE, 2015).
- 12 China accounts for more than half of world metals demand (World Bank, 2015).
- 13 *Financial Times*, "Chinese fund doubles down on copper short", 12 May 2015; *Financial Times*, "Copper benefits from equity margin calls", 29 June 2015; *Financial Times*, "China's low rates sound death knell for copper carry trade", 3 July 2015; *Financial Times*, "Copper hit by China equity swings", 6 July 2015. It is also noteworthy that going short on copper and long on Chinese equities was one of Goldman Sachs' six top trade ideas for 2014 (see: <http://www.businessinsider.com/goldman-sachs-top-trades-for-2014-2013-12?op=1>).
- 14 See, for instance, *Financial Times*, "Weak Brazilian real drags down coffee and sugar", 30 March 2015.
- 15 A replication of this exercise for different representative commodities, such as oil, copper, wheat or coffee, also confirms that the declines in prices are not so pronounced in SDRs or euros as the dollar appreciates.
- 16 This discussion does not refer to oil, as its prospects in the current production environment have been discussed earlier.
- 17 See Backhouse and Boianovsky (2015) for a review of the origin and development of the secular stagnation thesis.
- 18 On the contrary, it has been found that measures aimed at increasing labour market flexibility actually lower labour productivity (Vergeer and Kleinknecht, 2010; Pessoa and van Reenen, 2013).
- 19 See Mukhisa Kituyi (2015). Statement by the Secretary-General of UNCTAD for the thirty-first meeting of the International Monetary and Financial Committee. 18 April. Available at <https://www.imf.org/external/spring/2015/imfc/index.asp>.

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Annex to chapter I

HAVE COMMODITY MARKETS DE-FINANCIALIZED?

Financialization of commodity markets refers to the observation that commodities have become an asset class for portfolio investors, just like equities and bonds. While the debate on financialization is ongoing, a significant body of analysis suggests that commodity price dynamics have changed substantially since the early 2000s, and that these changes have been associated with a sizeable increase in financial investors' positions on commodity markets, as well as with changes in the composition of these positions (*TDRs 2009 and 2011*; UNCTAD, 2011).

Regarding financial positions on commodity markets, evidence for the period since 2006 shows that total commodity assets under management (AUM) increased dramatically prior to the global financial crisis and during the period 2009–2011. They reached a peak of almost \$450 billion in the first half of 2011 and declined from a level that was still over \$420 billion in January 2013, to about \$270 billion in May 2015. While this is a sizeable drop, the level of AUM is still close to its pre-crisis peak of mid-2008 (chart 1.A.1).

The fall in overall AUM positions between early 2013 and mid-2015 is the combination of two elements. First is the sharp decline in positions of exchange-traded commodity products, such as futures and options contracts held by hedge funds, which slumped by almost 40 per cent between January and June 2013. This is also the period spanning the third round of quantitative easing by the United States Federal Reserve, which was adopted in September 2012, and the announcement in June 2013 that a “tapering” of the Federal Reserve’s quantitative easing policy could begin later that year. The last quarter of 2012 also marks the time when the S&P 500 equity

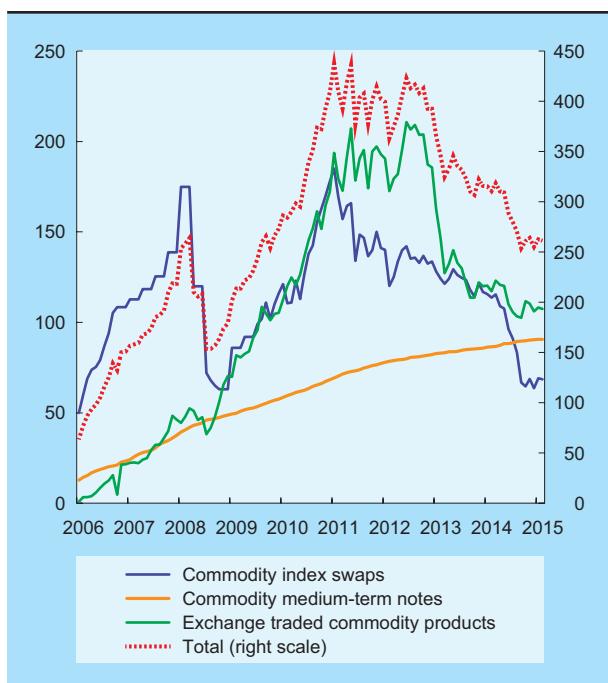
market index started to rally, rising beyond its previous peaks, which may have been supported by a re-composition of financial portfolios away from commodities towards equities. Second, there was an equally sharp decline in passive index investment positions in the second half of 2014, followed by a bottoming out of these positions at a level of roughly \$70 billion during the first half of 2015. Given that energy products have a sizeable weight in most commodity indexes, this movement was associated with that of the oil price and probably reflected continuous growth of oil supplies in the context of tepid global demand growth and the decision by OPEC not to cut output to stem the price decline.¹

It is also noteworthy that since mid-2011, positions in exchange-traded commodity products have almost continuously exceeded those in commodity index swaps, often by a significant margin. This may indicate that commodities are now seen more as opportunistic short-term investments rather than as long-term investments as was likely the case before the onset of the financial crisis in 2008 when index investments accounted for most of AUM. Indeed, the profitability of index investments mainly relies on the absence of a close correlation with that of other financial assets. But it also depends on a trend increase in the spot prices of commodities, such as through rapid growth in countries with sizeable commodity consumption, and/or a situation of backwardation, i.e. a downward sloping futures curve where index investors experience positive roll yields and realize a profit on their positions even when spot prices do not rise (*TDRs 2009 and 2011*).² A rapid rise in commodity spot prices accompanied the strong increase in index investment positions between 2006 and the onset of the crisis in mid-2008. Commodity spot

Chart 1.A.1

COMMODITY ASSETS UNDER MANAGEMENT, APRIL 2006–MAY 2015

(Billions of dollars)



Source: UNCTAD secretariat calculations, based on Barclays Research.

prices also strongly increased between mid-2009 and mid-2011, when economic growth in large developing countries, especially China, continued unabated. Since then, however, developing-country growth has declined, commodities have proved to be strongly correlated with other asset classes (see below), and commodity prices have fallen. This change of fortunes has caused index investors to suffer significant negative roll yields, and probably explains most of the decline in commodity index investments since 2011, and especially the acceleration of this decline during the second half of 2014.³

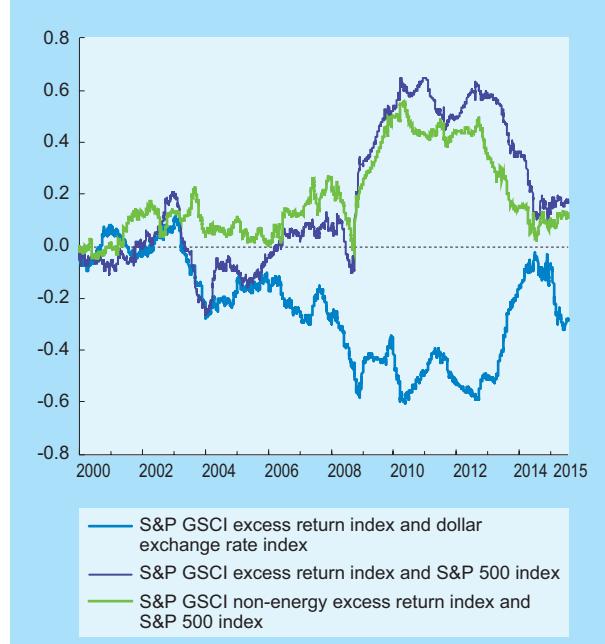
Another factor that is likely to have caused the decline in AUM, and especially that of index investments, is the increased correlation between commodities and other financial assets. These correlations were trending upwards between the early 2000s and 2008, and were particularly pronounced during the period 2008–2013. While the correlation between returns on commodities and other financial assets declined between about mid-2013 and

mid-2014, the correlation with equity markets has stabilized roughly at pre-crisis levels and that with the dollar has gone up again since the beginning of 2015 (see chart 1.A.2). The latter may mainly reflect stabilization of the dollar exchange rate amid fading expectations of an imminent increase in interest rates by the United States Federal Reserve that had driven its appreciation between mid-2014 and early 2015.

The increased correlations between commodities and other financial assets that started in the early 2000s and were accentuated during the period 2008–2013 may be attributed to the change in commodity futures' price dynamics. As discussed in detail in *TDRs 2009* and *2011*, there are mainly two economic mechanisms that underlie the financialization of commodity markets.⁴ First, according to the theory of risk-sharing, financial investors that take long positions on commodity markets provide liquidity, accommodate hedging needs and improve

Chart 1.A.2

CORRELATIONS BETWEEN COMMODITY INDEXES, EQUITY INDEXES AND THE DOLLAR EXCHANGE RATE, 2000–2015



Source: UNCTAD secretariat calculations, based on Thomson Reuters datastream.

Note: The data reflect one-year rolling correlations of returns on the respective indexes on a daily basis.

risk-sharing. However, they base their trading strategies on their own needs, which are determined on the financial markets. This means that they tend to build and unwind positions on commodity markets according to price developments or changes in perceived risk on other asset markets. When they do so, for example when they need cash to honour margin calls on equity markets, they consume liquidity and adversely affect risk-sharing on commodity markets.⁵

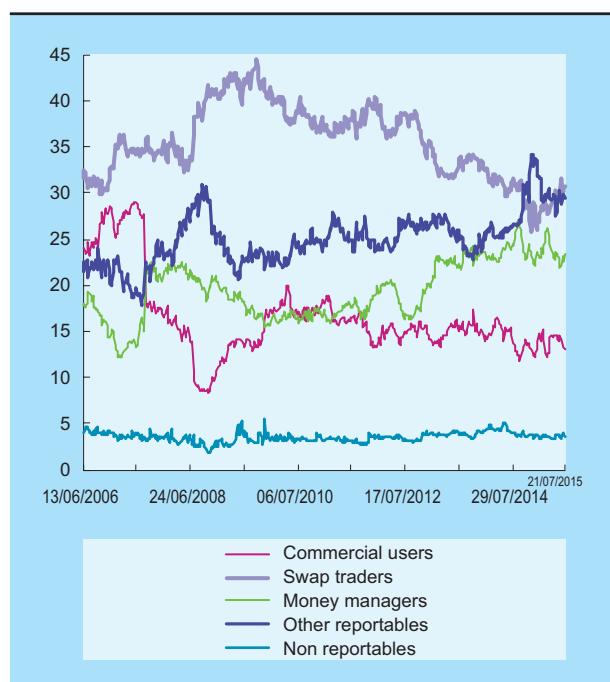
Second, financial investors tend to trade in response to information signals emanating from financial markets, thereby introducing “noise” in commodity trading (i.e. trading unrelated to fundamentals). Such noise trading is reinforced when financial investors’ expectations differ among them, which makes them engage in speculative trading against each other. It is also reinforced when the most profitable activities arise from herd behaviour (i.e. when market participants follow the price trend for some time and disinvest just before the rest of the crowd does), and when acting against the majority, even if justified by accurate information about fundamentals, may result in large losses. Most importantly, market participants interested in physical commodities often act on incomplete information⁶ on global demand and supply shocks, as well as on changes in inventories, which often lack transparency. Therefore, they cannot differentiate between prices that move due to financial investors’ trading or to changes in fundamentals. This causes the “herd” to acquire market power and move prices in the desired direction, which tends to make them overshoot.

The increased correlation between commodity and other financial markets has undermined the view that commodity investment is a suitable portfolio diversification strategy. This view was based on evidence for the period 1959–2004 indicating that commodity investment offered returns similar to those from other asset classes but had a low or negative correlation with returns from equity and bond markets (Gorton and Rouwenhorst, 2004). This finding received considerable media coverage, and is usually considered as having provided the intellectual underpinning for the investment boom in commodity derivatives, and especially of index investment positions for diversification purposes. Following an update of this analysis, it has recently been argued that the diversification characteristics of commodity investments are still present, and that the financialization hypothesis was never valid, mainly

Chart 1.A.3

**THE COMPOSITION OF TOTAL OPEN
INTEREST IN WTI CRUDE OIL ON NYMEX,
BY TRADER CATEGORY, 2006–2015**

(Per cent)



Source: UNCTAD secretariat calculations, based on the United States Commodity Futures Trading Commission (CFTC), *Commitment of Traders Reports*.

Note: The CFTC provides disaggregated data on long and short positions for commercial users, swap dealers, money managers and other reportables, as well as spread positions of the latter three categories. Total open interest is the sum of all these positions and the positions of non-reportables. Following Bhardwaj et al. (2015), the data shown reports each category’s total gross position (long plus short plus twice the spread position) as a share of twice the open interest.

for two reasons (Bhardwaj et al., 2015). First, the authors argue that the composition of open interest on commodities markets has remained relatively stable despite the doubling of that interest between 2004 and 2014. They base this observation on an aggregation of positions in 27 commodities. However, this aggregation may well have introduced a bias. Evidence for oil, which is the most traded commodity and whose price movements are widely acknowledged as having considerable impacts on prices of agricultural commodities (chart 1.A.3), indicates that the share of swap traders (who are usually considered a proxy for index investors) sizeably increased between

mid-2008 and early 2010, after which it embarked on a decline until end 2014, and that the share of money managers (such as hedge funds) has increased since mid-2012. The chart also shows that the share of other reportables spiked when oil prices moved particularly sharply (i.e. in 2008 and between the third quarter of 2014 and the first quarter of 2015), and that the share of commercial users (including producers, merchants and users) sharply dropped in 2007–2008 and, following a rebound, has trended downwards since 2010. Hence, there is little evidence to suggest stable market shares of different categories of market users. What is more, it is difficult to clearly slot market participants into these categories, as individual traders may not always adopt the same trading strategy. In particular, the line between commercial users and financial investors has been increasingly blurred, partly because trading houses have progressively engaged in financial activities (for further discussion, see United Nations, 2013: box II.2). This issue raises more general queries as to how meaningful the evidence cited by Bhardwaj et al. (2015) could actually be, even if it were unbiased.⁷

A second argument against the financialization hypothesis holds that the increase in return correlations between commodities and other asset classes

was merely a temporary phenomenon related to the financial crisis (Bhardwaj et al., 2015). However, as shown above, and also argued in *TDR 2011*, the crisis-related temporarily strong increase in correlations can largely be attributed to successive rounds of monetary easing by the United States Federal Reserve, which accentuated the cross-market correlations and added a second shift to the one that had occurred already in the early 2000s. Accordingly as noted by UNCTAD (*TDR 2011*: 132–133), “a tightening of monetary conditions [in the United States] would merely have eliminated the source of the second shift in the cross-market correlations, but it is unlikely to have eliminated the financialization of commodity markets altogether and brought cross-market correlations back to where they were at the end of the 1990s”.

Taken together, there is no reason to presume that the economic mechanisms that have driven the financialization of commodity markets, and made these markets follow more the logic of financial markets than that of a typical goods market, have disappeared. Nor does the empirical evidence related to financial investment in commodity markets or the development of return correlations across different asset markets suggest that commodity markets have de-financialized. ■

Notes

- 1 The evidence also shows there was a steady increase in commodity medium-term notes (i.e. corporate debt financing instruments collateralized through commodities). This may at least partly reflect increased debt exposure in the energy sector where the debt burden increased from \$1 trillion in 2006 to \$2.5 trillion in 2014 (Domanski et al., 2015). The issuers of these notes generally hedge their liabilities by taking long positions in the futures markets. The finding that the prices of the underlying commodities increase when such notes are issued, and decrease on their termination date (Henderson et al., forthcoming) suggests that these notes are a determinant of commodity price volatility which is unrelated to changes in market fundamentals.
- 2 The hedging pressure theory considers such a situation of backwardation “normal”, because commodity producers need to offer a premium to speculators for them to assume the price risk in hedging operations. This situation is also a key characteristic of the traditional partial segmentation of commodity futures markets from the broader financial markets, due to the fact that commodity consumers are often unwilling to engage in direct hedging operations with individual producers. This is because consumers face risks on multiple commodities, and are not prepared to assume the fixed costs of hedging on multiple commodity markets. However, empirical evidence strongly suggests that commodity markets are not always in backwardation, and hence

capturing phases of backwardation is crucial for the profitability of commodity index investments (Basu and Miffre, 2013).

- 3 For example, the value of the S&P's Total Return Commodity Index in April 2013 stood at only 90 per cent of its value in 2011, before declining to barely 50 per cent by the beginning of 2015; this was followed by a slight rebound during the first half of 2015. The total return on a commodity futures contract is the sum of changes in the spot price, the roll yield and the collateral yield. Given that the level of the latter is a function of interest rates, it is not surprising that periods of quantitative easing are characterized by low yields on total return indices. The excess return indices used in chart 1.A.2 include only the first two types of return, but not the collateral yield.
- 4 A third mechanism emphasizes the theory of storage. It holds that inventory must rise if financial investors drive futures prices upwards, as such price increases give rise to a convenience yield for physical commodity holdings and induce more commodity holdings, which in turn reduce the supply available for immediate consumption and increase spot prices. The convenience yield depends on the costs of warehousing and financing, and is therefore strongly affected by the level of nominal interest rates. As discussed in *TDR 2009*, this view assumes that physical markets are perfectly transparent and

that information on inventory holdings is fully available worldwide, which is generally not the case.

- 5 The direct impact of financial investment on commodity prices related to the theory of risk-sharing has often been examined on the basis of Granger causality tests spanning long time periods. These tests usually find little evidence of a direct impact of financial investment on commodity prices (Sanders and Irwin, 2011). However, this identification strategy assumes that financial-market signals make financial investors act contrary to commodity-market signals and consume liquidity all the time. This is not the case, especially in periods when financial investors' risk-return profiles on other asset markets cause their trading behaviour on commodity markets to add liquidity and improve risk-sharing. As a result, Granger causality tests on specific sub-periods tend to find more evidence of such direct price impacts of financial investors (Mayer, 2012).
- 6 Indeed, the very function of centralized commodity exchanges is to aggregate dispersed information and facilitate price discovery.
- 7 Regarding these authors' argument that index investment is still a valid portfolio diversification strategy, it is worth noting that Bhardwaj is "a researcher at SummerHaven, a \$1.4bn commodity fund manager where Prof. Rouwenhorst is also a partner" (see, *Financial Times*, "Investment: revaluing commodities", 4 June 2015).

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FINANCIALIZATION AND ITS MACROECONOMIC DISCONTENTS

A. Introduction

The growing influence of financial markets and institutions, known as “financialization”, affects how wealth is produced and distributed (UNCTAD, 2011). Consequently, the increasing integration of developing and transition economies (DTEs) into the global financial system, and the acceleration of capital flows into these countries since the turn of the millennium, have fuelled discussion about the links between openness, financial deepening and economic development. Increasing financial integration has the potential to enhance access to external financing for development. However, this chapter argues that there has been only a weak link between the integration of most DTEs into global financial markets and their long-term development. This link has experienced further strains in recent years due to overabundant liquidity generated by central banks in developed countries. While several DTEs have exhibited strong growth and current account surpluses (or lower deficits) over the past decade, accumulating, in aggregate, considerable external reserve assets, their greater openness to increasingly large and volatile international capital flows, especially short-term speculative flows, has exposed them to the risks of financial boom-and-bust cycles.¹ This chapter details the implications of such risks from a macroeconomic perspective.

Financial flows to DTEs in the period since the 2008–2009 crisis reflect a previously established

pattern of macroeconomic drivers that started to emerge in many countries beginning in the 1980s: a long-term deterioration in the global wage share and reduced public sector spending in the developed economies, which have contributed to the dampening of global demand. Global growth has been based mainly on expanding financial liquidity and the generation of credit and asset booms. After the crisis, developed-country policies of quantitative easing, coupled, after a brief expansionary interlude, with fiscal austerity, have largely perpetuated this pattern.² The promise of higher returns on investments in DTEs, and perceptions that they posed lower risks than before, made them an attractive alternative for international investors. However, an increasing proportion of the resulting financial flows into these countries has tended to be short-term or of a more speculative nature, and they are already exhibiting the type of volatility reminiscent of conditions that preceded financial crises in a number of DTEs in the 1980s and 1990s.

This chapter first considers financialization in DTEs at an aggregate level, and highlights the relationship between capital flows and factor income payments, and the resulting pressures on trade balances. The higher aggregate rates of return on DTEs’ liabilities relative to those earned on DTEs’ assets are an insufficiently acknowledged and potentially

problematic aspect of these relationships. Existing patterns point to unsustainable trends for the current account, therefore leading to greater financial fragility. Moreover, in the current context of sluggish recovery from the crisis, which requires strong contributions to global demand, especially by surplus countries, the pressure to mitigate the effect of net factor income losses on the current account is counterproductive for global welfare.

This chapter then discusses the implications of financialization for domestic macroeconomic policy. It argues that excessive financial flows alter prices and influence policy in ways that compromise the potential for sustainable growth and development. With fully open capital accounts, monetary authorities become more exposed to the pressures and expectations of external finance. In particular, large capital inflows generate pressures for exchange-rate appreciation, which is exacerbated by a widespread commitment to maintaining extremely low rates of inflation as a goal in itself. The reach of fiscal policy is similarly limited by a compulsion to maintain a finance-friendly public policy stance, which discourages policy intervention on both the expenditure and revenue sides. The result is a tendency towards a deflationary macroeconomic environment, coupled with structural fragilities in the systems of finance and productive investment. All of this discourages both the growth of robust aggregate demand and the deepening of productive capacity.

The expected repercussions of these fragilities on domestic aggregate demand are then discussed by reviewing the history of several financial crises in terms that link surges in speculative finance with private sector risk-taking and subsequent public sector losses. Those losses are incurred as governments

eventually and universally assume the risks and costs generated by private speculation and production failures. A broader, stylized framework then juxtaposes domestic and external sources of economic growth, emphasizing how past conditions parallel those that prevail today.

The chapter concludes with a discussion of a number of policy responses that developing countries could consider in the light of these fragilities. Such responses would aim at better managing financialization and its macroeconomic effects, as well as strengthening the link between fiscal and monetary policies and development goals. Strong domestic financial regulation needs to be at the core of efforts to harness the benefits of international finance. Instead of relying on narrowly conceived inflation targets and high interest rates to manage capital inflows and the balance of payments, a judicious combination of capital controls and exchange rate management, including by influencing the amount and composition of capital inflows, would help maintain access to productive external finance while also encouraging domestic investment. Proactive fiscal and industrial policies are also essential for generating the structures and circumstances that support domestic productivity growth and the expansion of aggregate demand. Given the extent of financialization and the large size of global capital flows, however, macroeconomic management at the national level must be supplemented by global measures that discourage the proliferation of speculative financial flows. Further support can be provided at the regional level by means of more substantial mechanisms for credit support and shared reserve funds. Policy coordination should also extend to domestic macroeconomic management. And such measures have a greater chance of success if they are implemented regionally and, ultimately, globally.

B. The challenges of global liquidity expansion

1. Liquidity expansions before and after the crisis

Inadequate global demand is a primary problem resulting from the Great Recession that has yet to be resolved. In part, this reflects an ongoing failure to re-link finance to sustainable income generation and spending. In the run-up to the financial crisis of 2008–2009, effective demand in major economies was not supported by a sustained growth of wage income, which is the main factor driving household demand, nor, in most cases, was it supported by rising public sector spending. From the 1990s, fiscal stances were either moderating or being subject to downward adjustments in most of the major economies. The exception was the United States between 2001 and 2004, where extraordinary fiscal injection helped lift the economy after the dot-com crash. In the absence of these two main drivers, GDP growth was based on liquidity creation, initially by monetary authorities and then by private financial institutions (see chapter III). In some of the major economies, this succeeded in boosting demand through asset appreciations and borrowing, leading to consumption booms and private investment bubbles. The counterpart driver in other economies was net export demand. This hazardous configuration of finance and demand was very different from the process of credit creation that sustains production and employment generation.

Likewise, in the recovery from the 2008–2009 crisis, the failure to reverse the long-term deterioration of the wage share, which began in many countries in the 1980s, was compounded by a general shift to fiscal austerity by most developed economies after the brief expansionary episode of 2009–2010. This left recovery almost exclusively dependent on

renewed liquidity expansion. However, there are some important differences between the pre- and post-crisis periods that help explain the recent configuration of growth and financial positions across the global economy.

The first and most obvious difference is the post-crisis rise of public sector deficits in developed economies, an inevitable analogue of the unprecedented balance sheet adjustments of banks, businesses and households. The second difference is that this time liquidity creation has been engineered by central banks, unlike during the pre-crisis period when the main trigger for liquidity creation was excessive leveraging by the private (and shadow) banking sector.³ A third difference, a consequence of the first two, is that liquidity expansion has been channelled through financial sectors as portfolio assets, including in developing countries, and is therefore mostly detached from the real economy.⁴

The latter became apparent in the rise of cross-asset correlations among global equities, commodity markets and currencies in the early 2000s (*TDR 2011*, UNCTAD 2012a). Portfolio allocations between equity and currency markets reflected mostly risk-on/risk-off perceptions, while perceived benefits from diversification drove commodity investment and reduced the link between asset prices and the performance of the underlying real assets, especially between mid-2008 and mid-2013. This contributed to a noticeable rise in volatility across all markets. Since 2013, fundamentals have been more significant in explaining price movements for most primary commodities (see chapter I). In this context, the changing degrees of importance of drivers of price formation in real, financial and foreign-exchange markets have considerably undermined the ability of policies to

influence real economic performance or mitigate external shocks.

As far as DTEs are concerned, their performance, both in the pre- and immediate post-crisis periods, has generally been characterized by a combination of supportive domestic demand and export buoyancy. As a group, they have also enjoyed greater domestic financial stability than developed countries, despite increased liberalization of financial flows and opening up that has allowed a greater presence of foreign banks and investors in their domestic markets. However, global financialization in the absence of sufficient regulation of domestic financial markets has left DTEs more exposed to the consequences of boom-and-bust cycles of capital inflows, as noted in earlier *TDRs* and other studies (Akyüz, 2008 and 2011). Exposure to any shock emanating from external financial cycles could quickly erode the strength of domestic demand in several DTEs, with potential repercussions for the stability of the global economy.

In China, where monetary policy sterilization and reserve accumulation have largely moderated the impact of capital inflows, overindebtedness in sectors linked to the construction boom is becoming a growing concern for policymakers (Chandrasekhar and Ghosh, 2015; Magnus, 2014).⁵ Although a slowdown of investment can be expected, if this coincides with a sharp decline in housing construction and infrastructure building, it could contribute to a reversal of the large short-term and equity capital inflows (as detailed below). In other DTEs, socially more inclusive policies have played a relatively effective role in supporting domestic demand by implementing countercyclical fiscal measures, advancing strategic plans for export diversification away from primary commodities (with limited success), socializing gains from commodity extraction, and moderating the effects of excessive capital inflows via reserve accumulation or different forms of capital controls. Nevertheless, there remains a strong possibility that the scope and impact of such policy measures could be insufficient to counter the considerable size and consequent influence of global financial markets. Indeed, the “taper tantrum” of 2013, which generated substantial shocks to performance and deflationary policy reactions in several developing countries, could prove a (mild) harbinger of possible capital reversals to come (Neely, 2014; UNCTAD, 2014). The landscape may be more challenging in DTEs that

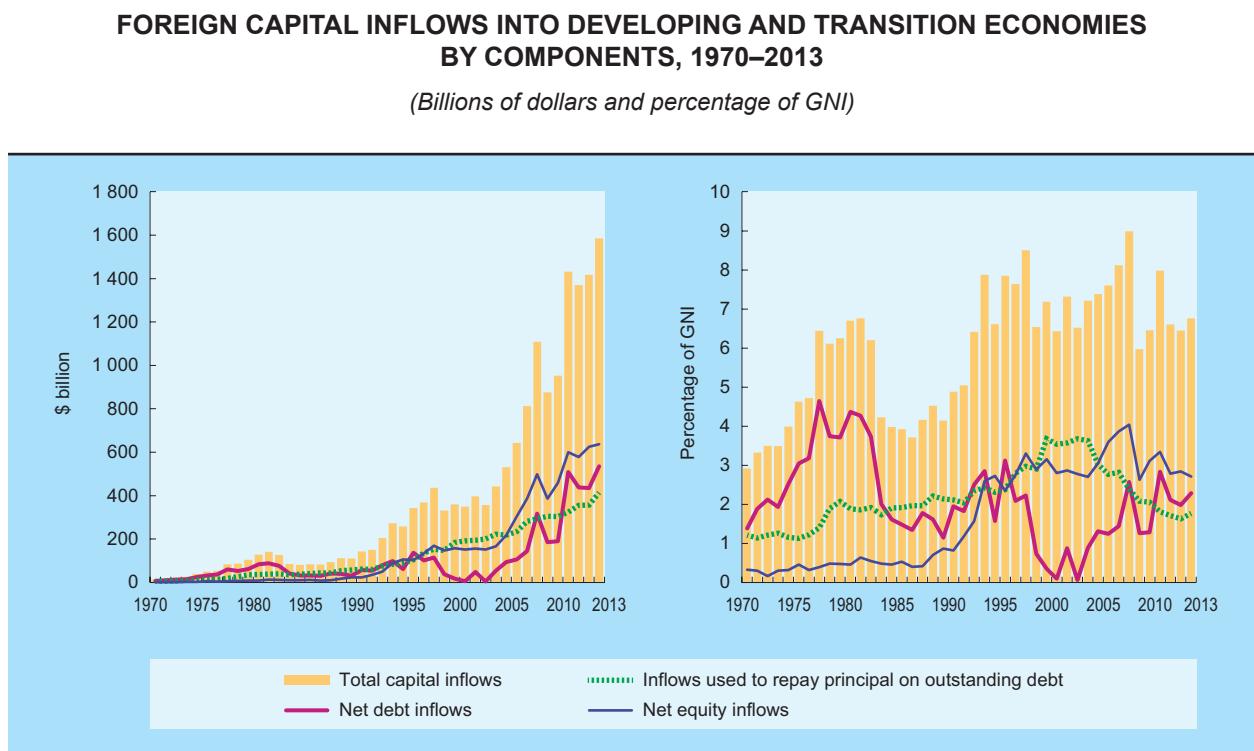
have not implemented any countervailing policies to manage financialization.

2. The rise and aggregate risks of capital inflows to DTEs

Comprehensive records of external flows and stocks for a large number of DTEs confirm that their exposure to external sources of financing has continued to rise (Chandrasekhar, 2007; Gallagher, 2015).⁶ Gross annual debt flows (net flows plus debt repayments) to DTEs reached nearly \$1 trillion in 2013. This is about five times more than in 2002, the last significant trough after the sequence of financial crises in the late 1990s and the dot-com crash in 2001, when gross debt flows to DTEs amounted to \$204 billion. It should be noted that a rising share of gross annual debt flows is on account of debt repayments, which grew proportionally to the volume of accumulated liabilities over time. However, there was also a huge rise in *net* debt flows (i.e. gross inward flows minus repayments), from \$3.5 billion in 2002 to \$535 billion in 2013. Net equity inflows into DTEs, which, according to the World Bank’s *International Debt Statistics 2015*, comprise portfolio equity as well as direct investment, rose more than fourfold during that period, from \$152 billion to \$637 billion (chart 2.1).

These increases of external flows to DTEs do not seem so staggering considering that these economies experienced a period of nearly uninterrupted rapid economic growth after 2003, despite being affected to varying degrees by the global financial crisis. Comparisons of the same flow variables noted above as a per cent of aggregate gross national income (GNI) are captured in chart 2.1. By this measure, there was a considerable rise of gross and net debt flows from 2002 to 2007, resuming again in 2010. Particularly for gross flows, the pattern is similar to the boom cycle of the 1990s, though not as dramatic as that of the 1970s which led to the debt crises of the early 1980s. Net equity inflows as a per cent of GNI experienced fluctuations as well, but from a consistently higher level from the mid-1990s onwards. As a proportion of GNI, both sources of external inflows to DTEs together (debt and equity) increased from 2.8 per cent in 2002 to 5 per cent in 2013, after having reached two historical records of 6.6 per cent in 2007 and 6.2 per cent in 2010.

Chart 2.1



Source: UNCTAD secretariat calculations, based on World Bank, *International Debt Statistics (IDS)* database.

These aggregate patterns are not unique to the larger DTEs, which have relatively more developed financial and capital markets. Lower-income DTEs⁷ may have absorbed a considerably smaller volume of capital flows, but their patterns are similar to those of the group as a whole, showing a clear rise from 2002 to 2013, with peaks in 2007 and 2010. As a proportion of GNI, both sources of external flows to this subgroup of DTEs together (debt and equity) increased from 2.5 per cent in 2002 to 5.1 per cent in 2013, after having reached a historical record of 7.7 per cent in 2007.

Relative to earlier periods, from 2003 onwards most DTEs experienced strong growth and current account surpluses or lower deficits, suggesting that financing needs for development may not have been the main driver of the boom in capital inflows.⁸ Rather, “push” factors like monetary conditions and risk perceptions of developed-country investors, in tandem with stock market appreciations in DTEs, may have been the dominant drivers (see *TDR 2013*, chap. III for a detailed econometric exercise). Not unrelated is the fact that DTEs as a whole, particularly

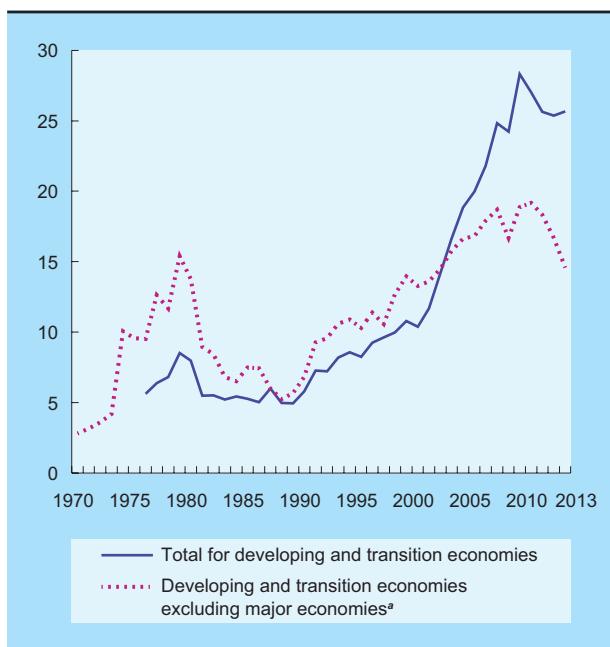
the larger economies of this group, accumulated considerable amounts of external reserve assets during this period (chart 2.2).⁹ Under these circumstances, reserve accumulation primarily reflects an excess of inflows over the amounts that would normally be consistent with domestic spending and investment patterns. By 2013, over 40 per cent of the reserves held by DTEs were “borrowed”, in the sense of not deriving from a current account surplus, but rather set aside from capital inflows (Akyüz, 2014: 11). While policy makers often see reserve accumulation as a precautionary measure, there are limits to this strategy. Given the levels of inflows and reserve accumulation, an important question is whether these patterns are consistent with financial stability and sustained global demand.

When considering the balance of payments, the focus is often on trade deficits and surpluses, on the assumption that net factor incomes¹⁰ will simply reflect a neutral pattern of capital flows. But the determination and implications of the factor income balance involve a few complexities. First, factor incomes depend on the volume of assets and

Chart 2.2

FOREIGN RESERVE STOCKS IN DEVELOPING AND TRANSITION ECONOMIES, 1970–2013

(Percentage of GNI)



Source: UNCTAD secretariat calculations, based on World Bank, *IDS* database.

- a The major economies excluded are Argentina, Brazil, China, India, Mexico, South Africa and Turkey. Also excluded are Algeria, Egypt, Libya, Morocco and Tunisia. The Russian Federation is not in the IDS sample.

liabilities, as well as on their rates of return. In turn, assets and liabilities are accumulated from the outward and inward flows respectively. Second, a current account surplus, by definition, equals a *net* outflow of funds on the “capital and financial account” (hereafter referred to as the “capital account”).¹¹ Conversely, a current account deficit will equal *net* inflows of capital. But this does not mean that an economy will receive precisely the amount of gross inflows that match the current account deficit, or have gross outflows that exactly equal the current account surplus. Rather, inflows and outflows are partly the autonomous result of investors’ perceptions, leading to mismatches between finance and the real economy. As noted above, capital inflows in excess of those required to finance a current account deficit end up as residents’ private capital outflows or reserve accumulation by a central bank. Likewise, surplus countries which, in addition to their earned foreign

exchange from trade, receive large amounts of private inflows end up accumulating “borrowed” reserves.

Taking into consideration that rates of return paid to foreign investors are usually greater than those obtained by private residents or central banks of developing countries, the end result is that the balance of factor incomes often may have a tendency to worsen the current account.¹² For example, rising net (positive) investment positions of surplus DTEs could eventually coexist with declining net factor incomes. These disadvantages are magnified for DTEs with prolonged current account deficits, where the accumulated reserves are mostly “borrowed”. Thus, with worsening net factor income imbalances and trade deficits, these DTEs will face growing net liability positions. If deficit DTEs do not succeed in improving their trade performance, they must depend on capital inflows to fulfil their external obligations. By implication, these are extremely fragile “Ponzi finance” schemes, where current liabilities can only be met by greater borrowing, and any small change in circumstances or sentiment, internal or external, can destabilize both the financial system and macro-economic conditions (Minsky, 2008).

DTEs generally aim at improving trade performance for a variety of reasons related to growth, and technical progress, among others. But the prospects of ever larger net factor payment outflows due to the accumulation of inherited liabilities and unequal rates of return may intensify the search for economic strategies to increase net exports, including by reducing imports.¹³

In sum, the empirical evidence reveals that financialization is associated with a continuing rise of global capital flows to DTEs.¹⁴ Furthermore, DTEs face uneven rates of return on their assets relative to their liabilities. From a global perspective, these patterns combined may be problematic in ways that have not been sufficiently acknowledged. First, economies may find themselves in a situation where a deterioration in their factor incomes account leads to increasing liabilities on Ponzi-finance-type terms. Second, in the current circumstances of sluggish recovery from the crisis, when efforts need to be made to boost global demand, especially by surplus countries, the aim of achieving trade surpluses in order to mitigate net factor income losses creates a contractionary bias.

3. Greater financial integration and increasingly unstable capital flows

Mainstream views on financial integration stress that it will be beneficial for both investors and recipient countries, provided that it takes place within a “sound” macroeconomic framework. Recommended policies for DTEs include reducing government intervention (creating a correspondingly bigger role for financial institutions such as private banks and pension funds) and increasing competition and structural reforms in product and labour markets (Caruana, 2011; Milken Institute, 2014a; OECD, 2011).

By contrast, the analysis here adopts a broader and more critical approach to financialization by emphasizing how both push and pull factors have influenced the re-emergence of risks for DTEs since the financial crisis. These greater risks stem from external as well as domestic conditions. External conditions include excessive global liquidity, driven most recently by quantitative easing in developed countries that was insufficiently matched by an expansion of demand because of fiscal austerity.¹⁵ Within DTEs, risks have tended to stem from macro-financial policies that disregard the importance of domestic financial regulation and underestimate the potentially deleterious effects of speculative bubbles. Therefore this section stresses the composition of portfolio flows as a guide to an assessment of potential risks.¹⁶

During the course of the past 10 years, the weight of private, non-guaranteed, short-term speculative flows has increased significantly in the external portfolios of many of the larger DTEs (chart 2.3) as well as for all the DTEs taken together, excluding the countries illustrated individually.¹⁷ Chart 2.3 traces patterns of more speculative capital inflows relative to total inflows as a share of GNI; the difference includes mostly long-term or publicly-guaranteed loans to public sector institutions and foreign direct investment (FDI). Admittedly, there are significant differences in terms of initial conditions, behaviour and other factors among such a varied group of countries. Chandrasekhar (2015), for example, stresses the influence of previous and recent financial crises on the direction of countries’ policy responses. A case in point is Indonesia, where re-regulation and capital controls in the aftermath of the 1997–1998 Asian financial crisis help explain why capital inflows did

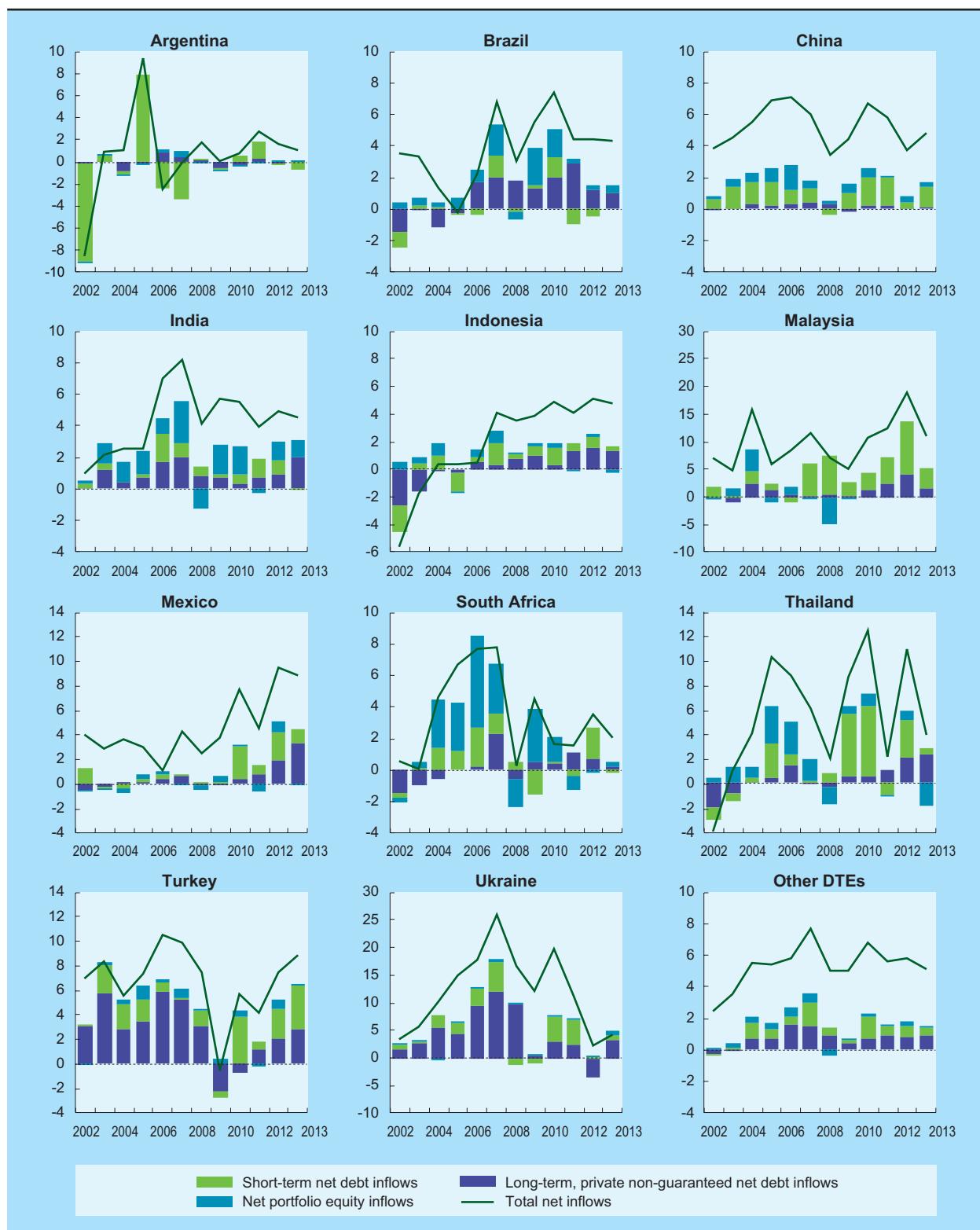
not recover until well into the mid-2000s. Another case is that of Argentina, where the amount of net capital flows remained moderate after the 2001–2002 crisis.¹⁸ Other authors, such as Gallagher (2015), propose a mapping of cross-border financial regulations in the wake of the 2008–2009 financial crisis, highlighting the cases of Brazil, Peru, the Republic of Korea and Thailand, which implemented second- and third-generation measures, price-based controls and foreign-exchange regulations respectively.

Observations on diversity notwithstanding, the set of countries presented in chart 2.3 shows a considerably large proportion of typically unstable or unreliable flows in the total, strongly driving upswings and downswings, which, in some cases, have been dramatic. Within periods of one or two years, in almost all of these economies the size of net inflows has varied by more than 5 per cent of GNI in either direction, apparently driven by fluctuations in the combination of private, non-publicly-guaranteed debt, short-term debt and portfolio equity (i.e. unstable) flows. In some countries such as South Africa and Turkey (as well as Ukraine until the crisis of 2013), such unstable flows represent almost the totality of inflows, which, combined, can add up to fairly significant proportions of more than 6 per cent of GNI. These flows are even larger for other countries such as India, Malaysia and Thailand. Among the selected sample, only China, Indonesia and Mexico reflect situations where most of the inflows may not be of a short-term or unstable nature. This can be explained, at least partly, by the greater role of regulation in the two former countries.

These patterns represent increasing vulnerabilities for DTEs, not only because of their size relative to GNI, but in particular because of the fact that some markets, such as stock markets, foreign-exchange markets and in some cases even real estate markets, operate in spheres relatively beyond the reach of public policy. These markets are typically unstable and highly correlated with one another, which exacerbates the potential for destabilizing co-movements. And while it may be difficult to measure the size of foreign-exchange markets from the perspective of a single economy, domestic capitalization measures of stock markets are telling: for this sample of DTEs presented in chart 2.3, domestic capitalization is generally considerable, in some cases greater than 100 per cent of GDP (Akyüz, 2014; Milken Institute, 2014b).

Chart 2.3
COMPOSITION OF CAPITAL FLOWS, SELECTED DEVELOPING AND TRANSITION ECONOMIES, 2002–2013

(Percentage of GNI)



Source: UNCTAD secretariat calculations, based on World Bank, *IDS* database.

In many countries and in the DTE subgroup, the gap between the total and the combination of unstable flows includes FDI and non-portfolio equity inflows (chart 2.3). FDI in productive activities, especially in industrial sectors that underpin development, can positively contribute to development.¹⁹ This is particularly the case when FDI in the form of greenfield investments is appropriately absorbed at the national level. However, FDI data in aggregate should be interpreted with caution. For example, the classification of FDI typically refers to the size of the ownership stake (10 per cent or more, according to the IMF), and not to the liquidity of the investment. Indeed, financial innovation and the deepening of financial markets can make large ownership stakes more apparent without significant changes in the liquidity of investments. Another example is the fact that real estate, a highly liquid and volatile sector, attracted the most greenfield FDI in 2014, and of the top 20 recipients, all but 4 were developing countries.²⁰

Furthermore, the potential magnitude of factor income payments related to FDI needs to be considered. In 2014, the value of global FDI income exceeded that of all FDI inflows.²¹ Economies that are major recipients of FDI may experience the sorts of balance-of-payments instabilities discussed above, since maintaining a sustainable growth path requires generating sufficient foreign exchange to cover external payments, particularly in the context of large profit outflows (*TDR 1999*). If FDI inflows were to slow down, the problem of covering even a modest repatriation of profits could quickly become

acute, especially when a large proportion of FDI inflows consists of reinvested earnings and may behave more like portfolio flows than long-term flows (Kregel, 2014b).²²

This picture of unstable capital flows echoes the experience of many developing countries in the late 1980s and the 1990s (as discussed below). Although the combined share of private, short-term and equity capital flows as a percentage of GNI is now larger than it was in those two decades, at the time, many developing countries started to rely on such forms of financing, since debt markets remained virtually dry after the debt crisis that erupted in 1982. Singh and Weisse (1998), in a critical analysis of the interactions between speculative capital flows and stock markets in developing countries, concluded that the resultant volatility, likelihood of macro-financial shocks, misallocation of resources, and severe disruptions to long-term development goals called into question the argument that developing countries should turn to stock markets as a way of mobilizing resources for sustainable development.

Combining these points on volatility arising from the structure of global capital flows with the aggregate fragilities stemming from countries' balance of payments, this section argues that the expansion of unstable, short-term and speculative flows presents a challenge for using such external finance in ways that could enhance development. The next section takes up the question of the challenges and opportunities for domestic macroeconomic management.

C. The macroeconomic costs of financialization

1. Effects of unfettered financial integration on prices and policy

In addition to the macro-financial risks identified above, unstable financial flows to DTEs have effects on key prices, such as exchange rates, and at the same time they constrain monetary and fiscal policies. So-called "balance-of-payments-constrained"

growth frameworks provide a basis for understanding the myriad connections and lines of causality between external flows and economic growth. They are based on the insight that to achieve sustained growth it is necessary to balance imports and net factor income payments with exports in a sustainable manner.²³ For instance, the size of the current account deficit or external debt relative to domestic income can limit pathways to stable growth. Policymakers may change

course by either reducing domestic expenditure, and thus imports, or supporting investments that trigger faster output growth, such as by increasing exports (Moreno-Brid, 1998). Alternatively, according to this approach, conditions in international financial markets can determine the extent of foreign financing available, which in turn affects imports and fixed investments, eventually determining the trade balance and the growth trajectory (Barbosa-Filho, 2001).

These relationships are perhaps most immediately apparent in terms of how financial flows, in combination with monetary policy reactions, affect prices. Influencing the real exchange rate to maintain competitiveness and encourage the production of tradables represents a challenge for policymakers in DTEs. Excessive nominal exchange rate depreciation will tend to exacerbate domestic price inflation due to the higher cost of imported capital and consumption goods. Conversely, excessive nominal exchange rate appreciation, when not sufficiently compensated by lower domestic inflation, may create a tendency towards real exchange rate appreciation that has a prolonged effect on the current account. Navigating within these constraints is difficult for central bank policy in developing countries.

Interventions in the foreign-exchange market to avoid an appreciation of the domestic currency lead to monetary expansion, which central banks usually try to sterilize by selling government securities in money markets. However, these operations may not necessarily result in interest rates that are stable and consistent with real demand; generally, the interest rate tends to overshoot and is followed by a drastic fall. A higher interest rate exerts further upward pressure on the exchange rate as foreign investors respond by engaging in interest rate arbitrage. Even assuming that exchange-rate management and reserve accumulation may be helpful in the context of capital inflows, often, this policy is not symmetrical. Authorities usually have greater difficulty coping with capital reversals. Using a large amount of reserves to meet demand for foreign currency can risk eventually emptying the coffers.²⁴ Usually, money market operations aimed at raising the interest rate are activated.

Independently of whether the central bank is engaged in explicit exchange-rate management, if the behaviour of the central bank is driven by a narrow inflation target rule, there will be a tendency towards nominal appreciation (for further explanation, see

Barbosa-Filho, 2012). Inflation-targeting frameworks typically tend to conform to narrow monetarist ideas about the existence of an exogenous supply of money and its impact on inflation. Thus, following surges of capital inflows, monetary authorities may consider it critical to avert an inflationary spiral resulting from the increase in money supply. But capital outflows leading to exchange-rate depreciations can also trigger inflationary pressures via the pass-through effects of import prices. In the context of inflation-targeting, independently of the source of inflationary pressures, the critical instrument to tame the inflation rate is the interest rate, which often brings with it pressure for nominal appreciation. If this effect is stronger than the presumed effect of reducing the inflation rate, a real-exchange-rate appreciation follows, with the potential of a currency crisis if the current account deteriorates significantly. As a matter of fact, high interest rates have perverse effects on price formation, as producers tend to pass on the higher cost of borrowing by raising prices (Lavoie, 2001). The destabilizing effect of speculative capital movements on nominal exchange rates, combined with inflation targeting regimes that aim at high interest rates, may not only create balance-of-payments problems in the short run, resulting from an overshooting and successive corrections of interest rates; it may, in the long run, also translate into slower growth, because real exchange rates tend to remain appreciated in order to avert financial shocks, effectively damaging the current account (Frenkel and Rapetti, 2009).

Chart 2.4 illustrates some of the mentioned interactions between capital flows, exchange rates and short-term policy rates for the same countries shown in chart 2.3. In some cases, the suggested influences of external capital on the macroeconomic environment seem unambiguous. Increases in capital inflows in excess of what is needed to finance real demand tend to exert upward pressure on the exchange rate. This influence may be magnified during commodity price booms for net commodity exporters. Brazil, Malaysia, Ukraine and to some extent India appear to be representative of these patterns, while China is an exception, as the authorities have managed a steady appreciation of the exchange rate. For the entire group of DTEs, the relationship holds quite well despite the high level of aggregation. In other cases (e.g. South Africa and Turkey), the correlation applies only for selective years, while in Thailand the variations in the exchange rate seem to be influenced by the pace of capital inflows over the

Chart 2.4

NET CAPITAL INFLOWS, NOMINAL EXCHANGE RATES AND NOMINAL INTEREST RATES IN SELECTED DEVELOPING AND TRANSITION ECONOMIES, 2002–2013



Source: UNCTAD secretariat calculations, based on World Bank, *IDS* database; IMF, *World Economic Outlook*, April 2015; and IMF, *International Financial Statistics* database.

medium term, with central bank intervention acting over the short term. Argentina shows a steady currency depreciation in nominal terms, resulting not from capital movements (which remained subdued), but rather reflecting its inflation rate and proactive exchange-rate management. In these more ambiguous cases, it seems that other drivers, including some degree of proactive policy management, may be the cause of exchange rate fluctuations. Indonesia, as noted earlier, has for several years maintained varying regimes of exchange-rate management, while the resumption of capital inflows seems to have responded to the commodity boom that started in 2003–2004.

Typically, the correlations between capital flows and exchange-rate cycles are more pronounced in the short term. Indeed, drastic capital flow reversals occurred in mid-2013 in many of the economies discussed here following the announcement by the United States Federal Reserve that it would reduce the pace of quantitative easing. Sharp depreciations followed, and in some economies it took specific monetary policy responses to halt the turnaround. Fears that instabilities of this kind, and perhaps of a greater magnitude, will emerge following a tightening of United States monetary policy are justifiable in view of such experiences. Some short-term monetary policy responses to changes in capital flows are discernible in the annual flows shown in chart 2.4, where decelerations in the pace of capital inflows are followed by interest rate increases – a pattern that is often quickly reversed. In these cases, interest rate fluctuations can be sharp from one year to the next. This volatility may have damaging effects on financial stability and on the environment for productive long-term investment. What is more, because high interest rates are often not sufficiently effective, or may even hamper efforts to control inflation, a resulting tendency towards appreciation of the real exchange rate will have lasting effects on the current account.

To sum up, it appears that, for the most part, the economies shown in chart 2.4, as well as many others, have been adversely affected by the globalization of finance as a result of perverse effects on exchange rates, and volatile and often high interest rates. In some countries, some degree of capital controls may have helped mitigate these effects (Gallagher 2015; Ostry et al. 2010).

Exchange rates, the balance of payments and monetary policy are the most frequently discussed aspects of the macroeconomic consequences of

financial flows. However, financialization also may exert general deflationary pressures on national economies, partly as a result of the constraints that open capital accounts impose on fiscal policy (Patnaik and Rawal, 2005; Patnaik 2006).²⁵ As noted above, in an environment characterized by free and typically unstable financial flows, policymakers cede control over the domestic interest rate, with the result that the rate that prevails is generally higher than what would be appropriate to support domestic capital formation, dampening economic activity and lowering GDP. In addition, financialization and open capital accounts exert macroeconomic pressures that tend to restrict fiscal policy. Interventionist policies and expansionary fiscal stances, no matter how important they are for development, may be a concern for international finance. Whether these sentiments stem from a fear of unsustainable debt accumulation or inflation, or a desire to expand the scope for private investors by limiting the reach of the public sector, or simply from resistance to a proactive role for the public sector, the result tends to be the same: policymakers become apprehensive that government spending may drive finance away (Krugman, 2000; Patnaik, 2006). Recent debates about fiscal austerity and growth reflect both this concern and the prevalence of the idea that public deficits and debt are unequivocally bad for growth, even when the empirical evidence shows otherwise (Herndon et al., 2013).²⁶ On the revenue side, tax receipts may decline for two related reasons: first, due to lower levels of economic activity associated with weaker public stances; and second due to ongoing pressures to offer international investors favourable tax rates lest they move elsewhere. The upshot is less government activity, which directly reduces national income as a result of limited government spending, but also indirectly lowers productive capacity by restricting the types of public investments in physical and human capital that support private investment and productivity growth.

Furthermore, openness of the capital account, by strongly altering relative prices and demand patterns, may have longer term effects as well, including by creating deindustrialization pressures in DTEs. Given this risk, it is important to consider the interaction between, and sequencing of, liberalization of the capital and current accounts. This has been, in particular, the experience in parts of Latin America and sub-Saharan Africa (dating back to the late 1970s in some countries), where capital account deregulation, which initially led to massive capital inflows and currency appreciations, took place at the same

time as increased openness to trade. The lower cost and greater variety of industrial imports constituted a gain for consumers and a source of imported inputs into production; but they also depressed the relative prices of tradable goods and services (both imported and exported), squeezing domestic profit margins and wages, and lowering domestic investment and employment.

Recent empirical evidence shows how, in economies with less developed manufacturing industries, these conditions can hollow out local capacities (*TDR 2003*; Rodrik, 2015).²⁷ This has meant lost opportunities for growth and for an expansion of higher quality employment, since industrial growth is essential for both. Indeed, in such cases, there has been an increase in often informal, lower productivity service sector jobs.

Thus, financialization and open capital accounts, and the higher interest rates they often require to maintain stability, compromise domestic investment and the ability of governments to support it, independently of whether any inflows or outflows have taken place (Patnaik and Rawal, 2005; Kregel, 2014c). When inflows or outflows do occur, they can have deleterious effects on industrialization and development in various ways. As discussed above, capital inflows exert pressures for real exchange rate appreciation and elevate the primacy of short-term returns in speculative markets over long-term projects that raise productive capacity (Patnaik, 2003). This makes it more difficult to conduct the type of structurally transformative investments required for development. On the other hand, sudden stops or capital flow reversals can turn deflationary tendencies into contractionary crises, resulting in substantial real economic and human costs and relegating fiscal policy to servicing debt rather than supporting development. The next section uses the recent history of financial crises in DTEs as a guide to determining the consequences of such overexposure to speculative finance.

2. Learning from the past: Public sector finances and economic development after financial crises

As discussed above, financial liberalization and deregulation provide an opening for a surge of capital flows as well as domestic lending, adding to the likelihood of bubbles in stock markets and real

estate markets. Such large inflows are often magnified by the way fiscal and monetary policies adapt to investors' expectations. The consequent build-up in financial fragility, driven by largely private speculation and risk-taking, is often swiftly unwound by a crisis, with substantial negative real effects and a sharp rise in public debt. Table 2.1 lists countries and the dates of their currency, sovereign debt or banking crises, grouped by the four waves of financial crises identified: various debt crises in the 1980s, the Mexican crisis in 1994–1995 and its so-called tequila effects, the Asian financial crisis in 1997–1998, and its ripple effects on countries outside the Asian region.²⁸ It is not a complete list of all of the financial crises that occurred during these periods, but rather a representative sample dictated by data availability and core themes.

Almost all of these crisis episodes listed (31 out of 33) were preceded by a "capital flow bonanza", defined as an unusually large negative surge in the current account balance.²⁹ Similarly, domestic credit booms preceded crisis nearly 75 per cent of the time (24 out of the 33 episodes listed). In the table, minimum real per capita GDP growth refers to the minimum growth rate within four years of the start of the crisis (including the crisis year, recorded as the earliest year that any of the three types of crises began, and is referred to as time T). Its intent is to make inferences, however rough, about the output losses resulting from these crises. The last two columns indicate the costs of the financial crises in terms of the growing public debt, both to domestic and external creditors. Comparing public debt as a share of GDP the year before the financial crisis begins ($T-1$) relative to two years after ($T+2$) for the entire group of crises listed, the median (average) increase in total gross central government debt is 85.9 (124.3) per cent, while the median (average) increase in external government debt is 42 (60.5) per cent. Interestingly, although fiscal mismanagement is a frequent refrain in mainstream accounts of financial crises, it is typically the public fielding of the private bust, and all the costs associated with it (e.g. nationalizing private debt, recapitalizing banks, and the impact of currency devaluation on the value of foreign currency liabilities), that run up public debt.

(a) Lessons of the 1980s

The Latin American debt crises of the 1980s caught many investors and analysts by surprise.³⁰ The world had not witnessed a major financial

Table 2.1**PERIODS OF FINANCIAL CRISES, CAPITAL FLOWS AND PUBLIC DEBT**

Country	Currency crisis (year)	Sovereign debt crisis (default year)	Banking crisis (starting year)	Capital flow bonanza	Domestic credit boom	Minimum annual real per capita GDP growth	Change in total gross public debt as a share of GDP (Per cent)	Change in gross external public debt as a share of GDP
Debt crises of the 1980s								
Argentina	1981	1982	1980	x		-7.1	417.7	53.4
Chile	1982	1983	1981	x	x	-11.7	161.7	106.9
Mexico	1982	1982	1981	x	x	-6.1	95.7	117.9
Uruguay	1983	1983	1981	x	x	-10.9	378.5	302.9
Colombia	1985		1982	x	x	-1.3	71.1	35.2
Ecuador	1982	1982	1982	x		-2.9	60.5	16.0
Paraguay	1984	1982		x		-5.9	78.7	35.5
Turkey			1982	x	x	1.2	83.1	32.7
Venezuela (Bolivarian Rep. of)	1984	1982		x		-6.3	95.2	62.1
Brazil		1983		x	x	-5.6	12.7	39.7
Peru	1981		1983	x	x	-12.5	127.6	73.4
Philippines	1983	1983	1983	x	x	-9.8	n.a.	34.2
Argentina	1987		1989	x		-8.8	111.4	87.7
Peru	1988			x	x	-14.2	146.8	68.7
Venezuela (Bolivarian Rep. of)	1989			x	x	-10.9	43.9	8.8
Brazil			1990		x	-5.9	191.1	32.1
<i>Group median</i>						-6.7	95.7	46.6
Tequila crisis								
Mexico	1995		1994	x	x	-7.6	26.4	47.0
Argentina			1995	x	x	-4.1	14.5	41.3
<i>Group median</i>						-5.9	20.5	44.2
Asian financial crisis								
Indonesia	1998	1999	1997	x	x	-14.4	246.0	100.9
Republic of Korea		1998	1997	x	x	-6.4	278.8	65.3
Malaysia	1998		1997	x	x	-9.6	7.1	38.1
Philippines	1998		1997	x	x	-2.7	10.4	42.5
Thailand	1998		1997	x	x	-11.5	597.7	28.0
<i>Group median</i>						-9.6	246.0	42.5
Ripple effects from the Asian financial crisis								
Colombia			1998	x	x	-5.8	117.5	20.8
Ecuador	1999	1999	1998	x	x	-6.6	49.9	28.9
Russian Federation	1998	1998	1998	x		-5.1	39.5	96.4
Ukraine	1998	1998	1998	x			70.0	n.a.
Brazil	1999			x		-1.2	-15.2	46.1
Turkey	2001		2000	x	x	-7.1	144.4	35.1
Argentina	2002	2001	2001	x	x	-11.7	208.1	149.9
Paraguay	2002			x		-2.0	-3.3	18.5
Uruguay	2002	2002	2002	x	x	-7.8	88.6	60.7
Venezuela (Bolivarian Rep. of)	2002			x	x	-10.5	22.5	10.1
<i>Group median</i>						-6.2	60.0	35.1

Note: Country and crisis listings: Countries are listed in order of earliest crisis year of the three types of crises listed, referred to as time T , and then alphabetically; source for dates of the currency, debt and banking crises is Laeven and Valencia, 2008.

Capital flow bonanza: An “x” indicates that a capital flow bonanza occurred within any one of three years preceding the earliest crisis date; source: Reinhart and Reinhart, 2008.

Domestic credit boom: An “x” indicates that a domestic credit boom was identified preceding time T in one of three sources: Arean et al., 2015; Elekdog and Wu, 2011, or Takáts and Uper, 2013.

Minimum real per capita GDP growth: This refers to the lowest annual growth rate within four years of the beginning of the crisis (i.e. the range is time T to $(T+3)$); source: World Bank, *World Development Indicators* database.

Public debt: Total gross central government debt includes both domestic and external debt. Total gross external government debt includes all external debt owed to both the public and private sectors. Percentage changes are based on UNCTAD secretariat calculations; source: Reinhart and Rogoff, 2010a, except for data on Ukraine, which is from de Bolle et al., 2006, and percentage changes are based on UNCTAD secretariat calculations of the change between $(T-1)$ and $(T+2)$.

crisis since the 1930s, commodity prices were high and real interest rates low. Flush with petrodollars, many developed-country banks provided financing to (mostly private) borrowers in developing economies as an alternative to the lacklustre investment opportunities at home. The fact that the loans were overseen by banks (and not based on bonds) was supposed to enhance information and oversight, adding to the general sense of confidence and optimism that prevailed (Reinhart and Rogoff, 2009). Many developing countries used these funds to cope with oil price shocks, maintaining growth in the face of mounting balance-of-payments constraints; even oil exporters borrowed heavily, drawn in by international lenders eager to extend loans (Palma, 2003). At the policy level, a number of Latin American countries introduced financial deregulation and trade liberalization in the 1970s, especially those in the Southern cone (Argentina, Chile and Uruguay).

Beginning in 1979, there was a series of global economic shocks involving real interest rate hikes. These were a consequence of United States efforts to tame inflation, intensified recession in developed countries and a fall in non-oil commodity prices. As a result, optimism swiftly gave way to panic. The cut-off in lending, balance-of-payments crises and devaluations that ensued led to a cascade of defaults (see table 2.1 for a partial list). In response to the alarming spectre of widespread bankruptcies, Latin American governments nationalized what had been largely private debt, with renegotiation and servicing orchestrated by international financial institutions on the condition of implementing stabilization and structural adjustment programmes (Díaz-Alejandro, 1985; Younger, 1993; Damill et al., 2013).

Looking back at this period, there were several reasons to be critical of domestic policy choices, such as liberalizing domestic financial markets without implementing adequate oversight, or underestimating the deleterious effects of real-exchange-rate appreciation in the context of trade liberalization. But DTEs' domestic policies and economic structures varied much more than critics typically emphasized. For instance, some Governments had relatively interventionist models of economic governance (e.g. as in Brazil), while others engaged in more free market reforms, including financial liberalization (e.g. as in Argentina, Chile and Uruguay). A third set had open capital accounts but imposed limits on private sector access to external finance (e.g. as in Mexico and the

Bolivarian Republic of Venezuela) (Díaz-Alejandro, 1984). What these countries did share were the same external economic conditions that generated capital flow bonanzas in the years leading up to the crisis, a consequent build-up of financial fragility, and the inevitable crash that followed on the heels of common economic shocks (Stiglitz, 2003).³¹ Explicit and implicit public guarantees of private debt then transformed the crises into sovereign debt problems.

Predictably, given the dominant economic paradigm of the era, early economic models that grew out of the experiences of the 1980s debt crises focused primarily on the challenges of "fiscal sustainability", and how fiscal deficits and expansionary policies, for instance, made economies vulnerable to speculative attacks in the context of effectively fixed exchange rate regimes (e.g. Krugman, 1979; Obstfeld, 1994). Accordingly, government missteps could generate a loss of investor confidence, inducing a self-fulfilling prophecy as investor fears would fuel the currency depreciation that had sparked their unease in the first place (Krugman, 2014). The conventional wisdom that emerged emphasized getting a country's fiscal house in order, and letting markets do the rest (Calvo, 2005). This perspective was also reflected in the policy prescriptions associated with structural adjustment, which accorded priority to servicing debt and required liberalization and privatization.

(b) The return of capital flows to Latin America

In 1989, Mexico signed on to the United States Government's Brady Plan, which was designed to further encourage free market reforms and ease debt burdens by converting government debt into bonds collateralized by United States Treasury bills. A number of other countries swept up in the 1980s debt crisis soon followed Mexico's example. This marks the beginning, particularly in Latin America, of the era where the Washington Consensus on economic policy dominated much of the thinking on how to manage global integration and the domestic economy, including strong commitments to financial liberalization and privatization (Damill et al., 2013). These reforms and debt restructurings eased concern over fiscal debt, alleged as to be the key policy mistake of the 1980s, and reopened access to international capital for debtor countries.

Attracted by relatively high rates of return, and reassured by domestic policy reforms and the prospect of a satisfactory conclusion of the negotiations on the North American Free Trade Agreement (NAFTA), portfolio investors herded into Mexico, driving booms in domestic credit (helped by the privatization of commercial banks) and stock prices, but this did little to boost real GDP growth (Grabel, 1996). In 1994, an increase in interest rates in the United States, as well as a series of destabilizing political events, ended the capital flow bonanza and necessitated the drawing down of reserves in order to finance the substantial current account deficit (Moreno-Brid and Ros, 2004). International investors became concerned that Mexico's exchange rate, which was essentially pegged to the United States dollar, was headed for devaluation. As these self-fulfilling crises typically work, the consequent capital outflows induced the currency crisis that investors had feared. In the lead-up to the crisis, Mexico's increasing reliance on dollar-denominated debt instruments called *tesobonos* introduced additional risks, stoking investors' fear of default and crisis (Lustig, 1995). The Clinton Administration helped secure a quick bailout that gave priority to bond repayment and furthered neoliberal reforms (FitzGerald, 1996; Grabel, 1996).

The Mexican crisis created devaluation pressure among a number of other emerging markets as worried investors re-evaluated risk in the context of fixed exchange rates (the so-called "tequila effect"). The strongest impact was felt in Argentina. In early 1991, Argentina had established a currency board, which maintained a fixed peg of its currency to the United States dollar and established that the monetary base would be entirely covered by international reserves (an arrangement that persisted to 2001, when the crisis that the scheme helped to build finally erupted). While the regime was effective at curbing high inflation, the liberalization of trade and finance led to an appreciation of the real exchange rate, increasing current account deficits and external debt (Damill et al., 2013). When the Mexican crisis struck, Argentina also faced sudden capital outflows, mainly from residents' deposits in domestic banks. The pressure on Argentina's banks proved too strong, forcing the government to negotiate a bailout agreement with the IMF in 1995. IMF support, which was conditional on the Government tightening its fiscal policy by increasing taxes, opened the way for significant foreign financing of government debt (Calcagno, 1997;

Boughton, 2012). Brazil avoided a similar fate largely by raising short-term interest rates, which introduced other fragilities (i.e. persistently high interest rates, including on public debt) that rendered it susceptible to crisis later in the decade (Palma, 2011).

Though limited in scope and relatively short-lived, these crises challenged some of the conventional wisdom on the determining roles of fundamentals and liberalization, as well as the reputation of some of the "star students" that had followed this policy advice (Boughton, 2012: 487–488). There were some efforts to suggest the lack of domestic savings as an insufficiently recognized vulnerability, but the spectacular savers caught up in the Asian financial crisis a couple of years later quickly undermined that line of reasoning (Calvo, 2005). A more enduring alternative explanation, for what would become a common neoliberal "exceptionalism" story, laid the blame for the crisis squarely on the Mexican Government for economic mismanagement, political overreach and corruption (Grabel, 2006). Echoes of this reasoning would reappear to try and explain the Asian financial crisis.

(c) The Asian financial crisis and beyond

If the Mexican crisis caught many by surprise, the Asian financial crisis came as a veritable shock. Most of the region's macroeconomic fundamentals seemed indisputably sound: growth and savings rates were high, and since fiscal policy was generally conservative, most borrowing was private. In 1996, the year before the crisis hit, current account deficits in Malaysia and Thailand were on the large side,³² and the region's overall growth had declined slightly, but none of this really justified the extreme alarm and consequent dislocation that would soon follow (Krugman, 1999).

As with other crises, the pathway to the Asian financial crisis began with financial liberalization, both on the capital account and in domestic financial markets (Montes, 1998). These reforms were partly in response to pressure from domestic firms and banks, which were eager to access lower interest loans in global capital markets for investments at home; and large institutional investors in developed countries were happy to oblige (Wade, 1998). South-East Asian governments caved in to the pressure, and, in some cases, had developed vested interests in

allowing property bubbles to grow (Wade, 2004).³³ The practical result was widespread expansion of private lending, much of which was linked to short-term, hard-currency-denominated debt instruments (Grabel, 1999). At the same time, capital inflows were associated with higher rates of inflation and real exchange rate appreciation, leading to a loss of international competitiveness and worsening current accounts (Chandrasekhar and Ghosh, 2013). These changes drove even more investors into the real estate and stock market bubbles, especially in South-East Asia. With growing signs of weakness in Thailand's asset markets by 1995, and global capital starting to shift away from emerging markets as the United States Federal Reserve raised interest rates in March 1997, investors became increasingly worried that Thailand's pegged exchange rate would not hold (Wade, 1998). The Thai central bank, after unsuccessfully using its reserves to defend the baht against speculative attacks, finally let the currency float in July 1997. The baht's consequent depreciation spooked investors, setting off contagion first to neighbouring economies in South-East Asia (Indonesia, Malaysia and the Philippines), and then to Hong Kong (China), the Republic of Korea and Taiwan Province of China.³⁴ The IMF swiftly moved in to help contain the crisis, pushing an agenda that has since been criticized for possibly worsening the contagion and deepening the crisis (Radelet and Sachs, 2000), as well as over-reaching in its imposition of market-oriented structural reforms (Crotty and Lee, 2004; Stiglitz 2002).

Outside Asia, the Russian Federation was next to be pulled into a crisis. Soon after liberalizing finance and allowing more foreign participation in its stock and public bond markets, the Russian Federation faced an increasingly widespread reversal of capital flows to emerging markets – initially led in the Russian Federation's case by the exit of investors from Brazil and the Republic of Korea in response to the Asian financial crisis (Pinto and Ulatov, 2010). Declining commodity prices further compromised the ability of the Russian Federation to defend its fixed exchange rate, resulting in devaluation and default in 1998. The large private sector losses (both domestically and among international investors) generated by the Russian crisis induced a sudden stop of capital flows to Latin America, which manifested as a series of financial crises and low growth that came to be dubbed the “lost half-decade” of 1998–2002 (TDR 1999; Calvo and Talvi, 2005).

The experiences of Argentina and Brazil illustrate these dynamics and their links with vulnerabilities established in prior crises. Brazil's system of public financing was severely weakened by its efforts to weather the tequila crisis, where in addition to raising interest rates, a banking sector restructuring loaded the Government with lots of additional debt. The economic slowdown and very high interest payments caused Brazil's internal fiscal debt to soar between 1994 and 1998, with interest on public domestic debt amounting to 3.4 per cent of GDP in 1994 and 7.3 per cent of GDP in 1998 (TDR 1999; Sainz and Calcagno, 1999).³⁵ Defending the currency peg in light of the sudden stop in capital inflows and insufficient reserves became quickly untenable, and currency crisis and devaluation ensued in early 1999. In Argentina, with unsustainable exchange rates, any economic growth increased its trade deficit, but the lack of growth led to a fiscal deficit: neither of these deficits was consistent with the convertibility regime. This contradiction could be circumvented as long as external financing kept flowing. However, when that stopped, tough fiscal austerity and IMF assistance could not prevent an economic implosion, a run on deposits and a partial default on public debt (Calcagno, 2003; Calvo and Talvi, 2005; Damill et al. 2013; Grabel, 2006). Real average annual per capita GDP growth in Argentina sank to -4.2 per cent during the lost half-decade, while the average for Latin America as a whole was 0.2 per cent.³⁶

(d) Public sector finances in the context of financial liberalization and systemic risk

This brief review clearly suggests that the likelihood of financial crises increased as DTEs liberalized their capital accounts and domestic financial markets, which led initially to surges in capital inflows and then to the sudden stops or reversals that almost always ensue.³⁷ And although capital flow bonanzas increased in tandem with free market policy stances in developing countries, they continued to be significantly driven by circumstances external to the economies that hosted them, such as changes in global commodity prices or in United States interest rates, or by the psychological and economic contagion effects of crises elsewhere. These external forces interact with domestic macro policy and structure in ways that raise overall fragility and risk. But domestic factors are only significant when they exist within a larger global financial system characterized by

Table 2.2

FINANCIAL CRISIS AND PUBLIC DEBT IN MEXICO, THE RUSSIAN FEDERATION AND ARGENTINA
(Per cent)

Country (crisis date)	Total gross public debt as a share of GDP			Total gross external public debt as a share of GDP		
	Reference level	Pre-crisis growth	Post-crisis growth	Reference level	Pre-crisis growth	Post-crisis growth
Mexico (1994)	42.6	-29.2	26.4	37.3	-10.7	47.0
Russian Federation (1998)	30.2	34.1	39.5	31.0	4.0	96.4
Argentina (2001)	37.6	19.8	208.1	47.9	6.2	149.9

Source: UNCTAD secretariat calculations, based on data from Reinhart and Rogoff, 2010a.

Note: Time *T* refers to the crisis year in parentheses. The columns refer to the following:

Reference level is debt as a share of GDP at (*T*-3);

Pre-crisis growth refers to the percentage change between (*T*-3) and (*T*-1);

Post-crisis growth refers to the percentage change between (*T*-1) and (*T*+3).

too much liquidity and not enough macroprudential regulation, riding on waves of optimism, excessive private risk-taking and over-borrowing that precede the inevitable crash – a dynamic that is endemic to the financial system itself (Minsky, 1992).

The largely private risk-taking associated with financial liberalization then becomes a public debt problem. The most proximate reasons involve the explicit and implicit guarantees that governments provide on private liabilities and the nationalization of bad private debts. But a financial crisis also systematically reduces public revenues and wealth through the effects of exchange-rate depreciation on public assets and liabilities, increases in real interest rates, declines in real output, and the additional borrowing required to deal with the costs of the crisis (de Bolle et al., 2006). Although sovereign defaults are a common feature of financial crises in DTEs, contrary to the common rhetoric around development macroeconomics, in the cases analysed, large public debt is most often a consequence, not a cause.

Even among countries such as Argentina, Mexico and the Russian Federation, where public debt was identified as a major source of the financial fragility that pushed their economies into crisis in the 1990s, there is ample room for qualification. Table 2.2 takes a closer look at public debt for these three countries in their respective pre- and post-crisis years. Reference level refers to public debt as a share of GDP three years prior to the crisis date (*T*-3), and

pre-crisis growth to the percentage increase in that level over the three years leading up to the crisis. By way of comparison, the growth in public debt after the crisis presented in table 2.1 is repeated here. Total and external public debt as a share of GDP for Mexico was actually on the decline before the crisis, while the pre-crisis debt levels of the Russian Federation and Argentina certainly did not portend the crises that followed. However, these figures do not capture how the structure of debt makes DTE governments more vulnerable than their debt levels suggest (e.g. the extent of foreign-exchange-linked liabilities and short-term maturities). Even then, there are arguments to be made about the respective roles of fiscal profligacy versus having to bend to the rules of global financial markets.

3. Looming losses: Fiscal stance, macro policy and aggregate demand

This chapter shows that exposure to unregulated and large financial flows alters macroeconomic developments in ways that can lead to a slowdown of GDP growth as well as unstable internal dynamics marked by sudden shifts of income and wealth between the main sectors (private, public and external). A convenient way to map these shifts and their relationship with economic growth is by using the “demand stances” framework (see Godley and Cripps, 1983; Godley and McCarthy, 1998; and

Taylor, 2001 and 2006). This framework reasserts the Keynesian principle that sustained growth requires continuously increasing injections (which, in simple macroeconomic terms, include private investment, government expenditure and exports) into the flow of income. These injections, in turn, require a steady growth of leakages (measured by the propensity to save, the tax rate and the import propensity), which over time ensure financial stability, as credit rises along the circular flow of income. Thus GDP growth can be explained as the growth, along stable norms, of injections relative to leakages; these eventually determine financial transfers between the main sectors. Such ratios of injections to leakages are termed stances and provide a measure both of demand drivers and financial balances.³⁸

Therefore, a useful way to assess changes in behaviour is to trace the patterns of the three stances (fiscal, private and external) along the path of growth. Each of the three stances can be observed relative to GDP in order to see which components of aggregate demand are contractionary and which provide stimulus to the economy. Weaker fiscal stances (declines in government expenditure relative to the tax rate), weaker private stances (declines in investment relative to the savings propensity), and weaker external stances (declines in exports relative to the import propensity) adversely affect the growth path and may generate financial imbalances that increase financial instability.

Applying this framework to the crises discussed in the previous section and listed in table 2.1, we find that in two thirds of these cases, the leading source of demand shifted away from the domestic stances (private and government) before the crisis, and towards the external stance after the crisis.³⁹ This reflects a tendency, post-crisis, for external accounts to go into surplus while domestic sources of demand taper off. Structural trends and cyclical effects jointly come into play. Current account liberalization prior to a crisis, along with financial inflows and strong exchange rates, allow an expansion of domestic demand with substantial import leakages. After a crisis, wage compression and lower profits, along with fiscal contraction and interest rate hikes to attract capital inflows, weaken private sector stances and lower imports. Stronger external stances mostly derive from a decline in domestic demand and the consequent swift reduction of imports. Regarding the domestic sectors, the triggers are a shift towards deleveraging

of households (higher saving propensities) and a contraction of government expenditure when austerity is applied (particularly after private sector losses are transferred to the public sector and fiscal imbalances grow as a result). Further, depreciation of the exchange rate can frequently make the foreign sector the leading source of effective demand without any substantial increase in real export capacity.

Two additional considerations serve to highlight the usefulness of the framework described above to trace demand drivers in some DTEs after the crisis: (i) the buffer role played by commodity export revenues, and (ii) changing views on countercyclical fiscal policy among DTEs. Rising commodity prices (a trend now in reversal) have sustained – at times narrowly – private sector profitability, preserving optimism in the face of ongoing financial volatility. In addition, when growth across the South decelerated in 2009 due to a contraction of exports to the North and the sudden stop of capital inflows, countercyclical policy responses made a recovery possible in 2010 (Grabel and Gallagher, 2015). Despite these ephemeral reversals on countercyclical policy conventions, powerful financial market institutions maintain their biased, short-term perspective which hangs on the importance of financial ratings (see also chapter IV). A policy aversion to providing a strong fiscal stimulus has been the rule. Fiscal orthodoxy and an excessive reliance on monetary policy have generated financial fragility and exchange-rate instability in major developing economies (Akyüz, 2013). Susceptibility to financial pressures is heightened either when public sectors incur debt directly or, as is more frequently the case, circuitously when increased liquidity generates private sector debt that is ultimately taken on by the public sector. Interest payments on debt, whether public or private, further dampen domestic stances.

To summarize, the most important elements that were present in previous crises and which persist today are: open capital accounts; hot money cycles worsened by monetary expansion in developed countries and a consequent rise in external and internal debt (in particular short-term debt); a shift away from deepening industrial development; and constraints on using fiscal policy as a tool for structural transformation and industrial expansion, as monetary policy continues to promote the deflationary trends favoured by global financial investors. Very broadly, these features apply to many countries today to varying degrees, depending on their financial

flows, stocks of debt, and movements in exchange rates and interest rates. Clearly, the most vulnerable

economies are those where domestic activities are highly concentrated in only a few sectors.

D. Concluding policy discussion

The analysis in this chapter has focused on the reshaping of global financial markets, leading to the Great Recession and its aftermath to the present day. The extraordinary growth of unregulated global financial markets, in tandem with weaker domestic regulation in most DTEs, has exacerbated the vulnerabilities of these countries, rather than providing increased financing for development needs (discussed in chapter VI of this *Report*). The chapter has stressed that excessive private capital inflows, particularly those of an unstable or speculative nature, affect the configuration of net factor payments, exchange rates, interest rates and other prices, and influence monetary and fiscal policy stances in perverse ways. When DTEs face the threat of sudden stops or capital flow reversals as conditions in global markets change, the results can be even worse. It is clear from the discussion that under these circumstances, policymakers' search for alternatives to ensure more stable outcomes is becoming increasingly challenging.

A significantly more stable macroeconomic environment for development is implausible without collective efforts to reform the international monetary and financial architecture, the subject of chapter III. Nevertheless, there are a number of options that still remain within the purview of national policy. To be clear, none of the proposed recommendations call for delinking from the global economy in terms of either trade or finance, but rather for better managing the links to promote development.

One set of critical policy choices rests on the ability to influence the exchange rate. While avoiding “corner solutions”, such as fixed exchange rates or fully liberalized exchange rates, some sort of managed float remains an attractive option (Ghosh,

2007; Damill et al., 2013). The management of the exchange rate (as described by these authors and others) with a view to guiding its evolution as a tool for development entails combinations of monetary policy, central bank operations and incomes policies. How this is achieved in practice depends on the particular circumstances in each country, including their institutional diversity and their balance sheets.⁴⁰

As discussed above, guiding the evolution of the real exchange rate in an environment of large and deregulated global finance, and a global exchange system dominated by a few reserve currencies, will be extremely difficult without some degree of management of the capital account. The possible use of capital controls as a tool for development and financial stability has gained greater acceptability by many governments and international organizations in recent years. Indeed, UNCTAD has been a long-standing advocate of such a policy: in the early 1990s, it suggested that DTEs should consider measures that “discourage capital flows that were not related to real investment or to trade transactions but were motivated by short-term gains” (UNCTAD, 2012b: 50). These and complementary recommendations aimed at restoring stability and averting systemic crises are even more relevant in today’s context, as also evidenced by developed countries severely hit by the Great Recession and its aftermath. Again, the circumstances and scope for action differ from country to country, as does the degree of regional coordination required to ensure success.

In an effort to avoid the currency and interest rate risks historically associated with external debt, DTEs have also shifted more of their borrowing from debt denominated in foreign currencies to one denominated in domestic currency.⁴¹ But not all

developing countries can attract international investors to domestic securities markets. And even when they do, there is the additional risk that larger shares of debt, regardless of currency denomination, will be held by more internationally mobile investors. Recent evidence bears out this warning: greater foreign participation in domestic currency sovereign bond markets has been associated with heightened volatility as a result of increased exposure to global financial shocks (Ebeke and Kyobe, 2015).

A similarly mixed result is seen in the growth of international reserves among DTEs. The build-up of reserves is in principle mostly precautionary, in the sense that it is expected to guard against a host of ills introduced by large and speculative international capital inflows and the negative economic and social consequences of their sometimes sudden or substantial departure. Precautionary reserve buffers also hedge against the loss of policy autonomy that often accompanies IMF-type bailouts or against pressures to provide the macro policy conditions preferred by international financial investors (Grabel, 2006). But even if reserve accumulation does offer some protection, providing some policy space to countries whose currencies are under attack, there is an opportunity cost to tying up development resources in this manner. Furthermore, when policymakers try to counter capital flow reversals through the use of reserves, they often end up resorting to complementary measures, such as interest rate increases, as the stock of reserves declines. These policy responses ultimately weaken the economy and erode confidence even further. As noted above, such trade-offs pose a challenge to central bank policy.

In considering policy options, central banks in DTEs should carefully evaluate the implications of narrowly applied inflation-targeting regimes. Pressing too hard to achieve inflation rates deemed desirable more often in developed-country contexts could easily lead to high interest rates and appreciation of the real exchange rate, both of which discourage productive investment and hence development. Still, the widespread (formal and informal) adoption of inflation targeting by some developing countries' central banks reflects real apprehension over any hint of inflation, given their histories of high inflation. But probably more important is the widespread belief that inflation targeting regimes give more credibility to the central banks that implement them, lowering expectations of inflation and enabling

higher employment rates for a given level of inflation. However, the empirical evidence does not support the credibility argument (Epstein, 2007). Indeed, stable price formation processes and sustained increases of high-quality employment in a developing country context are complex goals that require attention to the overall stability of credit and financial flows.

But central banks can do more than only maintain price stability or competitive exchange rates to support development, as attested by the historical record. After the Second World War, central banks in Europe and Japan used interest rate ceilings, subsidized credits and credit allocation policies to guide reconstruction and facilitate industrial upgrading (Epstein, 2015). Similar policies were followed by the newly industrializing countries in the second half of the twentieth century, where central banks provided key support to development banks and their governments' fiscal policies (Amsden, 2001; *TDR* 2013). Price stability goals can still help guide these types of policy choices, as when targeted or subsidized credit encourages productivity and employment growth rather than activities that generate inflationary pressures (Epstein and Yeldan, 2009), or when incomes policies ensure that wage growth tracks productivity growth.

However, as evidenced by the failures of developed economies to fully emerge from the recent crisis, monetary policy alone is not sufficient. Proactive fiscal and industrial policies are essential for generating the structures and conditions that support domestic productivity growth and the expansion of aggregate demand. Maintaining strong and stable fiscal stances can help increase production and incomes, generate high-quality employment, and encourage a more egalitarian distribution of income (which exerts a further positive effect on aggregate demand). Policies that ensure that wage incomes increase concomitantly with productivity growth enhance these mechanisms. By extension, trade policy also needs to be aligned with domestic goals and policies for productivity and wage growth, including in global, regional and bilateral trade negotiations (see *TDR* 2014).

These circumstances highlight the need for more effective international policy coordination. Given the sheer size of global capital flows, individual countries' management measures, such as capital controls, exchange rate management, central bank policy consistent with strategic development needs,

and a tighter regulation of domestic financial systems, may not be enough. Domestic policy options should be supplemented by global and regional measures that discourage the proliferation of speculative financial flows. In addition, more substantial mechanisms could be established for credit support and shared reserve funds at the regional level. At the same time, implementing countercyclical macroeconomic policies, improving income distribution and extending fiscal space for development purposes have a

significantly greater chance of success when applied also by partner countries, and effectively, the world at large. Indeed, domestic policy stimuli, when applied by only a few countries, are considerably weakened when the inertia of macro policy orthodoxies prevails in partner countries.⁴² Such conditions can even yield perverse effects if global investors and international financial institutions respond in ways that generate greater volatility and uncertainty. These aspects are discussed further in the next chapter. ■

Notes

- 1 Although middle-income countries tend to be more integrated into the global economy, and as such, seemingly more exposed to the effects of financialization, the magnitudes of capital flows relative to GDP and their macroeconomic effects discussed in this chapter apply to all DTEs (see section B.2 for more detail.)
- 2 Among a group of 26 developed countries, all but 4 (France, Japan, Sweden and Switzerland) had contractionary fiscal stances relative to their long-run trend between the second quarter of 2010 and the fourth quarter of 2013 (*TDR 2014*, chart 2.1).
- 3 See Chandrasekhar (2007) for an analysis of factors that led to an explosion of global liquidity creation by private agents after the 1997 Asian crisis, which was transmitted to developing countries through the operations of hedge-funds, foreign direct investment in the form of portfolio equity and increased mergers and acquisitions.
- 4 Think tanks providing analytical insights for international investors trumpeted the potentially attractive returns of developing economies. See, for example, Accenture, 2012; Black Rock, 2011; Credit Suisse, 2011; Economist Intelligence Unit, 2011; UBS, 2012; and Ahmed and Zlate, 2013, for a more rigorous analysis of factors determining the relative attractiveness of emerging market economies as investment destinations. (The latter study also evaluates the influence of the unconventional monetary policy of the United States as a factor in the composition of flows, a large proportion of which are portfolio allocations.)
- 5 The crash in China's stock market in June–July 2015, and the Government's responses to it, echo these worries (*Bloomberg Business*, "China stocks plunge as State support fails to revive confidence", 8 July 2015).
- 6 The World Bank's *International Debt Statistics 2015* contains records of 125 countries, of which 121 are DTEs according to the United Nations classification. Unless otherwise specified, the empirical discussion refers to this group of 121 DTEs. Elsewhere in the chapter the term DTEs refers to all developing and transition economies.
- 7 These are identified as all the 121 DTEs minus Algeria, Argentina, Brazil, China, Egypt, India, Mexico, Morocco, South Africa, Tunisia and Turkey.
- 8 There are a few exceptions among DTEs where current account deficits in the 2000s were significantly larger than those in the 1990s, including, most notably, India, South Africa and Turkey.
- 9 Even countries with a current account surplus obtained additional financing to manage their portfolios, increase their asset accumulation buffers in view of uncertainties, and cope with intertemporal inconsistencies (since expected expenditures are decided in advance of earned income), or even for financial speculation purposes.
- 10 The current account is the sum of the trade balance and the balance on transfers and net factor incomes. Net factor incomes are primarily the earnings on outward investments and loans less payments made to foreign investors and creditors. Remittance flows from residents working abroad are also accounted

- as factor incomes and for some DTEs (e.g. India, Mexico and the Philippines) the size of such flows is substantial.
- 11 Any statistical errors between the current and the capital and financial accounts in the balance of payments are captured by the “net errors and omissions” category; this item is used to preserve the accounting principle of equality between the current account and the capital and financial accounts.
- 12 The discussion that follows draws from the analytical framework developed by Kregel, 2014a.
- 13 In theory, the situation for surplus countries exposed to unfettered capital flows would present similar challenges. Even they could face declining trends in net factor incomes, and therefore downward pressure on their current accounts. Aside from other factors driving their export successes, the prospects of falling net factor incomes might generate pressure to compensate by aiming at ever greater trade surpluses.
- 14 While the aggregate perspective taken in this section is critical for pinpointing the macrofinancial implications of capital flows in the current context, the detailed analysis below sheds a different light by distinguishing between more unstable and speculative short-term flows and those that are longer term and more likely to be better linked to development needs.
- 15 This configuration of policies is found, for instance, in the United States, the eurozone and the United Kingdom, and only partially in Japan where quantitative easing was accompanied by some degree of fiscal relaxation. See *TDR 2014* for an extensive analysis.
- 16 This perspective is in line with recent studies such as those by Gallagher (2015), Kaltenbrunner and Karacimen (forthcoming), Kaltenbrunner and Panceira (2014) and Powell (2013).
- 17 Some countries of similar relevance, such as the Russian Federation, are not included due to the lack of detailed data in the World Bank’s *International Debt Statistics*.
- 18 The spike in private capital inflows recorded in 2005 is in fact the way the World Bank recorded debt relief.
- 19 For a discussion about channeling FDI for the good of development, see the joint UNCTAD/ILO volume on industrial policy (Salazar-Xirinachs et al., 2014).
- 20 See *Financial Times*, “Real estate and China dominate FDI flows”, 4 June 2015.
- 21 UNCTAD, 2015: 18, table I.5.
- 22 Between 2011 and 2013, net FDI inflows to DTEs consisted of, on average, reinvested earnings (45 per cent) and intra-firm loans (22 per cent); the remaining 33 per cent consisted of equity, including mergers and acquisitions (UNCTAD, *World Investment Report* database).
- 23 For a recent review, see Thirlwall, 2011.
- 24 See Patnaik (2007) for an analytical exposé of the limited effectiveness of precautionary holdings of foreign-exchange reserves; and also Torija Zane (2015), with special reference to central banks in Latin America.
- 25 For formal derivations of the points made here, see Patnaik and Rawal, 2005; and Patnaik, 2006.
- 26 Herndon et al. (2013) replicate and empirically challenge Reinhart and Rogoff (2010b and 2010c), whose writings have been widely used to support fiscal austerity arguments based on the stylized finding that public debt exceeding 90 per cent of GDP reduces growth. Herndon et al. (2013) conclude that Reinhart’s and Rogoff’s selective exclusion of data, coding errors and inappropriate weighting of summary statistics underlie the result on public debt and growth. When these errors are corrected, the results show that the growth consequences of public debt vary and the effects are modest.
- 27 In Latin America, the context of overvalued exchange rates, expanding domestic demand and a more open trade regime, “led to increased imports and a growing current-account deficit, which was financed by foreign investors who were attracted by the promise of higher returns. However, the creative process of technological progress and restructuring remained to be carried out, and the macroeconomic environment of high interest rates, strong exchange rates and volatile capital flows did little to support the new investment required for such a transformation. Thus policy reforms were unsuccessful because the ‘creative’ element in the ‘destruction’ process failed to bring about real transformation of the productive structure through higher investment and technological change” (*TDR 2003*: 145–146).
- 28 These ripple effects are grouped separately from the Asian financial crisis in order to differentiate between the regional contagion of that crisis and how these costs manifested in other emerging market economies.
- 29 These data and the term “capital flow bonanza” are from Reinhart and Reinhart (2008), who note that, although a better measure would be reserve accumulation less the current account balance, the longer time series and greater consistency of data on the current account make this a satisfactory substitute.
- 30 This section limits the discussion to Latin America. Many other developing countries were swept up in the same cycle of financial crises, but the Latin American experience is emblematic of the larger economic forces at work.
- 31 Even Brazil, which had capital controls and did not experience much capital flight, suffered because of the general suspension of lending to Latin America (Díaz-Alejandro, 1984).
- 32 As a share of GDP, the current account deficits of Thailand and Malaysia that year were -8.1 and

- 4.4 per cent respectively (IMF, *World Economic Outlook* database, October 2014).
- 33 Wade considers the Republic of Korea a different case on the grounds that there it was more the industrial conglomerates that had links with finance through their access to cheap foreign capital, rather than vested interests in property.
- 34 Taiwan Province of China and Hong Kong (China) successfully fended off speculative attacks, but the Republic of Korea was much more exposed because of short-term debt.
- 35 By contrast, government spending on goods and services as a share of GDP rose from 19.2 per cent in 1994 to 20.6 per cent in 1998, with the bulk of the rise occurring in 1995 (when it increased to 21 per cent) as a result of a one-time positive shock of inflation-related adjustment of wages and salaries (*UNCTADstat*).
- 36 Source: World Bank, *World Development Indicators* database.
- 37 See also Demirguc-Kunt and Detragiache, 1998; Reinhart and Reinhart, 2008; and Weller, 2001.
- 38 In mathematical terms, the main accounting identity defines GDP as the sum of consumption (C), private investment (I), government expenditure (G) and exports (X) minus imports (M). Simple assumptions allow specifying the tax rate (t) and the savings and import propensities, s and m respectively, as:
 $T = t \cdot GDP; S = s \cdot GDP; M = m \cdot GDP,$
where T stands for total tax revenue and S for private savings. Arrangements of these equations around the accounting identity yield the expression:
 $GDP = (G + I + X)/(t + s + m)$, or alternatively:
 $GDP = w_t \cdot (G/t) + w_s \cdot (I/s) + w_m \cdot (X/m)$
where w_t , w_s and w_m are the weights of each of the leakages (tax, savings and import propensities, respectively). This equation establishes that growth of GDP depends on the growth of the three variables, G/t, I/s and X/m; defined as fiscal stance, private stance and external sector stance, respectively, amplified by the strength of the respective multipliers, given the mentioned weights, in the macroeconomic context. To avoid complicating the presentation with derivation of the steady state conditions, it is sufficient to note that these stances reflect financial conditions as well, where a larger numerator than the denominator points towards a net borrowing position. Thus, a steady path of sustained growth and financial stability requires that none of these stances grow at a proportionally faster pace than the others for a prolonged period of time.
- 39 The external account became the leading driver in 40 per cent of these cases, and became significantly more important in another 27 per cent of cases.
- 40 See Frenkel and Taylor (2006) for a discussion of the varying circumstances and challenges that are associated with managing the exchange rate to support development.
- 41 Data from the World Bank (2013) indicate that at the end of 2012 the share of non-resident holdings in local DTE debt markets was 26.6 per cent, and that it was as high as 40 per cent in some economies (cited in Akyüz, 2014: 20).
- 42 See *TDR 2013*, annex to chap. I, where a global model simulation provides empirical illustration of the fact that policies based on improved labour income and supportive fiscal policy yield weaker results, even if still positive, when partner countries take an opposite stance and profit in a typical “free-rider” manner.

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Chapter III

SYSTEMIC CHALLENGES IN THE INTERNATIONAL MONETARY SYSTEM

A. Introduction

The tensions and troubles in today's global economy emerge from the interaction between weak effective demand and persistent financial instability. The global financial crisis in 2008 was a reminder of the economic and social damage that such an interaction can generate. Much of the subsequent reform effort has concentrated on repairing bank balance sheets, strengthening regulatory frameworks and improving the resilience of financial institutions to shocks through actions at the national and international levels. This is an ongoing process (see chapter IV of this *Report*). But the success of such efforts is closely related to global macroeconomic forces whose current weakness stems partly from the malfunctioning of the existing international monetary system (IMS).

The main function of the IMS is to contribute towards global macroeconomic and financial stability by maintaining stable exchange rates, ensuring sustainable current account positions, providing an adequate amount of international liquidity and enabling orderly adjustments to external shocks. The erosion and eventual breakdown of the system along all these fronts

contributed to the accumulation of global macroeconomic and financial imbalances which facilitated the build-up of unstable financial market conditions that eventually triggered the crisis (e.g. United Nations, 2009; Kregel, 2010; Dorrucchi and McKay, 2011; see also *TDR 2010*).

The global spread of the crisis from its origins in the financial markets of developed countries, as well as those countries' subsequent approaches to crisis management, have revealed the inadequacy of existing global safety nets to deal with large adverse shocks. The crisis has also revealed the tendency of the current IMS to create substantial instability in the provision of international liquidity¹ and its inability to provide sufficient support to the recovery of global aggregate demand. Moreover, ongoing financial instability raises questions about how supportive the global environment

The current IMS creates substantial instability in the provision of international liquidity and is unable to adequately support global economic recovery.

will be for attaining the Sustainable Development Goals (SDGs) that are currently the subject of debate on the Post-2015 Development Agenda. All these factors point to the need for more fundamental reform of the IMS.

This chapter examines the weaknesses of the current IMS, and proposes some elements for its reform. It focuses on three fundamental challenges commonly perceived as confronting any IMS (see, for example, United Nations, 2009; Erten and Ocampo, 2012), and examines how these challenges and the responses to them have changed over time. It suggests that the reforms aimed at addressing the inadequacies of the current IMS exposed by the global economic and financial crisis have been timid at best.

The three fundamental challenges are:

- First, regulating the provision of international liquidity. Traditionally, private and public agents of different countries have willingly accepted one or several national currencies to use as a unit of account, as a means of payments or as a store of value in their international economic and financial activities. The dollar has, predominantly, served these purposes since the end of the Second World War, but this has been associated with large swings in the availability of international liquidity and in exchange rates. Furthermore financial globalization and the increasing role of private financial intermediaries in the provision of international liquidity have compounded the complexity of this challenge.
- Second, providing access to short-term liquidity for managing shocks.² The International Monetary Fund (IMF) was designed to provide such finance in order to prevent countries from resorting to a combination of trade restrictions and competitive currency devaluations. However, developing countries have increasingly shunned IMF assistance, especially following the Asian crisis in 1997–1998, in favour of accumulating large foreign-exchange reserves as a form of self-insurance and a first line of defence against external shocks.
- Third, ensuring a more equitable sharing of the burden of current account adjustment.³ The asymmetric adjustment process implied by

curtailed spending in the deficit countries without offsetting spending increases in the surplus countries represents the so-called “contractionary bias” of the IMS. This has particularly undesirable impacts on global macroeconomic dynamism when global output growth is already anaemic, as is currently the case.

This chapter suggests that the increased role of short-term private international capital in the provision of international liquidity has caused boom-bust cycles, and has led developing countries to accumulate large amounts of foreign exchange reserves in spite of the inequity that the associated transfer of resources to reserve-currency countries implies. In its current form, the IMS will continue to generate both instability and inequity, and force developing countries to adjust to the effects of policies beyond their own control.

The chapter does not provide a comprehensive blueprint for reform. Rather, it focuses on the major difficulties in meeting the three challenges described above, and discusses various proposals as well as the conditions required to implement those proposals.

The chapter is organized as follows. Section B offers a historical account of the way in which successive forms of the IMS have addressed the three challenges mentioned above. It also examines how the post-Bretton Woods era has accentuated these challenges. On the basis of this analysis, section C evaluates a number of proposals for a comprehensive reform of the existing IMS that would lead to a new, centrally administered IMS, as well as some more incremental changes which might be easier to implement. The discussion of such incremental changes includes proactive measures that developing countries could take to better attain their developmental goals. The ways in which greater regional monetary cooperation could help deal with the contractionary bias of the IMS and provide stepping stones for more comprehensive reforms in the future are also discussed. Section D summarizes the main conclusions and sets out a policy agenda.

B. The international monetary system: Main challenges and evolving responses

Any international monetary system will face the three challenges noted above. The prevailing global economic and institutional situation determines how these challenges manifest themselves, as well as the nature and effectiveness of the responses to them. This is the focus of this section.

1. *The gold standard and the Bretton Woods system*

The classical gold standard, which lasted from around 1880 to the beginning of the First World War, supposedly managed these three challenges by linking the provision of global liquidity to the physical availability of gold, and making prices adjust to changes in the domestic stock of gold that resulted from movements on the current account. However, its actual functioning did not depend on the automatic working of the “price specie flow” mechanism that was designed to ensure symmetric adjustment; rather, it depended on the dominant role played by the United Kingdom as the major source of global capital flows at that time and the entrepot for world trade, and therefore by the set of commercial, financial and political networks centred on the City of London (see Triffin, 1961; de Cecco, 1974; Panic, 1992; and Eichengreen, 1992). This enabled a period of relative economic stability in the global economy, along with large cross-border flows of capital (and people) and expanding trade flows. However, stability was concentrated in countries that came to constitute

the “core” of the world economy. Continuous capital flows from the United Kingdom ensured that some countries, such as the United States, could run large current account deficits for prolonged periods, while developing countries with current account deficits experienced much greater volatility of capital flows and more damaging adjustment because surplus countries did not feel the pressure to adjust. The system collapsed on the eve of the First World War, by which time it was evident that the major economies – and particularly the United Kingdom – had not adhered to the rules and had expanded their domestic monetary base far beyond what was justified by their gold holdings.

Efforts to re-establish gold standard arrangements after the First World War confronted the dual problems of higher nominal prices resulting from wartime inflation and the shifting positions of creditors and debtors. This affected the ability of the United Kingdom to take on the mantle of global economic leadership. With the burden of adjustment falling heavily on the deficit countries, including the United Kingdom, this system proved to be impossible to maintain. The United Kingdom moved to the massively over-valued pre-war exchange-rate parity in 1925, and was eventually forced to exit from the gold exchange standard in 1931. It also meant that the surplus countries provided no expansionary impulse to the world economy that could have offset the contractionary measures that the other countries were obliged to adopt as a result of the decline in their gold stocks. The combination of these factors had a huge contractionary effect on the world economy that contributed

The Bretton Woods conference aimed at a system that would prevent the restrictive trade practices and competitive devaluations of the interwar period.

to the Great Depression, leading to sharp price falls and the threat of debt deflation (Eichengreen, 1992).

Instead of engaging in expansionary macroeconomic policies in a coordinated way, many countries responded to this by abandoning the gold-exchange standard and devaluing their currencies in an effort to boost net exports, and by resorting to protectionist measures to restrict imports. However, one country's additional exports are another country's additional imports. Thus the net effect of such a beggar-thy-neighbour policy was heightened volatility of both the exchange rate and output, which depressed international trade and exacerbated the fall in global demand.

Finding an international system that would prevent the restrictive trade practices and competitive devaluations of the interwar period was a key objective of the Bretton Woods Conference in 1944. Conference participants also sought to eliminate gold as the monetary base and determinant of exchange rates, and discussed whether and how the burden of adjustment should be shared more equally between surplus and deficit countries.

As is well known, the post-war IMS that emerged from the Bretton Woods Conference largely followed the wishes of the dominant creditor country, the United States. Its main feature was a grid of fixed exchange rates between the dollar and all other currencies, combined with the possibility for central banks to convert dollars into gold at a fixed parity of \$35 per ounce. The exchange-rate parities could be changed only in cases of fundamental disequilibrium, thereby preventing the competitive devaluations that took place during the interwar period. However, this also implied that adjustment through prices (i.e. exchange-rate changes) rarely occurred,⁴ taking place instead through changes in quantities (i.e. changes in domestic demand).

The system also sought to limit the size of external imbalances, and thus the need for capital flows to finance external deficits. This was achieved by providing loans to deficit countries out of national currencies contributed to the newly established IMF by its members, subject to conditions determined by the IMF's Board of Governors. However, because these conditions would only apply to deficit countries requesting assistance, and because IMF loans to deficit countries were accompanied by strict policy conditionalities, including requirements for currency

devaluation and monetary and fiscal contraction, the system exhibited a contractionary bias at odds with the original intention of the architects of Bretton Woods.

By the early 1960s, the stock of foreign-held dollars started to exceed the value of the United States' gold holdings in terms of its declared parity of \$35 per ounce. This gave rise to what is known as the "Triffin dilemma": should the United States no longer provide dollars to other countries, global trade and income would risk stagnation, but if it continued lubricating trade and growth through an unlimited provision of dollars, confidence in its commitment to convert the dollars into gold at the fixed price would be eroded. One attempted solution to the Triffin dilemma was the creation of an artificial currency known as Special Drawing Rights (SDRs), which has given central banks the right to obtain dollars or other internationally widely used currencies from the IMF without conditions attached. These SDRs were intended to be used by countries to support their expanding trade and payments without requiring the creation of additional dollars. But when these units finally became available in January 1970, this reform proved to be too little, too late.

2. The post-Bretton Woods era

The United States unilaterally suspended the convertibility of the dollar into gold on 15 August 1971. The Bretton Woods system of fixed exchange rates finally collapsed in 1973, and flexible exchange rates became the norm, with the IMF's Articles of Agreement amended to legitimize floating exchange rates.⁵ At the same time, the IMF was called upon to "exercise firm surveillance over the exchange rate policies of members" with a view to preventing competitive depreciations and sustained undervaluation, while making the adjustment mechanism more symmetrical.

In addition to the abandonment of dollar convertibility into gold and the adoption of widespread floating, the other core characteristic of the post-Bretton Woods era is a change in the modalities under which liquidity is provided. The growing role of often short-term private international capital flows as a complement to liquidity supplied through current account deficits of the United States has implied that

the provision of global liquidity is no longer limited to what may be called “official liquidity”, i.e. “the funding that is unconditionally available to settle claims through monetary authorities” (BIS, 2011: 4). Official liquidity can be mobilized from accumulated foreign-exchange reserves, from swap lines between central banks, and from the IMF through SDR allocations or loan agreements. It can be and has increasingly been augmented by “private liquidity” resulting from cross-border operations of financial institutions, such as banks, and non-financial institutions, such as enterprises that provide cross-border credits and/or foreign-currency-denominated loans.⁶ This has effectively meant the merging of the international monetary and financial systems.

The combination of floating exchange rates and the gradual liberalization and increasing role of international capital flows in the provision of international liquidity was expected to reduce the pressure on deficit countries to make adjustments through changes in quantities (i.e. reduced domestic demand), giving greater weight instead to adjustment through prices (i.e. exchange rate changes), including through currency appreciation by surplus countries. This was considered particularly important in the context of substantially greater international capital flows following the sharp increase in oil prices. It was also expected that these market-friendly mechanisms would discourage countries from accumulating ever-increasing official reserves, while according each country the necessary autonomy to pursue its domestic macroeconomic policy goals.

However, contrary to these expectations, the post-Bretton Woods era has seen recurrent and significant exchange-rate swings, large payments imbalances and growing reserve holdings. Moreover, the new elements of the IMS have failed to remove the contractionary bias associated with the greater pressure on deficit than on surplus countries to adjust payments imbalances, and the liberalization of international capital flows has introduced new forms of instability associated with the inherent volatility and procyclicality of private capital flows.

Prior to the global financial crisis that began in 2008, bank loans constituted the bulk of dollar credit.

Short-term private international capital flows have assumed a growing role in the provision of international liquidity, and make it procyclical and unstable. ...

European banks (mainly from France, Germany, Switzerland and the United Kingdom) accounted for one third of the global dollar banking market, as they searched for (supposedly) safe assets with minimum capital requirements, such as the asset-based securities issued by United States banks (Borio et al., 2014). This may also indicate that the role of European banks in financing the pre-crisis credit boom in the United States exceeded that related to developing countries’ accumulation of foreign exchange reserves in the form of United States Treasury securities, despite these countries’ often large trade surpluses. Since the crisis, by contrast, most of these dollar credits have been in the form of bonds issued by firms and governments other than those of the United States. A recent evaluation by McCauley et al. (2015) estimates that the dollar credit to non-financial borrowers outside the United States, comprising outstanding bank loans and bonds, amounted to \$8 trillion in mid-2014, equivalent to 13 per cent of global output excluding that of the United States.⁷ This amount of offshore dollar credit considerably exceeds its euro and yen counterparts that total \$2.5 trillion and \$0.6 trillion respectively. Another notable feature is the considerably faster

expansion of dollar credit to borrowers outside the United States relative to that of domestic credit, both between 2005 and the onset of the financial crisis, as well as since 2009.

There are several consequences of this surge of privately created global liquidity. First, the provision of international liquidity has become procyclical and unstable as private capital flows are subject to global financial cycles driven by push factors, such as financial investors’ search for higher yields, their capacity to leverage, and advanced countries’ monetary policy decisions. The share of total private international capital that flows to an individual country is influenced by that country’s pull factors, such as its growth expectations and external financing needs, as well as by the openness of its capital account (e.g. Rey, 2013; Ghosh et al., 2014). In boom periods, private liquidity creation will augment official liquidity. In crisis periods, by contrast, financial investors’ risk appetite and capacity to leverage tend to decline causing a slump in the availability of private international liquidity. This procyclicality of private capital flows poses the

risk that when countries face the most severe liquidity shortages, the provision of international liquidity shrinks, leaving mainly its official component intact.

Second, the increased provision of private liquidity implies that countries with current account deficits can avoid adjustment as long as they can access sufficient private lending. But this is often at the expense of aggravating procyclical pressures and disconnecting exchange-rate movements from underlying fundamentals. Unless capital inflows are contained or central banks intervene in currency markets to prevent the capital inflows from causing an appreciation of their currency, there are no economic or institutional mechanisms that would limit this self-reinforcing process leading to growing trade deficits and capital inflows, other than the confidence of global financial markets in the sustainability of the process – which eventually vanishes.

Third, gross capital flows are more relevant than net flows (or developments in the quantities and prices of traded goods and services) in explaining balance-of-payments crises. They also affect current account balances, since large gross asset and liability positions generate significant investment income flows. Their net impact on the current account tends to be negative for developing countries, owing not only to financial liabilities being, in general, larger than assets, but also to the difference between the interest rates paid and earned.

Moreover, if gross inflows stop suddenly and gross outflows surge simultaneously, a country will experience an adverse shock in terms of net capital flows, which is equivalent to a deterioration of the current account in terms of causing exchange rate changes. These changes can be particularly damaging if there are large currency mismatches in balance sheets; and sharp declines in the exchange rate in turn can result in increased debt servicing difficulties and defaults. This will be the case, in particular, when such balance-sheet mismatches occur in the private sector for which foreign-exchange reserves cannot be readily mobilized to compensate for liquidity shortages.

Since the 1970s, there has been a sequence of financial crises in emerging market economies that

were closely linked to sudden changes in the direction of private capital flows (see chapter II). This experience led financially integrated developing countries to accumulate official liquidity in the form of foreign-exchange reserves for two reasons: first, as a form of self-insurance in order to compensate for eventual liquidity shortages arising from a sudden stop and reversal of capital flows; and second, as a by-product of intervention in foreign-exchange markets designed to avoid currency appreciation resulting from capital inflows that are unrelated to the financing of imports. This means that reserve accumulation can to a large extent be considered a policy measure aimed at mitigating adverse effects on the domestic economy emanating from procyclical international capital flows.

A related objective of this strategy is to avoid reliance on the IMF in crisis situations, given the severe macroeconomic contraction caused, to a significant extent, by policy conditionality attached to IMF loans. Such conditionality is often based on an inappropriate assessment of the underlying problem, as also recognized by the IMF itself (*TDRs 2001 and 2011*; IMF, 2011a).

The accumulation of foreign-exchange reserves can also reflect non-precautionary motives, such as a country's choice of exchange-rate regime and specific macroeconomic strategies. This has played an important role for those countries that support domestic growth through net export promotion and rely on intervention on foreign-exchange markets to maintain external competitiveness. Such export-led growth strategies have sometimes resulted in large current account surpluses.

The total holdings of foreign-exchange reserves have grown sharply since the beginning of the millennium, amounting to almost \$12 trillion in 2014 (chart 3.1). Developing countries accounted for most of the increase, which was particularly large in China. In 2014, China held about one third of the world's total foreign-exchange reserves and roughly 45 per cent of those of developing countries.⁸

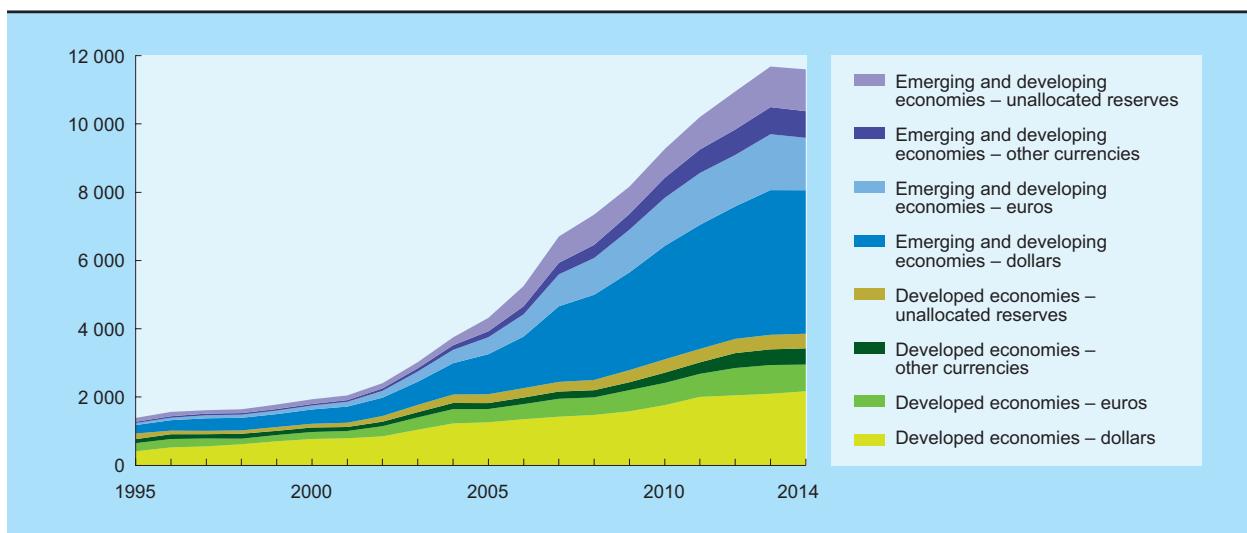
These reserve stocks have sometimes been judged "excessive" based on conventional measures, such as the levels needed to counter fluctuations

... In response, developing countries are seeking to accumulate sizeable foreign-exchange reserves for self-insurance. ...

Chart 3.1

**FOREIGN EXCHANGE HOLDINGS OF SELECTED COUNTRY GROUPS,
BY CURRENCY DENOMINATION, 1995–2014**

(Billions of current dollars)



Source: UNCTAD secretariat calculations, based on IMF, 2015a.

Note: Since data for the composition of China's foreign-exchange reserves are not publicly available, in the chart those reserves have been allocated for the entire period based on estimates for 2014 (*Financial Times*, 15 April 2014), with about two-thirds in dollars, a quarter in euros, and the rest in other currencies.

in export earnings or to roll over short-term (up to one year) external debt (the so-called “Guidotti-Greenspan” prescription of reserve adequacy). However, empirical estimates suggest that financial openness, desired exchange-rate stability and the size of the domestic banking system are additional considerations in determining the adequacy of reserves. In crisis situations, policymakers attempting to avoid or mitigate currency depreciation may need to counter a large and sudden withdrawal of liquid domestic deposits (i.e. “sudden capital flight”) in addition to stemming depreciation pressure from sudden stops and reversals of foreign financial inflows. This implies that a determination of reserve adequacy differs by the type of economy.⁹ For financially integrated developing economies, reserve adequacy may be determined by the Guidotti-Greenspan rule, as well as by the size of broad money as a potential source of capital flight by residents. For countries such as many least developed countries (LDCs), which are less integrated in global financial markets, the traditional trade-related rules remain practical starting points beyond which country-specific factors determine precise assessments. In developed

economies, reserve adequacy will depend on whether they have ready access to other sources of official international liquidity for these purposes (such as through standing foreign currency swap arrangements among central banks, as discussed in the next section). Otherwise, they need to rely on reserves to lower the risks to bank and non-bank balance sheets resulting from shortages in dollar liquidity and related dysfunctioning of their foreign-exchange markets, as well as to contain adverse effects once such situations occur (for further details, see, for example, IMF, 2015b).

The large size of countries’ foreign-exchange reserves has given rise to a new form of the Triffin dilemma. The original dilemma was linked to the size of official dollar reserves and the confidence of their holders that the United States could convert these holdings into gold at the fixed price. The new form of the dilemma refers to the combination of two mechanisms: first, the persistent accumulation of foreign-exchange reserves is associated with the continued purchase of supposedly safe assets in the form of government securities in the reserve-currency

countries; and second, this requires confidence of the holders of these foreign-exchange reserves that Treasury securities and reserve currencies will not depreciate, as this would imply a decline in the purchasing power of their reserves (Aglietta and Coudert, 2014).¹⁰ In the medium to long run, the status of the dollar as the main international currency will partly depend on the future fiscal policies and performance of the United States and other significant economies (Eichengreen, 2011), and partly on the availability of alternatives that could challenge its role.

Such alternatives are not yet evident. The global financial crisis that began in the United States in 2008 may have been expected to seriously challenge the dollar's international role.¹¹ Yet the dollar's predominance as an international currency remains intact, and has, if anything, actually strengthened since the onset of the crisis (e.g. Prasad, 2013). There has been no discernible diversification away from the use of the dollar in the invoicing of international trade (Goldberg and Tille, 2008; Auboin, 2012).¹² Moreover, it has maintained its dominance in foreign-exchange markets, as it continues to be used in over 85 per cent of foreign-exchange transactions worldwide, either on both sides of the transactions or in exchanges between the dollar and other currencies (BIS, 2014; Goldberg, 2011).¹³ The dollar also continues to be the central currency in the exchange-rate arrangements of many countries, and is still dominant in central banks' foreign-exchange reserves, accounting for roughly two thirds of their reported composition in

both developed and developing countries (chart 3.1). Moreover, the dollar remains the major currency used in international capital markets.

To sum up, this section suggests that the current dollar standard is both unstable and inequitable. The combination of widespread floating and the sizeable role of private international capital flows in the provision of international liquidity, with macroeconomic policies largely based on national priorities, has been accompanied by wide swings in the availability of international liquidity and the accumulation of often wide external imbalances whose adjustment has generally occurred through crisis. Hence, the current system has failed to provide a reasonable level of global macroeconomic and financial stability. Financially integrated developing countries have chosen to address this shortcoming through the accumulation of substantial foreign-exchange reserves, in spite of the associated transfer of resources to reserve-currency countries that makes the system highly inequitable.¹⁴ The accumulation of large external imbalances – frequently associated with

volatile capital flows – and their disorderly unwinding point to the need for imposing limits on the size of such imbalances. They also suggest the need for globally more efficient forms of foreign-currency-denominated liquidity provision, especially in crisis situations, to complement – and eventually replace – large holdings of foreign-exchange reserves held for precautionary purposes. These aspects are examined in the next section.

... However, the associated resource transfers to reserve-currency countries make the IMS highly inequitable.

C. Reforming the international monetary system

The many existing proposals for reforming the IMS generally exhibit an inverse relationship between comprehensiveness and feasibility. This is particularly true of proposals that aim to take the IMS back to a more rules-based and multilaterally coordinated system designed to address all of the three challenges mentioned in the introduction. Most of these proposals have a long history, and surface periodically after every major international financial crisis. This is not surprising. Indeed, they serve as a benchmark for more incremental but feasible reform measures that may achieve consensus in the near term. A related question is whether the current unsatisfactory global economic situation will improve the chances of political acceptance of comprehensive reforms and produce the high degree of multilateral agreement and macroeconomic policy coordination they would necessitate.

This section starts by discussing some of these comprehensive proposals. It then focuses on a second category of less ambitious proposals, but which could be more easily implemented. This second category generally considers reforms which, in addition to increasing the supply of safe assets, and especially the availability of official liquidity during periods of crisis, should aim at curbing the role of short-term private capital flows in providing international liquidity. This would reduce both the demand for foreign-exchange reserves and the accumulation of unsustainable current account imbalances. Such reforms also seem well-suited to be combined with measures designed to increase the contribution of surplus countries to adjustment. Various possibilities at the regional level or across groups of countries, such as liquidity provision, policy surveillance and mechanisms for the sharing of the burden of adjustment, are also considered. Adopting such measures at the regional or interregional level may be an

improvement on the current system that subjects developing countries to disorderly adjustment pressure and requires them to hold large foreign exchange reserves, thereby exposing them to the system's inequity. These proposals for greater regional monetary integration among developing countries might be more politically feasible at the present juncture than comprehensive global reforms, while also preparing the ground for global reforms in the future.

This section does not aim at providing a blueprint for a new IMS; rather, it examines how features of existing proposals address the three eternal challenges of an IMS. It also discusses what conditions would need to be met in order for these proposals to be implemented so as to lay the foundations for global macroeconomic and financial stability.

1. *Creating a new global monetary order*

Proposals for a new global monetary order often emphasize the need for a world currency, and usually start from the premise that the managed floating regime of the post-Bretton Woods era has not lived up to expectations. Extreme exchange rate gyrations have been identified as a major systemic defect, posing a constant threat to the smooth expansion of global trade and incomes (Mundell, 2012).

Creating a world currency is seen by some (e.g. Mundell, 2012) as following a natural sequence, from establishing target zones for the three main reserve currencies, followed by a multi-currency monetary union which would lock in exchange rates, fix an inflation target, establish a joint monetary policy committee and create an arrangement for the

coordination of fiscal policies, to a world currency initially representing a weighted basket of the three main currencies, but gradually extended to other countries.¹⁵ Lin (2013) has presented an alternative proposal for a world currency, whereby the supply of the newly created global currency would be governed by an international treaty and augmented according to some well-defined rule. It would be combined with a system of fixed, but adjustable, exchange rates between the global currency and all national currencies.

While recognizing that similar proposals have had limited traction in the past, their supporters argue that both the increased frequency of currency crises and the declining weight of the United States in the world economy could convince countries that such a reconstructed IMS would be in their own interests as well as in the interest of global economic stability (Mundell, 2012).

The adverse effects of exchange-rate misalignments on trade flows have also given rise to proposals for multilateral exchange-rate coordination. Such proposals may simply mark a step towards a world currency (i.e. the first stage in the scheme advanced by Mundell). But to the extent that such aspirations seem difficult to fulfil, searching for an appropriate system of exchange-rate management constitutes a reform agenda in itself.¹⁶ This is particularly true if exchange-rate policy coordination follows rules that prevent the accumulation of large external deficits resulting from cross-country price and cost differentials. Thus, the main objective would be to design an exchange-rate system that aims at stable real exchange rates and global macroeconomic stability (*TDRs 2009 and 2011*).

Focusing international policy coordination on exchange-rate management has some advantages. For example, it can rely on countries' obligations under Article IV of the IMF's Articles of Agreement to collaborate with a view to "assuring orderly exchange arrangements" and "promoting a stable system of exchange rates". Moreover, multilaterally agreed exchange rates would provide a consistent set of multilaterally agreed external positions of individual

countries. Indeed, the few instances of effective international policy coordination have been mostly associated with correcting exchange-rate misalignments, such as through the Plaza Agreement and the Louvre Accord in the 1980s. However, any coordi-

nation of exchange-rate policies will invariably face significant problems in defining the criteria to be used both to set the initial target rates and to change them, in identifying the causes that underlie any wide divergence of actual from targeted rates, and in determining whether targets

should be adjusted.¹⁷ In addition, there is also tension between the loss of policy autonomy to which policymakers would need to agree, and the degree of policy coordination required to maintain the exchange rates within a band that provides reasonable exchange-rate stability. The absence of regulations on international capital movements would make such coordination difficult if not impossible. Moreover, the current simultaneous attempts by many central banks to engineer currency depreciations suggest that the exchange rate remains a major policy tool used predominantly to support national economic interests.

The drying up of private liquidity during financial crises and constraints on the rapid provision of official liquidity for emergency finance have led to renewed interest in moving towards a more diversi-

fied IMS. This would entail the current dollar standard being replaced by a multi-currency system, with a range of international currencies – such as the dollar, the euro, the renminbi and possibly other currency units – playing a more important role. Some observers believe

such a system would offer several advantages (see, for example, Farhi et al., 2011; Lee, 2014) in terms of more elastic liquidity provisioning and easing the Triffin dilemma. They suggest it would provide alternatives for countries to diversify their foreign-exchange reserves, exert greater discipline on the policies of the reserve-currency countries and prevent their issuers from abusing the supposed exorbitant privilege of issuing a reserve currency to bolster narrow national interests over broader global interests. In addition, rejecting the idea of network externalities in the use of just one international currency, a

There is an inverse relationship between comprehensive and feasible reforms.

New multilateral arrangements remain the long-term objective of any comprehensive reform.

multi-currency system may be economically more efficient, because using multiple currencies would better match economic transactions between currency blocks, resulting in savings on transaction costs. As pointed out by some authors, history has seen many episodes of coexisting international currencies (e.g. Eichengreen, 2005).

Others have noted that any central bank that issues an international currency takes decisions based solely on national concerns, rather than concerns related to the needs of the international payments system and the world economy. This problem also exists in a multi-currency system. Moreover, the supposed disciplining effect from currency competition can occur only if there is close substitutability. But if this is the case, there is the risk of abrupt and substantial exchange-rate changes, not only in the transition period, when central banks will diversify their reserve portfolios, but also once such a system has been established. This is because a multi-currency system would increase the risk that, when confronted by or in anticipation of any event that might adversely affect the value of their portfolios, reserve-currency holders would try to rapidly convert their holdings from one currency into another ahead of other holders. This conversion could be interpreted by the other holders as signalling an imminent crisis and cause them to rapidly convert their own portfolios as well. The overall result would be substantial volatility in the exchange rates of the reserve-currency countries.

In addition to querying the systemic stability of a multipolar monetary system, there would be the question of which currencies would combine with the dollar. Market forces play an important role in the increased use of a currency as an international currency, though policymakers have at times tried to foster, or hinder, the use of their country's currency in such a way (Roosa, 1982).¹⁸ More recently, and especially until the beginning of the euro crisis in 2011, the euro appeared to be a serious challenger to the dollar's dominant position as an international currency. This challenge was based on the economic size of the euro area, which is comparable to that of the United States, as well as the amount of its global exports. Moreover, the euro area has well-developed

financial markets with banks that operate internationally. On the other hand, while the euro area possesses an ample stock of government debt securities, the euro is backed by a heterogeneous group of countries that are united by a loosely structured federal arrangement, and there is no homogeneous market for government debt securities. Moreover, the Stability and Growth Pact and the exclusive focus of the mandate of the European Central Bank (ECB) on price stability hinder member States from undertaking the kind of expansionary macroeconomic policies that reserve-currency countries might need to offset the adverse output and employment effects arising from the current account deficits associated with other countries' demands for safe assets in the form of government securities. This presents a serious challenge, especially because of the current lack of economic dynamism in the euro area.

The drying up of private liquidity during crises and constraints on the rapid provision of official liquidity for emergency finance have renewed interest in a more diversified IMS.

ly promoted by the Chinese Government, partly in reaction to the slow pace of Asian regional financial cooperation and the international community's apparent lack of interest in reforming the IMS, as well as to avoid significant capital losses in their country's foreign-exchange reserves (Yu, 2014).¹⁹ Moreover, China is starting to reap the associated benefits of the renminbi's internationalization, including lower transaction costs in trade and a reduced need for accumulating additional foreign-exchange reserves. It is worth noting in this context, that in its quinquennial SDR review scheduled to take place in late 2015, the IMF Board of Governors will consider including the renminbi in the currency basket that forms the SDR. This will require an evaluation of whether the renminbi is being sufficiently widely used, and whether it is "freely usable" (Zhou, 2015; IMF, 2011b).

Nevertheless, it is widely believed that promoting renminbi internationalization while avoiding an undue increase in China's exposure to financial instability faces challenges. It will require the relaxation of foreign-exchange controls and further domestic financial market reform, promoting capital account convertibility,²⁰ greater exchange-rate

flexibility, market determination of interest rates and the commercialization of banks, as well as effectively addressing high corporate and local-government debt (Eichengreen, 2011; Yu, 2014).²¹ Thus, while renminbi internationalization is a long process, there can be little doubt that the continuing increase in the weight of China in the global economy is pushing in this direction.²²

Given that introducing a global currency may be a project for the very long term, and that the move towards a multi-currency system may not improve global financial stability, and in any case it would be a gradual and time-consuming process, the proposal to give the SDR a more prominent role in the IMS, initially discussed in the 1960s, has received new impetus. The idea of replacing the dollar with the SDR as the global international currency has been promoted, in particular, by the Governor of the People's Bank of China (Zhou, 2009), by a United Nations commission (United Nations, 2009) and also by a number of academics (e.g. Kenen, 2010a; Ocampo, 2011 and 2014).

Similar to advocates of a multi-currency system, proponents of an SDR-based system also argue that this would impose a greater degree of policy discipline on the United States, thus helping to promote global macroeconomic stability. Depending on how SDRs would be issued, an SDR-based system would also curb the need for reserve accumulation for self-insurance purposes, thus helping to cut the cost of holding borrowed reserves, and reduce the current system's bias in favour of the reserve-currency country. What is more, an SDR-based system would address the Triffin dilemma. It would delink the provision of official international liquidity from any national issuer, and the creation of a real alternative to national currencies as reserve assets would allay the concerns of holders of large foreign-exchange reserves about maintaining the purchasing power of their reserves. Also, since SDRs are based on a currency basket,²³ diversification out of dollar-denominated assets would entail much smaller exchange-rate fluctuations than a move towards a multi-currency system, thereby minimizing the threat to international financial stability.

A greater international role of the renminbi is a logical corollary to China's growing global economic weight in the long run.

On the other hand, moving towards an SDR-based IMS involves several technical and institutional challenges, including how SDRs would be issued, how the diversification away from dollar-denominated reserve assets would be managed, and how the required institutional changes would be handled (United Nations, 2009; Ocampo, 2011; and Erten and Ocampo, 2012).²⁴ In order to support the sustained expansion of international transactions, the IMF would need to be empowered to issue SDRs more frequently than under the current regular five-year reviews, whereby SDRs are allocated to

meet long-term global needs to supplement existing reserve assets. More regular allocations according to member States' quotas could be done, as currently, based on estimations of global demand for reserves (IMF, 2011a), but making them much larger²⁵ and more frequent, or by allocating to developing countries a larger share than their quotas.²⁶ Moreover, to avoid using SDR allocations as a substitute for needed adjustment while ensuring the availability of official liquidity as a form of emergency finance in times of crisis, the IMF could be empowered to issue SDRs in a countercyclical way, such as by increasing allocations at times of global financial stress and partly withdrawing such allocations once financial conditions normalize.²⁷ However, given that the demand for official liquidity for crisis-related emergency finance mainly emanates from developing countries and that the IMF's quota system is heavily skewed in favour of

Despite all its deficiencies, the dollar standard is likely to remain for the foreseeable future.

developed countries, this would require a substantial revision of quotas. In the light of continuing delays in the implementation of the quota reform in 2010, which awaits ratification by the United States Congress, this is unlikely to happen in the near future.²⁸

To further reduce exchange-rate volatility that might occur by moving out of official dollar-denominated reserve assets into SDR-denominated reserves, the diversification could be managed through a so-called "substitution account", as suggested in the debate on IMS reform during the 1970s. This would be under the auspices of the IMF and used by member States' central banks and governments to deposit some or all of their dollar reserves, obtaining

in exchange claims denominated in SDRs.²⁹ Moving towards an SDR-based IMS would also involve eliminating the Fund's distinction between its so-called general resources, which have been based on member States' national currencies, and the SDR accounts. Since any SDR represents a potential claim on some currency, an SDR must be underwritten by the central banks that issue the currencies included in the basket that make up the SDR. However, none of the underwriting central banks can determine the currency on which the SDR holder's claim will be exercised. This loss of control over money creation could well be difficult for any central bank to accept.

Enlarging the international role of SDRs and changing the rules for their issuance to meet more flexibly the economic needs of member countries, instead of reflecting the existing quotas, would be a major reform. In the light of continuing delays in the implementation of a comparatively marginal adjustment, such as quota redistribution, moving towards an SDR-based system poses economic and political challenges that may make it difficult to implement.

2. Reforming the dollar standard

Between the early 1990s and the early 2000s, a number of developing countries experienced boom-bust cycles of private international capital flows that precipitated a series of balance-of-payments crises in these countries, as discussed in chapter II. The Asian financial crisis in 1997–1998, in particular, triggered a debate on what system of global governance was compatible with flexible exchange rates and large-scale private capital flows, and what role the IMF should play in such a system (*TDR 2001*). Given that proposals designed to regulate and stabilize international capital flows were summarily dismissed from the outset, the outcome of this debate emphasized national policy measures that provided self-defence mechanisms combined with the creation of precautionary “pre-crisis” lending facilities at the IMF.

Since capital flows largely respond to conditions in developed-country markets, effective self-defence mechanisms in developing countries have mainly focused on the accumulation of foreign-exchange reserves. The new approach to IMF lending was designed to reduce the vulnerability of members to

the contagion effects from capital account crises in other countries through ostensibly “sound policies”. The IMF made available pre-committed credits to countries meeting pre-established eligibility criteria to bridge any liquidity shortage that might remain even after using a country's reserves. This was on the condition that potential recipients of such IMF financing would commit to maintaining policies that private capital markets would interpret as a credible defence against a crisis of confidence. However, the creation of new loan facilities for this purpose has had only very limited success. For example, the Contingent Credit Line (CCL) created by the IMF in 1999 remained unused until it was suspended in November 2003, because potential users feared that requesting a CCL loan could signal an impending difficulty that market participants had not detected, and might therefore cause private capital inflows to be withdrawn rather than increased. Similarly the Flexible Credit Line (FCL) adopted by the IMF in 2009 has been used by only three countries (Colombia, Mexico and Poland), despite less stringent eligibility requirements. An additional facility, the Precautionary and Liquidity Line (PLL), was created for countries that have sound policies but are ineligible for the FCL because of certain vulnerabilities – but only two countries (the former Yugoslav Republic of Macedonia and Morocco) have used it (IMF, 2015c and 2015d).³⁰ As a result, other instruments have emerged for the provision of official liquidity during times of market stress, such as currency swap arrangements.

(a) Central bank foreign-currency swap arrangements

Central bank foreign currency swap arrangements have begun to play a crucial role in the provision of emergency liquidity. When the implosion of the United States financial markets eventually led to the global financial crisis in 2007–2008, interbank funding began drying up beyond United States financial markets, and created an acute global shortage of dollar liquidity.³¹ The United States Federal Reserve could use its ordinary facilities to provide liquidity to United States banks, but could not do so for the multinational banks, many of which are based in other developed countries, and which, prior to the crisis, had relied on cheap dollar funding through their operations in the United States. Thus, in December 2007 the United States Federal Reserve started

to engage in currency swap arrangements with a number of foreign central banks. In a sense, these arrangements were the international extensions of the unconventional domestic monetary policy measures that many major central banks adopted at the time, with the crucial difference that the international swap arrangements were undertaken in a coordinated way.

Central bank currency swaps are arrangements between two or more central banks to enable a central bank in one country to provide foreign-currency liquidity to banks in its jurisdiction in the event of a sudden shortage of such liquidity. Given the dominant role of the dollar in global interbank markets, and the fact that most local foreign-currency loans are denominated in dollars, the United States Federal Reserve has been one of the parties involved in many of these arrangements.

Addressing these liquidity problems by using foreign currency swap arrangements and making the United States Federal Reserve the de facto international lender of last resort relied on three main premises. First, central banks can act swiftly; second, they face virtually no limit on their money-creating capacities; and third, the provision of international liquidity through swap arrangements with the central bank that issues the currency in which the liquidity shortage occurs does not cause any exchange-rate effects. If, on the other hand, foreign central banks sell their own currencies to buy, for example dollars on the spot market, the required massive scale of the transaction will exert strong downward pressure on their currencies. This will complicate, rather than facilitate, the securing of the required funding for their commercial banks, as well as creating upward pressure on the dollar, which may destabilize United States financial markets.

Moreover, many central banks, including those from developing countries that had accumulated substantial reserves, were reluctant to use a large amount of their dollar-denominated assets to meet dollar liquidity problems. They were concerned that their reserves would prove insufficient to resolve liquidity

Central bank foreign currency swaps now play a crucial role in providing emergency liquidity ...

... but swap arrangements extended by developed-country central banks mainly cater to developed-country needs.

problems if they started to experience capital outflows, and that using too much of their reserves would instead fuel market uncertainty and accentuate the dollar shortage. Indeed, according to some estimates, the dollar reserves of many central banks at the onset

of the global financial crisis were smaller than the amounts they subsequently borrowed through the swap arrangements. Thus their reserves alone would not have been sufficient to reduce funding pressure on financial institutions and improve the functioning of interbank lending

and credit markets during times of market stress (Obstfeld et al., 2009).³² Moreover, the United States Federal Reserve was conscious of the fact that a massive selling of Treasury securities by foreign central banks was likely to add to financial turmoil in United States financial markets.

According to some observers (e.g. Allen and Moessner, 2010; Bordo et al., 2014), the counterparts involved in these swap arrangements (most notably the ECB) were chosen because of their size and the potential spillover effects that serious banking crises in their jurisdictions could have on global financial markets.³³ From this perspective, the swap lines extended by the United States Federal Reserve represent a case of successful cooperation between central banks in addressing global concerns. Others (e.g. Aizenman and Pasricha, 2010; Prasad, 2013), on the other hand, argue that cooperation merely stemmed from coinciding interests under the special circumstances that prevailed at the time, and that the chosen countries had banking systems with a sizeable stock of liabilities owed to the United States' banking system, as well as a good sovereign credit history.

This might be taken to mean that extending the swap arrangements was in the interest of the United States, and served simply to control a situation that may have posed a systemic risk to that country's banking system.

The People's Bank of China (PBOC) did not request a swap arrangement with the United States Federal Reserve because it had access to a very substantial amount of dollar reserves, which some

estimate to have totalled \$3.8 trillion, or roughly one third of the world's total, in April 2014 (Aizenman et al., 2015). Moreover, Chinese banks are funded mainly from domestic sources, with few international operations that would require dollar-denominated liquidity.

Instead, the PBOC itself established currency swap arrangements with a wide range of other central banks, mostly from developing countries.³⁴ But it is generally believed that the main objective of these arrangements has not been to address the problem of liquidity shortages, but rather to foster the internationalization of the renminbi by increasing the share of China's trade invoiced and settled in renminbi (PBOC, 2012: 68), perhaps with a view to eroding the network externalities that have helped maintain the dollar's predominant role as an international invoicing and settlement currency.³⁵ These longer term objectives of the currency swap arrangements extended by the PBOC are also reflected in their duration of three years with the possibility of renewal, as well as their denomination in renminbi which differs, for example, from the PBOC's swap arrangements under the Chiang Mai Initiative Multilateralization that are denominated in dollars and serve to strengthen the defences of member States during financial crises, as discussed below.

Of particular interest in the context of this chapter may be the PBOC's currency swap arrangement with Argentina signed in July 2014, which enables Argentina's central bank to exchange the renminbi it receives (against Argentine pesos) through the swap into other currencies, including dollars, if necessary. This amounts to adding renminbi to Argentina's foreign-exchange reserves as if they were dollars. These "vouchers" for dollars thus free up Argentina's actual foreign-exchange reserves for its immediate needs.³⁶ In a sense, this swap arrangement enables Argentina to tap into China's very sizeable dollar reserves for its own foreign exchange liquidity requirements. While these arrangements may closely resemble foreign-currency loans, they nonetheless can help deal with

episodes of capital flow volatility and stabilize the foreign exchange market in times of stress.³⁷

Other currency swap networks have sprung up involving the central bank of a major economy in a specific region and a number of central banks in smaller neighbouring countries. For instance, some European countries that are not members of the euro area (such as Denmark, Hungary, Poland and

Sweden) which suffered from euro liquidity shortages benefited from swap arrangements with the ECB, while the Swiss National Bank extended swap arrangements to the ECB and to the central banks of Hungary and Poland that were suffering from liquidity shortages in Swiss francs. In Asia, China

and Japan established arrangements with Indonesia and the Republic of Korea, as well as with a number of other countries. What is more, these regional networks have been used not only for regionally dominant central banks to provide liquidity in their currencies, but also to redistribute dollars to central banks that could not get direct access to dollar liquidity through the United States Federal Reserve. An example is the swap arrangement between the Bank of Japan and the Reserve Bank of India.³⁸ But such swap lines have been much smaller in size and ultimately temporary, and at present they do not offer adequate emergency finance to those countries that are likely to need it the most.

The lack of decisive reform continues to encourage developing countries to accumulate more reserves ...

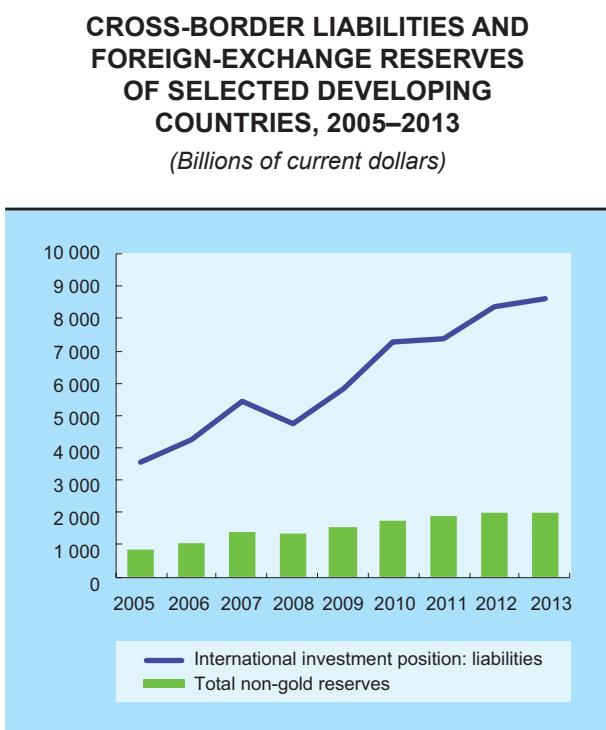
... but this implies serious risks for those countries themselves and for the global economy.

All of the swap lines established by the United States Federal Reserve in 2007–2008 expired, as scheduled, in February 2010. But the arrangements with five central banks (i.e. the Bank of Canada, the

Bank of England, the Bank of Japan, the ECB and the Swiss National Bank) were made permanent in October 2013. Given that these central banks established temporary swap arrangements with each other in 2011, when the euro crisis began to threaten the functioning of glob-

al financial markets, lenders could access emergency liquidity in these six international currencies. As a result, central bank swap arrangements have now become part of the IMS, and finance the bulk of lender-of-last-resort liquidity provisions of foreign central

Chart 3.2



Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database.

Note: The country sample on which the reported data are based comprises: Argentina, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, Egypt, El Salvador, Guatemala, India, Indonesia, Jamaica, Jordan, Malaysia, Mexico, Morocco, Pakistan, Panama, Peru, the Republic of Korea, South Africa, Thailand, Tunisia, Turkey, Uruguay and the Bolivarian Republic of Venezuela.

banks, while the United States Federal Reserve has become the de facto international lender of last resort.

A systemic question related to central bank currency swaps concerns their relationship with the existing international monetary and financial arrangements. Since swaps can potentially create unlimited amounts of international liquidity, a comprehensive network that gives automatic access to official international liquidity could obviate the need for self-insurance in the form of large foreign-exchange holdings. However, thus far, currency swap arrangements have been limited to countries that have a clearly perceived self-interest in maintaining access to liquidity in the partner country, and therefore a permanent institutional framework for such swaps is unlikely to emerge. Indeed, since the high degree of flexibility and discretion that allow rapid liquidity provision at relatively low transaction

costs are the key characteristics of central bank swap arrangements, their very logic prevents broader institutionalization (Destais, 2014; Sgard, 2015).

An additional systemic question is whether central bank currency swaps have reduced the desire of developing countries to accumulate large stockpiles of foreign-exchange reserves. To the extent that swap lines are rapidly available at times of market stress, central banks can reduce other liquidity buffers, including their reserve holdings. On the other hand, large reserve stocks may be required to reduce a lending central bank's sovereign credit risk and make swap lines accessible. And only the combination of secure swap lines and large reserves may contribute to crisis prevention by instilling confidence in the financial markets of a country's liquidity and solvency. Moreover, foreign-currency-denominated debt has increasingly been accumulated by non-financial actors, such as corporations and households, and central banks may be legally prevented from extending the borrowed foreign currency to them. Perhaps most importantly, evidence suggests that, despite the accumulation of significant foreign-exchange reserves by some developing countries, in most countries these are still modest compared with the increase in their external liabilities, and too modest to effectively avert threats to financial instability (chart 3.2). All of this, and especially the fear of exclusion, will continue to encourage countries to accumulate more reserves.

(b) Addressing the contractionary bias of asymmetric adjustment

To date, insufficient efforts have been made to effectively address the IMS' contractionary bias by making surplus countries contribute (more) to global adjustment, rather than leaving virtually the entire burden of adjustment to deficit countries.³⁹

Nevertheless, a number of concrete ideas have been proposed as to how countries with a current account surplus could be made to adjust. These proposals envisage such adjustment taking place either in an automatic or coordinated manner, but always ensuring that global adjustment is compatible with maintaining global aggregate demand at a level sufficient to provide full employment and support the national development strategies of developing countries. For example, countries might intervene in currency markets, limit or tax surplus

countries' holdings of foreign assets (particularly Treasury securities), symmetrically limit the share in GDP of countries' current account surpluses or deficits, or receive authorization from the World Trade Organization (WTO) to impose tariffs or other forms of trade retaliation on exports from surplus countries (for a review, see Williamson, 2011). But there are a range of unresolved questions: who would determine that a country's surplus situation is unacceptable, what would trigger action, how would it be determined that the action is proportionate and, perhaps most importantly, what would induce powerful surplus nations to agree?

The IMS' contractionary bias could also be addressed through more appropriate IMF surveillance through its Article IV consultations. However, it is well known that the IMF exerts its surveillance function in an asymmetric way, as it can meaningfully influence national policies only when a country formally requests financial support and thus becomes subject to IMF conditionality. Thus, IMF directives only affect deficit countries but have little leverage over surplus countries. Moreover, global surveillance procedures have failed to prevent currency turmoil and several international financial crises, particularly the global crisis that began in 2008. The IMF's inability to forestall financial crises and to deal with them, once they occur, has often been due to its inappropriate assessment of the underlying causes. This is partly attributable to its asymmetric surveillance. The IMF considers it necessary to focus its surveillance more on risk spreading and spillovers, as well as on linkages between financial and macroeconomic forces. It also considers it important to streamline its multilateral surveillance messages, such as by delivering more candid and practical advice to systemically important economies, and removing any doubts about the institution's even-handedness (IMF, 2014). While these are worthy intentions, there is no indication that it will go beyond the traditional "naming and shaming" of surplus countries.⁴⁰

Effective international policy coordination would be the optimal way to address the IMS' contractionary bias, but this appears to be very difficult to implement. The limited success of the G-7, and later the G-20, in this regard, as well as much of the initial causes and persistence of the euro crisis,

may be partly attributed to diverging views among policymakers as to the correct approach to adopt for tackling the crisis. They also differ on the extent (and sometimes even the direction) of the impact of

polices, especially fiscal policies (*TDRs 2010, 2012*). With such disagreement, decisions on the appropriate nature of policy coordination and monitoring mechanisms become more difficult. However, it is evident that the absence of such coordination

intensifies the contractionary pressures afflicting the global economy.

To sum up, the steps taken by the international community to reform the IMS have been insufficient for addressing the shortcomings of the current dollar standard. Of specific concern to developing countries is that the provision of international liquidity remains subject to the boom-bust cycles of short-term private international capital flows, and that central bank foreign currency swap arrangements are not effective disincentives to the accumulation of foreign-exchange reserves for precautionary purposes. Moreover, the shortcomings of international policy coordination have failed to address the problem of an unequal sharing of the burden of adjustment among deficit and surplus countries.

3. Strengthening regional and interregional cooperation

Since comprehensive reform of the IMS is not on the immediate agenda, and the measures taken by the international community to address the shortcomings of the current dollar standard remain unsatisfactory, developing countries need to consider what they could do for themselves. One important strategy which individual countries could consider pursuing is to use capital account management as a regular instrument for preventing the boom-bust cycles of international capital flows from exerting pressure on exchange rates and destabilizing financial markets (*TDR 2014*).

There are also ways of dealing with some specific concerns through bilateral, regional and other group-based arrangements that provide

Implementing effective international policy coordination has proved difficult.

some additional access to liquidity both in general and also as emergency finance when required. Recent developments in regional and interregional monetary arrangements have focused increasingly on alleviating adverse impacts of external financial shocks with a view to securing macroeconomic and financial stability within the group. This can be done in a number of ways: establishing payments systems that dampen the volatility of cross-border private capital flows and promote intra-group trade without using the dollar, reserve pooling that makes available short-term finance to facilitate external adjustment, and exchange-rate policy coordination that prevents the accumulation of intraregional imbalances or facilitates their adjustment.⁴¹

Regional payment systems which reduce the number and value of transactions that need to be carried out in foreign currencies are one way to mitigate exchange rate uncertainty and risk. They can also help to promote interregional trade by cutting the transaction costs through the use of domestic currencies in such trade rather than having to change currencies (often several times) against a third, international, currency.

Among developing countries, Latin America has pioneered the implementation of such payment mechanisms.⁴² In 1965, the Latin American Integration Association (LAIA) established the “reciprocal credit and payment agreement” (CPCR – the acronym for its Spanish name) among the member countries’ central banks. It has functioned as a clearing house and a short-term credit mechanism for trade transactions, which includes a clearance period of four months (with central banks assuming the risk of delayed payments) and net settlement in dollars thereafter. It was used a great deal during the 1970s and 1980s at times when access to dollar financing was extremely difficult. At its peak, during the Latin American debt crisis, 80 per cent of intraregional trade was channelled through this arrangement. However, changes in international

financial conditions in the early 1990s meant that it was more beneficial to prepay imports, effectively discouraging the use of this facility. This partly explains the subsequent marked decline in the volume of transactions settled through the LAIA, which fell to barely 5 per cent of intraregional trade (UNCTAD, 2011). Similarly, in 1969 Central American countries founded the Central American Monetary Stabilization Fund in order to finance balance-of-payments imbalances, but its operations were suspended in the mid-

1980s following widespread payment difficulties by the participating central banks (see *TDR* 2007).

Various groups of countries have instituted a number of innovative payment systems since the 2008 crisis years. One of the simplest, the Local Currency Payment System (*Sistema de Pagos en Monedas Locales*, SML), was established between Argentina and Brazil in 2008 for bilateral trade. It enables transactions between exporters and importers in the two countries in local currencies without the intermediation of the dollar, as would otherwise have been the usual practice. The SML is particularly useful for small and medium-sized enterprises, as it obviates their need to access foreign exchange markets, which added significantly to their costs because their low volume of transactions is typically associated with higher per unit costs. Initially, only a small number of transactions took place with a low total value, but use picked up quickly, and by 2013 almost 10,000 Brazilian export operations (Argentine imports) had been carried out through SML. Argentine exporters to Brazil have not been using the system to the same extent, partly because of the arbitrage benefits to them of retaining income in dollars. The system accounts for only 3 per cent of total bilateral

Since comprehensive reforms are not on the immediate agenda and the measures taken by the international community remain unsatisfactory ...

... developing countries need to consider what they could do for themselves at the regional level.

trade, but still clearly benefits smaller firms, almost three quarters of which reported using the system multiple times. Uruguay has recently signed SML agreements with Brazil (in 2014) and Argentina (in 2015), creating the basis for a multilateral system that could be joined by the other countries of the Common Market of the South (Mercosur).

A more complex mechanism established in 2010 is the Unitary System of Local Payments Compensation (Sistema Unitario de Compensación Regional, SUCRE), which is based on a “virtual” regional currency.⁴³ The countries participating in this arrangement are Bolivia (Plurinational State of), Cuba, Ecuador, Nicaragua, Uruguay and the Bolivarian Republic of Venezuela. Like the SML, SUCRE aims to avoid the use of the third-party currency, the dollar, for transactions within the region. It also enables delayed settlements of payments (unlike SML where transactions are mostly settled within 24 hours). Its use has increased rapidly: within four years of its inception it accounted for around 24 per cent of total intra-group transactions (Perez Caldentey et al., 2014). Like the SML, members of the SUCRE use the mechanism to varying degrees, reflecting their different economic structures and size. The Bolivarian Republic of Venezuela has used the system the most, with the SUCRE accounting for 93 per cent of its total intraregional imports in 2012. In contrast, Ecuador has used it for only 7 per cent of transactions and Cuba for about 10 per cent of exports.

Easing electronic payments and creating a more modern system of interregional transactions was the aim of another payment mechanism in Latin America known as the regional interlinked payment system or “Sistema de Interconexión de Pagos” (SIP). Introduced before the economic and financial crisis, this mechanism began with El Salvador (2007) and then gained additional members as the crisis unfolded, including Guatemala, Honduras, Nicaragua, the Dominican Republic and Costa Rica. This mechanism is broader than the SML and SUCRE, and comprises all kinds of transactions apart from those involving trade, including remittances. It aims to offer a cheap, rapid and safe platform for transfers and settlements between firms, financial institutions and central banks of member countries. All operations are centralized through one institutional administrator (currently the Dominican Republic), which is responsible for real time gross settlement of positions. As a result, it is estimated that the cost of regional trade transactions has fallen significantly (Perez Caldentey et al., 2014; Fritz and Mühlrich, 2014).

Regional mechanisms are also emerging to help meet developing countries’ medium- and short-term

needs for international capital, thus potentially contributing to strengthening their resilience to external shocks. Providing countercyclical finance has long been recognized as one of the critical pillars of regional financial cooperation and integration.

An example of such a mechanism is the Chiang Mai Initiative (CMI) launched by the ASEAN+3 economies⁴⁴ in May 2000. It is a system of bilateral swap arrangements designed to provide liquidity support to members experiencing short-term

balance-of-payments problems. The CMI has been replaced by the Chiang Mai Initiative Multilateralization (CMIM), which is a multilateral reserve-pooling and swap arrangement. The CMIM became effective in March 2010 with an initial size of \$120 billion, which was dou-

bled to \$240 billion in 2012. It is designed to supplement the existing international financial arrangements for addressing balance-of-payments and short-term liquidity difficulties in the region. There are also plans to create a CMIM Precautionary Line, which will operate in parallel with the CMIM mechanism, now renamed the Stability Facility.⁴⁵ In addition, an ASEAN+3 Macroeconomic Research Office (AMRO) was established in April 2011 as an independent regional surveillance unit that analyses and monitors the regional economies and supports CMIM decision-making.⁴⁶

However, neither the CMI nor the CMIM have emerged as major alternatives to the IMF or developed-country sources for helping to resolve members’ balance-of-payments problems. Indeed, they were not used at all during the 2008–2009 crisis, and have been only rarely used since then. To begin with, the amount of dollar liquidity that can be drawn from the CMIM appears to be too small to constitute a credible defence against reversals of international capital flows. More significantly, a member that seeks to draw more than a certain share of the maximum swap amount that it can obtain must have a loan agreement with the IMF and submit to IMF conditionality.⁴⁷ However, once the CMIM Precautionary Line and regional surveillance by the Macroeconomic Research Office become fully operational, the link with IMF conditionality could be reduced, making these funds more attractive. But then it is important to ensure that the arrangement does not attach similar

Developing countries could proactively build on existing regional and interregional monetary arrangements.

conditionalities to its loans as those imposed by the IMF, which could deter countries from using it.

Establishing swap arrangements between regional monetary institutions and a central bank issuing an international currency could significantly increase the amount of liquidity support available to members of regional arrangements.⁴⁸ In the ASEAN region, the CMIM would be well suited to take on this role as its members include both China and Japan, which have already participated in bilateral swap arrangements with countries in the region.

Such linked swap arrangements would, in principle, need to provide access to unlimited amounts of liquidity to be fully effective. It has been suggested that related moral hazard issues could be resolved by associating such access with the prequalification process of the IMF's FCL and PLL facilities. Thus, prequalified countries would access the IMF facilities as a first line of defence, and subsequently they would have access to unlimited swaps should a massive liquidity withdrawal occur (Park and Wyplosz, 2014). While this proposal raises many concerns associated with IMF lending, as mentioned earlier, it deserves further debate, especially if appropriate reform of IMF governance and surveillance is undertaken.

Latin America has a longer history of regional arrangements involving mutual credit support among countries. The Latin American Reserve Fund (or FLAR – the acronym for its Spanish name) established in 1978 is a liquidity-sharing mechanism between medium and small-sized members (Fritz and Mühlich, 2014). Its lending volume depends on the paid-in capital of its members and on the type of credit – whether it is to finance balance of payments, liquidity shortages, or other types of contingencies – with an upper limit of two and a half times the paid-in capital for balance-of-payments problems. However, its disbursement capacity is relatively small, since it has a paid-in capital of only \$3.6 billion, with individual contributions ranging from \$328 to \$656 million. Nevertheless, the voting mechanisms for decision-making have created a sense of ownership among its member countries.⁴⁹ This is reflected in its position as a favoured creditor and a zero default rate with a higher credit rating than that of the individual countries themselves, even in the context of

sovereign defaults. It has a record of speedy responses to loan requests, with no conditionality attached to its assistance. Larger member countries still tend to view it as a complementary mechanism to other liquidity-sharing arrangements such as IMF support, but some countries such as Ecuador have borrowed more from FLAR than from the IMF (Fritz and Mühlich, 2014: 10). Prospects for its enlargement to include other major regional players such as Argentina, Brazil and Mexico give rise to concerns related to its voting and surveillance mechanism (see Titelman et al., 2014), similar to the moral hazard concerns with respect to the CMIM, as mentioned earlier.

Similarly to FLAR, the Arab Monetary Fund (AMF) provides emergency balance-of-payments financing that tailors its lending conditions to each beneficiary's situation. The conditions are generally less strict

than those of the IMF. The AMF started operations in 1977 with 22 West Asian and African countries. Given that its total subscribed capital is about \$1.8 billion, which is even smaller than that of FLAR, it usually complements IMF loans (for further discussion, see *TDR 2007*; and Fritz and Mühlich, 2014).

Regional arrangements have suffered from institutional shortcomings and, especially, limited size, which could be overcome by linking them to global facilities.

One recent proposal goes a step further and builds on Keynes' idea of establishing a clearing house that would facilitate trade and other international payments using debits and credits denominated in a notional unit of account (Kregel, 2015).⁵⁰ The unit of account would have fixed conversion rates to national currencies but may not be traded. Credits with the clearinghouse could be used only to offset debits by buying imports. Countries with a current account surplus would have an incentive to spend their credits as these would lapse if not used within a specified period of time. This provision would both help support global demand and lead to a more equitable sharing of the burden of adjustment.⁵¹ In particular, the tax or interest charges on credit and debit balances would limit payment imbalances in a symmetric manner, and multilaterally negotiated exchange-rate changes would enable the adjustment of imbalances when their limits are breached. The collected charges could be used as additional credits to support the clearing accounts of developing countries. As an additional feature, a country's capital flows could be limited by its current account position

and capital outflows in the form of foreign direct investments or portfolio investments would balance out foreign credits in the same way as imports. There would be no need for foreign-exchange reserves, and notional exchange rates with the accounting unit could be adjusted to support development policy. Such clearing houses could be established on a regional basis, building on existing swap arrangements. This would allow developing countries to pursue their development trajectories without relying on reform of the international monetary and financial architecture, particularly as their concerns have not been adequately taken into account in discussions on reform. As argued by Kregel (2015: 21), for these countries, “the basic advantage of the clearing union schemes is that there is no need for an international reserve currency, no market exchange rates or exchange rate volatility, and no parity to be defended.”

A problem affecting regional arrangements is that all their members may be subject to external shocks simultaneously. This problem clearly underlines the need for such arrangements to be of a certain minimum size. Links to interregional swap arrangements would be particularly useful in this respect. Another possibility might be the creation of a common fund with a periodic increase of paid-in capital, whereby a regional clearing union or reserve pool could increase its liquidity provision capabilities by borrowing on its own. This could even be an effective tool for preventing intraregional contagion in the event of external shocks with different intensities or varying time lags. Moreover, in a heterogeneous international community, strong regional initiatives can combine with global, regional and national institutions to create a better governance system than an arrangement based solely on global financial institutions.

D. Conclusions and policy agenda: Merits and drawbacks of current reform proposals

The shortcomings of the IMS have been the subject of intense debate for decades, but the new global economic environment has altered some challenges and brought in new concerns. The challenge of providing an adequate level of international liquidity, which was at the heart of the debate on reforming the IMS during the Bretton Woods period, has lost much of its relevance. Private international capital flows have at times complemented, but more often dwarfed, official international liquidity. The boom-bust cycles associated with some of the private flows indicate the need for paying much more attention to the challenge of ensuring a predictable and orderly supply of official international liquidity, and especially of short-term

finance required to compensate for sudden liquidity shortages.

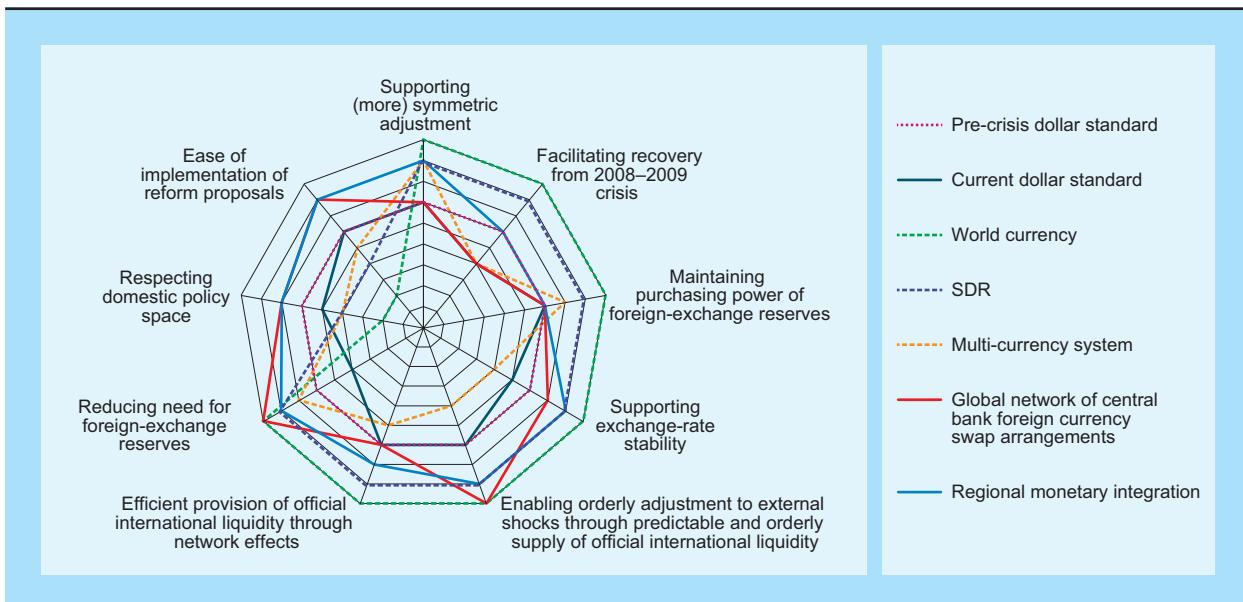
Efforts to reform the IMS can take the form of either wholesale changes to global arrangements and agreements or more piecemeal and less ambitious reforms of the dollar standard. Such choices generally involve trade-offs between comprehensiveness and feasibility, as illustrated in chart 3.3, where the pre-crisis dollar standard may serve as a benchmark.⁵² The chart presents the three fundamental challenges confronting

The evolving global economy poses new challenges to reform aimed at providing stable and secure emergency finance and redressing the IMS' inequity and contractionary bias.

an IMS mentioned in the introduction, along with those that feature in the more recent debate. For example, the crisis exposed the tendency of the dollar

Chart 3.3

FEATURES OF THE CURRENT DOLLAR STANDARD AND ALTERNATIVE REFORM PROPOSALS



Source: UNCTAD secretariat.

standard to create excessive external imbalances, pose risks to exchange-rate stability and make countries highly vulnerable to the boom-and-bust cycles that characterize international capital flows, with additional challenges to monetary policy in developing countries. This implies a lower ranking of the current, as compared with the pre-crisis, dollar standard, as the crisis has heightened the need for foreign-exchange holdings, sharpened the system's inequity bias, reduced domestic policy space and slowed down economic recovery.

New multilateral arrangements are the only reforms that would effectively resolve the system's biases, both in terms of inequity and asymmetry. Thus, such arrangements should remain the long-term objective of any comprehensive reform agenda. But as long as policymaking is dominated by national interests and there is no supranational institution with effective enforcement mechanisms, such as a global central bank, or a world financial authority, there is little prospect for a global currency. And despite all its evident advantages, effective global macroeconomic policy cooperation has been observed only in situations of acute crises, when countries' national interests coincided and disputes over the correct economic model, as well as the direction and

size of policy effects and the associated monitoring and commitment mechanisms, could be overcome. This trade-off between desirability and feasibility is particularly pronounced at present, when the transition from weak economic recovery to sustained global growth would greatly benefit from coordinated expansionary policies.

It is also doubtful whether, at the present juncture, it would be possible to implement the institutional changes required for moving towards an SDR-based system. And while moving towards a multipolar monetary system might be beneficial in terms of a more flexible provision of official international liquidity, it would probably pose risks to exchange-rate stability. Alternative international currencies such as the euro and the renminbi may assume increasingly important roles for trade invoicing and settling international transactions. However, their role as reserve assets is unlikely to substantially increase in the foreseeable future, as the crisis in the euro area persists and the internationalization of the renminbi is proving to be a prolonged process.

The various foreign currency swap arrangements created by central banks from various countries can offer a potentially powerful tool to ensure the

predictable and orderly provision of official international liquidity. Currently, the greater proportion of these swaps caters to developed-country needs, while such swaps involving developing countries are still relatively limited.

As long as attempts to strengthen financial regulation and improve the resilience of financial systems remain largely ineffective in addressing global risks and leverage factors that drive boom-bust cycles in international capital flows, and developing countries continue to be discouraged from adopting capital-account management policies as ordinary policy tools, the only collective insurance mechanism available to them is financial assistance from the IMF. However, IMF assistance often implies the adoption of procyclical policies during crisis periods, and many countries are choosing, more generally, to avoid the conditions attached to IMF-supported programmes. Hence, involving the IMF in IMS reform that meets the needs of developing countries will require prior reform of IMF governance, policy orientation and surveillance mechanisms.

These difficulties in the design and implementation of the various reform proposals have reinforced the perception that self-insurance in the form of large foreign-exchange holdings is an effective strategy for developing countries to foster exchange-rate stability and ensure the predictable and orderly availability of emergency finance. However, encouraging developing countries to take on still larger holdings of foreign-exchange reserves would imply serious risks, not only for those countries themselves but also for the global economy as a whole. Foreign-exchange reserves that are accumulated through borrowing in international credit markets or on the basis of portfolio capital inflows can further increase countries' vulnerability to capital flow reversals and global financial instability. Moreover, the costs involved in holding reserves borrowed in international credit markets will also increase the current system's inequity. Another possible solution is for the countries to try and achieve current account surpluses. However, given the many questions associated with the potential for export-led growth strategies in the post-crisis economic environment (*TDR 2013*), this

option would probably induce developing countries to aim for exchange-rate depreciation, which could jeopardize the sustainability of their external debt and risk triggering a currency war. Moreover, the increase in the IMS' contractionary bias associated with widespread attempts to accumulate foreign exchange reserves would have the effect of further holding back already weak global demand and economic recovery.

A preferred option for developing countries may be to proactively build on a series of regional and interregional initiatives designed to foster regional macroeconomic and financial stability, reduce the need for foreign-exchange accumulation, and strengthen resilience and capabilities to deal with balance-of-payments crises. While regional arrangements have suffered from some institutional shortcomings, the greatest problem probably is their limited size. This could be overcome by establishing zones of monetary cooperation at the regional level,

which would include both clearing arrangements and systems of emergency finance that could absorb a significant number of such shocks, and thereby reduce the need for self-insurance. An additional possibility could be to link regional arrangements to global facilities, such as the IMF or to central bank swap arrangements that include a central bank which issues an international currency (*TDR 2007*; Aglietta and Coudert, 2014). So far, proposals for cooperation with the IMF (e.g. Volz, 2012; IMF, 2013) have not included any binding rules or guidelines, and little seems to have been achieved on coordination with extra-regional swap arrangements. The modalities for coordination need to be clarified before a new crisis hits so that there will be a ready response when needed, and duplication and substitution of resources from various sources are minimized.

The reform proposals discussed in this chapter are difficult to separate from those designed to avoid, or at least mitigate, instability of the financial system. Indeed, the proposals discussed in this chapter are complementary to, and should not be seen as a substitute for, the equally necessary reform of the regulatory and supervisory architecture of the financial system. This is the topic of the next chapter. ■

Involving the IMF in IMS reform that meets the needs of developing countries requires prior reform of IMF governance, policy orientation and surveillance mechanisms.

Notes

- 1 The notion of “international liquidity” has evolved over time. Traditionally, it referred to the gold and foreign-currency assets that a country’s central bank could readily access. This notion is still relevant for those countries that directly control their residents’ international transactions and manage exchange rates. By contrast, for countries with floating exchange rates, and where residents can freely engage in international transactions, international liquidity also includes the gold and foreign-currency assets and credits to which their residents have access.
- 2 The purpose of providing short-term finance is to prevent countries that face problems in accessing international liquidity during crises from defaulting on their foreign obligations or being forced to adopt drastic “adjustment” measures. It is not aimed at managing problems associated with sovereign debt issues, which are addressed in chapter V of this *Report*.
- 3 It should be noted that the issues of external imbalances and their adjustment in the context of the IMS are based on a concept of balance-of-payments equilibrium, whereby a country’s current account is, on average, balanced over time. This does not take into account the fact that developing countries, and especially the least developed among them, may have current account deficits for a protracted period of time as a result of their need to import capital goods and finance investment projects. Ideally, the related financing requirements should be met by long-term development finance, which is the focus of chapter VI of this *Report*.
- 4 Indeed, while there were several cases of currency devaluation by developing countries over this period to compensate for higher inflation rates, the devaluation of the French franc followed by the United Kingdom’s pound sterling in the 1960s signified growing problems with this system and presaged its eventual demise.
- 5 More precisely, countries were allowed to choose their exchange rate system as long as they avoided “currency manipulation”, even though the notion of currency manipulation was never defined.
- 6 Indeed, as noted by the then Governor of the Bank of Italy: “There is no official institution capable of supplying the international payments system with the liquidity required for further expansion of trade. This function has been taken over by the private banking system, and primarily by the U.S. banks, through operations carried out by their branches at home and abroad” (Carli, 1976: 8).
- 7 The amount of dollar credit outside the United States increases to \$9 trillion if non-bank financial borrowers are included, such as the German state agency Kreditanstalt für Wiederaufbau which in mid-2014 held a debt of \$100 billion.
- 8 These numbers are UNCTAD secretariat calculations based on data from the IMF’s *International Financial Statistics* database.
- 9 It should be noted that reserve adequacy differs from the concept of an optimal level of reserves. The latter balances the benefits from reserve holdings in terms of avoided potential losses in output and consumption from sudden liquidity shortages against the opportunity costs of holding reserves, such as implied resource transfers to reserve-currency countries. The resulting optimal level is strongly determined by country-specific, and often time-varying, risk attitudes.
- 10 This new form of the Triffin dilemma also raises the question as to the extent to which the international role of the dollar continues to confer economic benefits on the United States, which has been a matter of debate. One argument is that such demand for dollar reserves pushes up the value of the dollar and thereby slows down output and employment growth in the United States, especially in the country’s tradable sector, and that it also affects fiscal revenues (Pettis, 2013; Galbraith, 2014). However, the United States can settle its current account and fiscal deficits by printing money, and is therefore less vulnerable to foreign shocks, while other countries must adjust to its macroeconomic policies. In addition, a reserve-currency country usually earns investment income because yields on its foreign assets usually exceed those on its foreign liabilities. According to

- Gourinchas and Rey (2007), these benefits exceed \$30 billion each year for the United States.
- 11 For a critical assessment of the link between the role of the dollar as an international currency, the large current account deficit of the United States prior to the crisis, and the way in which the crisis unfolded, see, for example, Pettis, 2013; and *TDR 2009*.
- 12 Nevertheless, trade finance is the one area where the internationalization of the renminbi has become particularly visible. In 2013, it emerged as the second most used currency for settling cross-border payments in trade, attaining a share of almost 9 per cent (ECB, 2014: 32).
- 13 The euro is used in roughly one third of all foreign exchange transactions, down from 39 per cent in 2010, and the yen's share has oscillated around 20 per cent. The remainder comprises a basket of currencies from developed and developing countries, the composition of which is not further disaggregated by the data sources. It should be pointed out that the sum of the percentage shares will necessarily exceed 100 per cent since many transactions involve two currencies.
- 14 However, the cost of holding foreign-exchange reserves needs to be weighed against the possible macroeconomic costs resulting from exchange-rate appreciation that would occur in the absence of currency market intervention (see *TDR 2009*: 124–125).
- 15 For technical details of these three stages, see Mundell, 2012. For lessons from the experiences with the construction and functioning of the European Monetary System and the European Monetary Union, see *TDR 2007*.
- 16 For such a proposal, albeit limited to the European Union, Japan and the United States, see Cooper, 2006.
- 17 For example, rules-based managed floating targeting a stable real exchange rate may be designed to immediately compensate for emerging price and cost differentials through commensurate adjustments of the nominal exchange rate, thereby preventing the build-up of large current account imbalances. In such a setting, interventions in foreign-exchange markets would be of crucial importance for adjusting the nominal exchange rate. While many of the technical problems associated with this proposal have been addressed (e.g. Bofinger, 2011), the concrete terms for such a scheme require further discussion.
- 18 According to one account of Germany's and Japan's strategies, the Japanese authorities resisted the internationalization of the yen until the mid-1970s to safeguard their country's development model that required minimizing spillovers from international to domestic financial markets, and to prevent upward pressure on the exchange rate (Eichengreen, 2011: 44–45). But from about 1975 onwards, they started to facilitate the internationalization of the yen (see also Matsukawa, 1982). However, the removal of restrictions on domestic and international financial transactions did not produce the expected result, as it led Japanese corporations to access international bond markets while domestic banks replaced their corporate clients with real estate developers, triggering a massive boom and bust cycle in real estate. Germany maintained restrictions on purchases of money market instruments by non-residents in order to be able to address inflation fears by raising interest rates without triggering appreciation pressure, which would have jeopardized the country's export-led growth model (see also Rieke, 1982).
- 19 China's policymakers have adopted a gradual approach to the internationalization of the renminbi, with an initial focus on its use as a settlement and investment currency, to be followed by its use as a reserve asset. A scheme launched in 2009 to encourage import payments in renminbi has led to a rapid increase in renminbi use for trade settlement and the creation of renminbi offshore markets (first in Hong Kong (China) and then Singapore, Taiwan Province of China and some European countries). Moreover, the introduction of renminbi qualified foreign institutional investors has boosted its use as a store of value. The establishment of foreign currency swap arrangements (further discussed below) has furthered the possibility of holding the renminbi as a reserve currency in certain contexts.
- 20 See Zhou (2015) for a brief review of both the history of China's move towards capital account convertibility and the respective reforms planned to be launched in 2015. Zhou also argues that one of the lessons of the global financial crisis is that capital account convertibility should no longer mean "fully and freely convertible" currencies. Rather, it should imply retaining a number of capital account management instruments, such as macroprudential measures that help manage excessive foreign debt in the private sector and significant currency mismatches as well as capital controls on short-term speculative capital flows.
- 21 Some observers argue that China may face similar problems to those encountered by Japan: the failure of the yen to emerge as an international currency in the 1970s and 1980s was due not only to the reluctance of Japanese policymakers to internationalize the yen, but also to the fact that the yen had not first established itself as a regional currency (Park, 2010; Lee, 2014).
- 22 For a further discussion of the wide range of issues involved in internationalizing the renminbi, see, for example, the *Journal of Chinese Economic and Business Studies*, May 2013 – a special issue dedicated to this topic.
- 23 The SDR is currently composed of a basket of four currencies – the dollar, the euro, the pound sterling

- and the yen – which currently account for 41.9, 37.4, 11.3 and 9.4 per cent of the total basket respectively.
- 24 The need to develop private use of SDRs is often mentioned as an additional challenge (Mateos y Lago et al., 2009). However, as pointed out by Ocampo (2014), an SDR-based IMS could be combined with a multi-currency system where the SDR would be the global reserve asset while national or regional currencies could continue to be used in private transactions. However, moving towards such a mixed system would still require substantial institutional changes.
- 25 The last SDR allocation which took place in 2009 comprised the allocation of 21.4 billion SDRs that had already been approved in 1997 and a new allocation of 161.2 billion SDRs (equivalent to about \$250 billion). Since the allocation was based on IMF quotas, more than half of these funds went to developed countries. These allocations brought the stock of total outstanding SDRs to roughly 5 per cent of global non-dollar reserves. Moreover, the allocations in 2009 fell considerably short of the estimated amount required to maintain a stable supply of global reserve assets, which a range of studies estimated at \$200–\$300 billion annually. For comparisons of several such estimates, see Erten and Ocampo, 2012: 15.
- 26 In a sense, this would be akin to creating a development link in SDR allocations, as suggested by UNCTAD (1965). However, the potential use of SDRs as an instrument of development finance should be clearly distinguished from their potentially enhanced monetary functions emphasized here.
- 27 Technically, this could be done in either of two ways (Ocampo, 2011: 22): by allowing the IMF “to create SDRs in almost unlimited amount in the face of a major global disturbance” or by treating SDRs that the IMF had previously allocated but countries have left unused as deposits – or “excess reserves” – which the institution could lend to countries in need.
- 28 It should be noted that the agreed quota revision is relatively small, so that even after its implementation, quotas would still not reflect the increased shares of developing countries in the global economy (Ocampo, 2011: 23–24).
- 29 In the 1970s, the debate stalled because of a lack of agreement as to how the exchange-rate risk and potentially ensuing losses should be distributed among member States. Calculations of hypothetical losses during the period 1995–2008 suggest that these would have been small relative to the size of the United States economy, and would not impair adopting a similar scheme today (Kenen, 2010b).
- 30 For a detailed discussion of these facilities, see, for example, Marino and Volz, 2012.
- 31 The mechanisms discussed here concern the currency and maturity mismatches in gross international capital flows. The fact that the dollar plays a key role in resolving emerging problems has to do with its position as the dominant international currency, and this is not directly related to the large deficit recorded in the United States’ current account in 2007–2008. Indeed, at the same time, similar liquidity shortages needed to be addressed in terms of the euro, with the euro zone as a whole recording a basically balanced current account position, and in terms of the Japanese yen and the Swiss franc, with Japan and Switzerland recording substantial current account surpluses.
- 32 The country-specific account of Aizenman et al. (2011), for example, indicates that, despite using a large share of its sizeable foreign-exchange reserves, the Republic of Korea was able to stabilize its financial markets in October 2008 only after the Bank of Korea entered into swap arrangements first with the United States Federal Reserve and then with the Bank of Japan and the People’s Bank of China.
- 33 At their peak in December 2008, outstanding swap lines totalled over \$580 billion and involved 14 foreign central banks, with the ECB alone accounting for about four fifths of this amount (Fleming and Klagge, 2010; Bourgeon, 2015). The group of countries covered by these arrangements included four developing countries, namely Brazil, Mexico, the Republic of Korea and Singapore, but Brazil and Singapore never drew on their swaps (Bordo et al., 2014; Bourgeon, 2015).
- 34 The PBOC’s swap arrangements with developed-country central banks, such as the Swiss National Bank, have often served to develop offshore renminbi markets (SNB, 2014). They enable importers in the country of the PBOC’s partner central bank, as well as in that country’s neighbouring regions, to easily obtain renminbi-denominated funds if they wish to settle transactions in renminbi. As such, their main purpose has been to provide liquidity in case there is a shortage of trade finance and to lubricate the emerging offshore renminbi money markets.
- 35 According to an empirical analysis by García-Herrero and Xia (2015), the choice of countries was influenced by the partner country’s economic size and geographical proximity, as well as by its size of exports to China and its signing of a free trade agreement with China.
- 36 See Wende P, “Por el swap con China, el BCRA incorporó yuanes a las reservas”, *Ambito Financiero*, 31 October 2014, available at: <http://www.ambito.com/diario/noticia.asp?id=765312>. In October 2014, the PBOC concluded a similar arrangement with the central bank of the Russian Federation (see PBOC, “Central Banks of China and Russia signed bilateral local currency swap agreement”, available at: http://www.pbc.gov.cn/publish/english/955/2014/20141015162604364930184/20141015162604364930184_.html). Contrary to the

- arrangements with central banks of other countries such as Chile (see http://www.pbc.gov.cn/publish/english/955/2015/20150528095203205835709/20150528095203205835709_.html), this arrangement is designed not only to facilitate “bilateral trade and direct investment”, but also to promote “economic development in the two countries”.
- 37 China has made similar arrangements with the Bolivarian Republic of Venezuela, whereby loans that extend over several years are initially deposited in the latter’s foreign-exchange reserves but are gradually used for development projects, especially in the oil sector. Other Chinese loans to the Bolivarian Republic of Venezuela may also boost the latter’s reserves, as their repayment will be in the form of oil and fuel (see Reuters, “China to lend Venezuela \$10 billion in coming months”, 19 March 2015, available at: <http://www.reuters.com/article/2015/03/19/us-venezuela-china-idUSKBN0MF2AD20150319>).
- 38 For a detailed account of these regional networks, see Allen and Moessner, 2010.
- 39 For a recent proposal that builds on the plan that Keynes presented to the Bretton Woods conference in 1944, see Davidson, 2007. For other suggestions as to how Keynes’ initial proposal might be employed today, see Mateos y Lago et al., 2009, and United Nations, 2009.
- 40 More ambitious approaches have called for amending Article IV of the IMF’s Articles of Agreement to introduce an obligation for member States to gear their domestic policies to achieving both domestic and global stability (Palais Royal Initiative, 2011), or giving the IMF the right to identify required measures for globally coherent macroeconomic policies and monitor progress (King, 2011). Such measures would obviously need to be backed by significant reform of the IMF’s governance and by changes in its approaches to surveillance and macroeconomic processes.
- 41 For a comprehensive review of regional monetary and financial arrangements, see UNCTAD, 2011; and Fritz and Mühlrich, 2014.
- 42 Among the macroeconomic coordination and monetary integration mechanisms in Africa, which are not pegged to the euro and supported by the French Treasury, only the Common Monetary Area (CMA) is operational. This arrangement between Lesotho, Namibia, South Africa and Swaziland constitutes an integrated financial market within which there is a free flow of funds and access by members to each other’s capital markets (*TDR* 2007; and Fritz and Mühlrich, 2014).
- 43 The SUCRE is an artificial unit of value along the lines of the SDR. It is calculated from a basket of currencies of the participating countries, weighted according to their economic size.
- 44 ASEAN+3 includes the members of the Association of Southeast Asian Nations (Brunei Darussalam,
- Cambodia, Indonesia, the Lao People’s Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Viet Nam), plus China (including Hong Kong (China)), Japan and the Republic of Korea.
- 45 See https://www.boj.or.jp/en/announcements/release_2014/rel140717a.pdf.
- 46 For details, see AMRO’s website at: <http://www.amro-asia.org/>.
- 47 The maximum amount is determined by a purchasing multiple applied to a member’s contribution to the CMIM, where the country-specific multiples range between 0.5 (for China and Japan) and 5.0 (for a number of small member economies). For example, it is roughly \$34 billion for China, \$38 billion for Japan and about \$23 billion for each of the major ASEAN economies (Indonesia, Malaysia, the Philippines, Singapore and Thailand). The share of this amount that can be drawn without an IMF link has been increased in steps, from an initial 10 per cent to the current 30 per cent, and there are plans to increase it further to 40 per cent. This requirement has remained in place since the CMI’s inception in order to address moral hazard, which is seen as a problem due to the continued lack of regional surveillance that would have sufficient political authority, and insufficient human and financial resources (Rhee et al., 2013; Shimizu, 2013). For details on the 2014 amendment of the CMIM, see: https://www.boj.or.jp/en/announcements/release_2014/rel140717a.pdf.
- 48 The swap arrangement envisaged as part of the BRICS Contingency Reserve Arrangement (after its creators Brazil, the Russian Federation, India, China and South Africa), which, as of May 2015, was scheduled to start operating by the end of 2015, would be interregional in character. However, it would not include a central bank issuing an international currency, though this may change over time, with the renminbi assuming an increasingly important role as an international currency. But with agreed initial resources of \$100 billion, it will remain significantly smaller than even the CMIM, and it too would include an IMF link for withdrawals exceeding 30 per cent of a member country’s limit. For further details, see: <http://brics6.itamaraty.gov.br/media2/press-releases/220-treaty-for-the-establishment-of-a-brics-contingent-reserve-arrangement-fortaleza-july-15>.
- 49 Each member has one vote, with decisions requiring a 75 per cent approval for most of the agreements, and 80 per cent requirement for special agreements such as capital augmentation.
- 50 Historical precedents of such regional clearinghouses include the European Payments Union (EPU), which existed during the period 1950–1958, as well as to some extent the LAIA. A similar mechanism is

- included in the SUCRE initiative launched in 2009, though it is not yet operational (for further discussion, see UNCTAD, 2011).
- 51 It is possible that intraregional imbalances would result from certain development strategies which could be taken into consideration by the member countries when designing a mechanism to address those imbalances, such as if a country acts as a regional engine of growth.
- 52 It should be emphasized that the objective of this chart is purely illustrative, and does not reflect precise numerical evidence.

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FINANCIAL REGULATORY REFORM AFTER THE CRISIS

A. Introduction

In the aftermath of the 2008–2009 global financial crisis, political leaders acknowledged that there were serious shortcomings in the way financial markets and institutions had been regulated. This was amply demonstrated by the failure of large private banks to manage risk, the unchecked expansion of a shadow banking system and the excessive reward schemes common throughout the entire financial sector. Initially, they showed a willingness for fundamental reform of the system aimed at making it more stable, less prone to crises and more resilient to shocks, as well as to orient it more towards supporting the real economy and economic development. They also recognized the need to accommodate the interests and concerns of the larger developing economies in the design of any subsequent reform agenda. Thus in late 2008, the G8 was replaced by the G20, which includes the larger developing countries, as the most relevant forum for international coordination and decision-making. Some of these countries were also given membership in the Financial Stability Board (FSB), which succeeded the Financial Stability Forum (FSF) to coordinate the activities of various financial standard-setting bodies and to take charge of monitoring implementation of the financial reforms agreed by the G20 countries.

The reform programme coordinated by the FSB aimed at strengthening prudential regulation and

the oversight and supervisory capacities of financial authorities. However, today, seven years since the eruption of the global crisis, it has become clear that, apart from some partial improvements, it has been unable to effect the required changes. The existing financial structures still lack adequate instruments to reduce the volatility of capital flows, prevent systemic crises and ensure that finance is available for small and medium-sized enterprises (SMEs) and innovation. Reforms introduced after the 2008–2009 crisis have taken only a limited account of some of the specific needs of developing countries.

This chapter discusses some key financial reforms agreed at the international level and which are in the process of being implemented by national authorities, and assesses their possible impacts, particularly in developing countries. Section B, which examines the new Basel capital requirements aimed at strengthening banks, shows that they still rely excessively on narrowly defined prudential rules as the best approach to banking regulation. The section also examines a number of initiatives to reform the financial system in developed countries. Section C studies the shadow banking system and the proposed measures to mitigate risks arising from this form of financial intermediation. Section D assesses other important issues for financial regulation, such as the excessive use of the ratings of credit rating agencies (CRAs),

the challenges arising from the growing presence of foreign banks in developing countries, and the need to address the vulnerabilities arising from speculative international capital flows. Section E argues for the

need for a more ambitious reform agenda, including the necessary separation or ring-fencing of some bank activities. It also discusses the regulatory elements of a more development-oriented financial system.

B. Post-crisis financial reform and prudential regulation

Over the past 40 years, the financial sector has expanded significantly and international capital mobility, in particular, has soared following successive waves of financial innovation and market deregulation. Global liquidity and the allocation of global funding have become influenced more and more by credit conditions in major financial centres, by the operations of the internationally active banks, and by the activities of a wide range of asset management companies and other institutional investors.

Financial deregulation included the progressive relaxation of quantity controls and other restrictions on banks, such as caps on interest rates or limits on the ability to engage in activities other than traditional lending.

One aspect of such deregulation was the retreat from direct government intervention in the financial sector and the erosion of instruments to achieve development targets. In their place, a light-handed regulatory approach based on prudential rules (i.e. required capitalization

and liquidity ratios) gained prominence. The central tenet of this approach was that banks should be allowed to freely allocate credit or engage in market-based activities provided they hold sufficient capital to cope with unexpected losses. Market competition was supposed to ensure the right funding for profitable investments, and therefore a high social return.

Since their introduction in 1988, Basel capital adequacy requirements have become an important reference for prudential policies, not only in

The global financial crisis of 2008–2009 revealed the shortcomings of the conceptual framework based on a commitment to free financial markets and self-regulation.

countries represented on the Basel Committee on Banking Supervision (BCBS) – originally a small number of developed countries – but also in a large number of developing countries, even though they were not party to the formulation process, and even though the guidelines were not conceived with their financial systems in mind.¹ The Basel Accords seek to prevent internationally active banks from building business volume without adequate capital backing. They also aim to remove the incentive for individual jurisdictions to impose less demanding requirements on the banks in order to attract business. The Basel rules reflected the belief that markets and financial entities were capable of self-discipline, and that prudent behaviour by a bank was integral to its reputational capital. As such, market forces were expected to prevent banks from taking excessive risks.

The global financial crisis of 2008–2009, which was by far the worst since the 1930s, revealed the serious shortcomings of financial deregulation

and of the conceptual framework based on a commitment to free markets and self-regulation (*TDRs 2009* and *2011*). The narrow focus of prudential regulation based on capital requirements for banks failed to prevent widespread turmoil in late 2008. Indeed, many of the world's largest banks that fully met the Basel II standards in 2008 were crippled by the subprime crisis and its ramifications, prompting very expensive bailout packages by governments that resulted in significant increases in public debt and high social costs.

In the post-crisis reform process, a consensus seemed to emerge that instability was global, and that international cooperation needed to be strengthened (*TDRs 2009 and 2011*; Haldane, 2014). The international reform agenda under FSB guidance delivered a number of initiatives, including the Basel III Accords, specific provisions for the “globally systemic important banks” and recommendations to improve oversight of shadow banking activities.²

G20 countries agreed to progressively introduce the new standards in their regulatory frameworks. However, the sources of systemic risk, that is, the risk that a default, liquidity squeeze or crisis on a given market would spread to other markets and eventually develop into a full-fledged crisis, are likely to persist, and the fragilities that contributed to the global crisis remain a serious concern. This section critically examines the spirit of the reform process, highlighting its main weaknesses and the challenges they are creating for developing countries.

Many of the world's largest banks that fully met the Basel standards were crippled by the subprime crisis, prompting very expensive bailout packages by governments.

With respect to capital rules, Basel III has improved the quality of the capital that banks are required to hold to better absorb potential losses. Common equity and retained earnings have become the predominant form of Tier 1 capital, as the new framework has eliminated the possibility to use preferred stock and debt-equity hybrids to boost core capital.

In addition, Basel III has introduced higher levels of capital compared with its predecessor, Basel II. The minimum level for total capital requirements remained at 8 per cent of risk-weighted assets, but the proportion accounted for by

common equity Tier 1 was raised from 2 per cent to 4.5 per cent of the risk-weighted assets. Basel III also requires banks to hold “capital conservation buffers” of an amount equal to at least 2.5 per cent of the risk-weighted assets, also in the form of common equity Tier 1 capital, to be made available in times of stress. When buffers are drawn down as losses are incurred, banks are required to rebuild them by reducing discretionary distributions of earnings and executive bonuses. Taken together, these measures have brought the total common equity requirements to 7 per cent of risk-weighted assets. The new framework also gives national authorities the discretion to request banks to uniformly adjust upwards the capital conservation buffers built to cope with stress situations, when, in their judgement, credit growth results in an unacceptable build-up of systemic risk. This countercyclical buffer is imposed within a range of 0–2.5 per cent and also should be met with common equity.

Another feature of Basel III is the introduction of a non-risk-based leverage ratio, based on a minimum Tier 1 capital of at least 3 per cent of total assets. For the calculation of the leverage ratio, banks’ exposures must cover on-balance-sheet items such as securities financing transactions, as well as off-balance-sheet items such as derivatives and letters of credits.

Finally, the proposed liquidity provisions in the Basel III package include liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) requirements. The LCR aims to ensure that banks have sufficient short-term liquidity to deal with situations

1. The new Basel III Accords

The Basel Accords offer the most comprehensive regulatory framework for the banking industry.³ However, they have been inadequate, in several ways, to ensure a strengthened financial system. Crucially, capital adequacy rules have not prevented high leverage nor promoted much portfolio diversification, and they have added to the already procyclical nature of the banking business, as noted by several analyses (e.g. Slovik, 2012).

In reaction to the crisis and to the increased scrutiny it was facing, the Basel Committee agreed to provide a new regulatory scheme “to strengthen the resilience of banks and the global banking system” (BCBS, 2011). The package of reforms, announced in October 2010, known as Basel III, includes new capital adequacy rules and a number of liquidity provisions. In accordance with the agreed timetable, G20 countries have been introducing the new standards since 2013, and have targeted full implementation of the framework by 1 January 2019.

of stress lasting up to one month. The NSFR aims to help banks deal with liquidity issues, but it has a time horizon of one year, focusing on the maturity structure of a bank's assets and liabilities. That is, it encourages banks to hold more stable funding (for instance from deposits) as well as more liquid assets (BCBS, 2014a and b). Although portrayed as a great leap forward when compared to its predecessor, Basel II, these reforms are unlikely to make banks more resilient.

Since Basel III has not changed the risk-weighting framework, core capital has to be measured, as previously, against risk-weighted assets. This means that in the calculation of the assets that have to be backed by the bank's capital, only assets deemed to be very risky are accounted at their full value, while those considered to be safer are considered at only a proportion of their value. This increases the incentive to invest in low-risk-weighted assets that can be leveraged much more than risky assets.⁴

At the macroeconomic level, the risk-based approach may have

adverse consequences for employment and economic growth, because it discriminates against SMEs. Since these firms are perceived to pose greater risks than big firms, banks would be reluctant to extend credit lines to them (Moosa and Burns, 2013) when choosing a portfolio skewed towards assets with low-risk weights. Moreover, Basel III does not question the reliance on external ratings by CRAs or the use of banks' internal risk models to calibrate the risk-weights.⁵ It is not clear why the Basel Committee still sees value in CRAs' ratings when the FSB itself stated that "it is particularly pressing to remove or replace such references [i.e. to external credit ratings] where they lead to mechanistic responses by market participants" (FSB, 2010).

By retaining the system of adjustable risk weights, Basel III has not addressed the procyclicality of Basel II. When default risks are perceived to be low, which is likely during periods of economic expansion – as in the 2003–2007 growth period – credit ratings are upgraded, thereby moving the assets towards a lower risk category for capital requirements. This causes a reduction of required capital for the same asset portfolio, thereby allowing

higher leveraging during the expansionary phase of the cycle. Conversely, capital requirements increase suddenly when the expansion ends and banks' assets are perceived to be more risky. Further, the Basel III reforms fail to address one of the more controversial components of previous Basel rules: banks are still allowed to calculate their regulatory capital themselves as an alternative to the use of external credit ratings, which means that two different banks, each using their own internal risk models, often end up with different capital needs for similar asset portfolios.⁶ Perhaps most fundamentally, the Basel norms continue to rely, implicitly, on large banks' effective self-monitoring, rather than on external supervision, based on the assumption that "market discipline" will

ensure responsible behaviour by financial agents. Yet this assumption is now recognized to be flawed and unrealistic.

Under the risk-weighted framework, institutions have accumulated an excessive level of leverage. Between the enforcement of the Basel risk-weighted capital requirements in 1992 (Basel I) and the global

economic and financial crisis in 2008–2009, banks' ratio of total capital to *unweighted* assets steadily declined. For example, in a sample of large international banks, the ratio fell from 4.8 per cent to less than 3 per cent between 1993 and 2008 (Ingves, 2014).⁷ The Basel III leverage ratio, supposed to serve as a backstop to the risk-based capital requirement, will improve the capital base only marginally. Set at only 3 per cent of unweighted assets, capital may be significantly below the level necessary to ensure banks are minimally positioned to withstand a major shock (Admati and Hellwig, 2013).⁸

2. The proposed framework for systemically important banks

Large, internationally active banks contributed significantly to the global financial crisis of 2008–2009. Their presence in different national jurisdictions and their cross-border trading activities facilitated the spillover of the crisis to various countries. Given their size, complexity, cross-jurisdictional

presence and interconnectedness, these large banks have created global systemic risks and challenges for regulators.

Their complex and intertwined operations, which are difficult to track by financial regulators, and even by the banks' own senior managers, are far from transparent. These banks have become so large that financial experts and policymakers consider them "too big to fail", meaning that letting them collapse would cause unbearable damage to the entire international financial system. The fiscal costs entailed in bailing them out in case of insolvency would be exorbitant, and would require a high level of international coordination, which is difficult to achieve.

Their international expansion and the large size of their balance sheets are difficult to explain on efficiency grounds (BIS, 2010a). Instead, evidence suggests that such expansion was facilitated by an underestimation of risk, which might have distorted their incentives. The "too-big-to-fail" label gives such banks a competitive advantage based on their assumption that if they suffer huge losses from engaging in risky behaviour, they will be rescued by the government. In addition, it gives them access to cheaper funding sources, as they are seen as less likely to default. Another competitive advantage arises from the fact that, under the Basel framework, large banks can choose the most convenient approaches for capital determination. They have the resources to use their own risk models, which gives them flexibility to determine their capital requirements and hold less capital relative to smaller banks that only have the means to adopt the simpler approaches for capital determination.

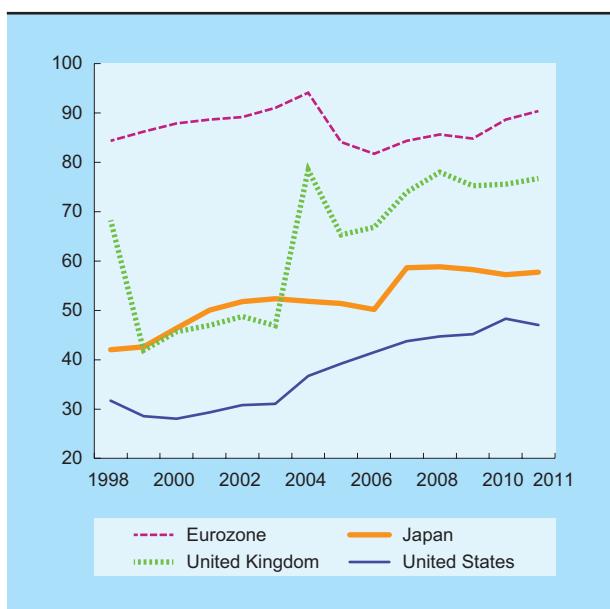
At the national level, the expansion of the activities of large banks has been a major reason behind banking concentration, especially between 1998 and 2007. In the post-2008 period this trend has stopped overall, although in a few countries, including the United States, it continues, partly reflecting post-crisis government-sponsored mergers (chart 4.1).

Since the global crisis, systemic risks associated with large banks have been a major concern. A United Nations Report recommended subjecting large financial institutions to additional capital requirements (United Nations, 2009). It also proposed the adoption by governments of strong anti-trust policies to discourage banks from growing too big. Other

Chart 4.1

ASSETS OF THE FIVE LARGEST BANKS AS A PROPORTION OF TOTAL ASSETS OF THE BANKING SECTOR IN SELECTED ECONOMIES, 1998–2011

(Per cent)



Source: Bankscope, Bureau van Dijk.

bodies have suggested similar regulatory changes. For example, the G20, at its Washington Summit in November 2008, recommended a review of the scope of financial regulations to ensure that all systemically important financial institutions are adequately regulated. A year later, the G20 Summit in London further proposed that complex financial institutions be subject to special oversight, and that regulators be given access to relevant information on financial institutions, markets and instruments in order to be able to detect possible failures or situations of stress that pose systemic risks.

Since 2011, the FSB has identified global systemically important banks (G-SIBs) using a methodology developed by the Basel Committee (BCBS, 2011).⁹ The latest update of November 2014 identifies 30 such banks (all of them from developed countries, except three from China), which are expected to build a greater loss absorption capacity as well as to have crisis management groups, cross-border cooperation agreements and disaster plans

(known as “living wills”). In 2014, the FSB presented proposals to enhance the loss-absorbing capacity of G-SIBs in resolution, according to which these banks would face capital surcharges, leading to total capital requirements equal to 16–20 per cent of their risk-weighted assets. This is meant to allow an orderly resolution that minimizes any impact on financial stability and ensures the continuity of critical functions.¹⁰

However, even these proposals may be insufficient to address the “too-big-to-fail” issue. First, the fact that loss-absorbing capacity is calculated using risk weights creates an opportunity for exercising considerable discretion in meeting the requirements. Second, it is not clear whether national regulators will cooperate without a globally agreed bank resolution regime; indeed, without such a regime, there could even be a local-asset-seizing frenzy to defend national interests in case of bankruptcy.

Given their size, complexity, cross-jurisdictional presence and interconnectedness, large banks have created global systemic risks and challenges for regulators.

economies that are FSB members have already become fully compliant with the new Basel III capital adequacy rules.¹¹ Among other developing economies that are not FSB members, adherence to Basel III has been rather weak (BIS, 2014 and 2015).¹² Table 4.1 summarizes the degree of implementation of Basel II and III in developing countries by region.

The adoption of the Basel II capital requirements by a large number of developing countries, and the steps they have taken to comply with the Basel III arrangements is somewhat puzzling. After all, implementation of the Basel recommendations

is voluntary, and the Basel Committee does not possess any formal supranational supervisory authority. Moreover, many developing countries that are adopting Basel standards were not even party to the formulation process. Indeed, Basel guidelines were not conceived with developing countries in mind; they were conceived for countries hosting large and complex, internationally active financial institutions with the purpose of harmonizing national regulations (Powell, 2004).

3. The prudential framework and developing countries

Since their introduction in 1988, Basel guidelines on capital requirements have become a significant reference for regulators throughout the world. More than 100 countries have adopted the Basel I guidelines for capital requirements (Barth et al., 2006), and all the developing countries that are G20 members, but also a large number of non-members, have implemented the Basel II requirements. Although most of these countries adopted the Basel II “standardized approach”, some of the non-members of the G20 (e.g. Bahrain, Malaysia and Thailand) also implemented the more complex internal ratings-based approach, allowing large banks to determine capital requirements on the basis of a self-assessment of risk. According to the FSB’s assessment of implementation of the regulatory reforms in November 2014, all the major developing

Basel guidelines were conceived for countries hosting large and internationally active financial institutions; they do not consider developing countries’ needs.

Nonetheless, there are various reasons for the partial adoption of Basel rules by developing countries. Since their introduction, Basel principles have come to be regarded by policymakers as the global seal of approval for the quality of countries’ banking supervision systems. Many developing countries “imported” regulatory credibility as a result of official and market pressures, especially those economies whose regulatory frameworks came under scrutiny following the

financial crises of the late 1990s and early 2000s (Walter, 2008). In addition, some large developing countries which joined the G20 came under further pressure to implement Basel regulations. All the G20 countries, including the developing-country members, agreed to allow the Financial Sector Assessment Program (FSAP)¹³ to conduct

an analysis of their domestic financial sector – which includes an assessment of their observance of Basel guidelines – as well as to accept peer reviews of their supervisory frameworks (Walter, 2015).

Table 4.1**BASEL IMPLEMENTATION IN DEVELOPING AND TRANSITION ECONOMIES**

	Total economies surveyed	Basel II		Basel III	
		Capital requirements (Standardized approach)	Capital requirements (Internal ratings based approach) (Per cent)	Leverage ratio	Liquidity coverage ratio (Per cent)
<i>Region (whole sample)</i>					
Africa	30	27	10	13	13
East, South and South-East Asia	17	82	59	47	29
Latin America and the Caribbean	21	38	23	14	24
Transition economies from Europe and Asia	11	73	9	18	18
West Asia	9	100	33	33	33
<i>Region (excluding BCBS members)</i>					
Africa	29	23	7	10	10
East, South and South-East Asia	11	27	13	0	7
Latin America and the Caribbean	18	16	7	7	3
Transition economies from Europe and Asia	10	23	3	7	3
West Asia	7	23	3	3	3

Source: UNCTAD secretariat calculations, based on BIS, 2014 and 2015.

Note: The data cover the following economies, by region: **Africa:** Angola, Benin, Botswana, Burkina Faso, Côte d'Ivoire, Democratic Republic of the Congo, Egypt, the Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Morocco, Mozambique, Namibia, Niger, Nigeria, Senegal, **South Africa**, Togo, Tunisia, Uganda, United Republic of Tanzania, Zambia and Zimbabwe; **East, South and South-East Asia:** Bangladesh, Bhutan, **China, Hong Kong (China), India, Indonesia, Malaysia, Mauritius, Nepal, Pakistan, the Philippines, Republic of Korea, Singapore, Sri Lanka, Taiwan, Province of China, Thailand and Viet Nam;** **Latin America and the Caribbean:** **Argentina, Belize, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Panama, Paraguay, Peru, Trinidad and Tobago, Uruguay;** **Transition economies from Europe and Asia:** Albania, Armenia, Belarus, Bosnia and Herzegovina, Georgia, Kyrgyzstan, Montenegro, Republic of Moldova, **the Russian Federation**, Serbia and the former Yugoslav Republic of Macedonia; and **West Asia:** Bahrain, Jordan, Kuwait, Lebanon, Oman, Qatar, **Saudi Arabia, Turkey, United Arab Emirates** (countries in bold are members of the Basel Committee).

Implementation of the new Basel III capital requirements by the major developing economies may not have been particularly difficult because, in general, their banking systems had higher capital levels before the global crisis than those stipulated in Basel III.¹⁴ However, this picture is not uniform. In India, for instance, public banks, which account for 62 per cent of Indian bank loans, will find it difficult to meet the Basel III capital requirements between now and 2019 (Moody's, 2014). The degree of compliance varies much more for Basel III's new liquidity requirements. An FSB survey indicates that Argentina, Brazil, Indonesia and Mexico are behind other countries such as China and South Africa in their extent of compliance (FSB, 2014a). According to a recent assessment by Fitch (2015), smaller banks in Mexico will struggle to meet the liquidity coverage

ratio, and will face an even bigger challenge when the net stable funding ratio requirements are eventually adopted by their country's regulators.

Developing countries other than the G20 members appear to be facing a much greater challenge in meeting Basel requirements. A critical challenge is the level of complexity of Basel rules, particularly the new rules under Basel III, which not only require sophisticated technical capabilities for their implementation but are also resource intensive (Haldane and Madouros, 2012). FSAP reports on countries from different developing regions indicate a general lack of compliance with Basel standards due to critical capacity gaps. These include, overall, insufficient and poorly trained staff who also lack the experience to perform regulatory and supervisory functions

satisfactorily. These gaps become even more critical with respect to the very complex Basel III rules.

There are other significant concerns related to the implementation of Basel III. The adoption of the NSFR, which aims at reducing the maturity mismatches between banks' assets and funding sources, may have adverse consequences for developing countries, as banks in those economies are mainly funded through (short-term) deposits. As such, the requirement for a strict match between maturities of assets and liabilities may reduce banks' abilities to supply long-term credit. Another challenge has to do with the implementation of countercyclical capital buffers. Economies at early stages of financial development may experience rapid credit growth which triggers the buffer mechanism, even though there may not be a build-up of systemic risks (Drehmann and Tsatsaronis, 2014).

A more general concern is that Basel regulations have increasingly focused (without much success) on a narrow view of financial stability at the expense of regulations geared towards the realization of growth and equity objectives. Reliance on risk-weighting for capital determination, whether through the standardized approach or the more complex methods, is likely to result in credit rationing to sectors that need support from a development perspective. The Basel guidelines for credit risk measurement may increase the capital requirements for financing SMEs (which are generally viewed as presenting higher risks) and for long-term projects, while making lending cheaper to larger firms, including international companies that are usually awarded higher ratings by external CRAs.

Therefore, it seems that, despite developing countries' greater representation on international forums, the reforms undertaken following the global financial crisis do not seem to address a number of their concerns. The focus on narrowly defined prudential reforms may be inadequate for preventing future crises. They are also complex and difficult to implement in many developing countries, and indeed, their implementation may pose obstacles to economic development.

Despite developing countries' greater representation on international forums, the reforms undertaken seem to neglect a number of their concerns.

4. Some attempts to ring-fence banking operations

In parallel to the adoption of the regulatory reforms coordinated by the FSB at the international level, many developed countries drafted new national legislation to address systemic risks in their financial systems. Of all the reform proposals triggered by the financial crisis, the most far-reaching are those containing provisions to "ring-fence" financial activities, which go beyond the prudential approach of the Basel framework.

The basic argument for ring-fencing is that insulating depositors' assets from risky bank activities would limit the probability of a bank run in case of insolvency resulting from "casino" investment decisions. Such separation would also facilitate resolution of a banking group in difficulty and would reduce the likelihood or the necessity of government intervention to save banks that have run into trouble as a result of their high-risk trading activities. A historical

precedent is the United States Glass Steagall Act, which prohibited commercial banks with privileged deposit insurance from engaging in market activities, while excluding investment banks from accepting deposits. That reform, which was part of the New Deal of 1933, regulated the functioning of the United States financial system for a period of over 65 years until the

Financial Services Modernization Act of 1999 lifted restrictions on banks.

The United States did not reintroduce deep bank reorganization measures after the 2008–2009 financial crisis, but opted instead for a rule restricting some of the activities of banks. Among its various provisions, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 included the Volcker Rule, which prohibits two types of activities. First, a banking entity under United States jurisdiction is not allowed to engage in proprietary trading. This means that banks cannot buy or sell securities for their own account.¹⁵ Second, the Rule prohibits banks from sponsoring, acquiring or retaining an ownership interest in hedge funds and private equity funds.

In late 2013, the United Kingdom introduced legislation on banking reform based on the so-called Vickers Report. Unlike in the United States, the reform did not focus on prohibiting banks' risky activities but on ring-fencing deposit-taking institutions. As such, it was decided that retail banking had to be set apart from investment banking in a separately capitalized subsidiary. The aims of the reform were to help insulate domestic retail banks from external financial shocks and facilitate resolution of troubled banks should the need arise (FSB, 2014b). The recommendations of the Vickers Report were a response to the worrying fact, from the United Kingdom perspective, that the international exposure of that country's banking sector was many times larger than the domestic economy measured by its GDP. One of the aims of ring-fencing was to protect domestically oriented banking from whatever might happen in the globally oriented activities (Wolf, 2014).¹⁶ The ring-fencing applied only to large financial groups holding core deposits of over £25 billion.

The European Commission (EC) also examined the possibility of structural reform of the European Union's financial system. Based on the recommendations of its High-level Expert Group on Bank Structural Reform (the so-called Liikanen Commission), the EC submitted draft regulations, a core proposal of which was that proprietary trading and other high-risk trading activities should be assigned a separate legal entity from the rest of a bank's businesses. If the reform is enacted, it will be restricted to banks holding assets larger than 30 billion euros, and it will apply not only to deposit-taking banks, but also to their parent companies and subsidiaries. France and Germany have already introduced rules partially based on the recommendations of the Liikanen Commission.

The structural measures proposed by the United States, the United Kingdom and the European Union aim to lower the probability of bank failure and its systemic implications by reducing the risk for deposits associated with banks' interconnectedness (Viñals et al., 2013). A possible way to restructure

Ring-fencing bank activities would limit the probability of a bank run in case of losses from "casino" investment decisions...

the financial sector would be to establish a firewall between banks taking deposits and those engaged in broker-dealer activities. However, ring-fencing initiatives – just like proposals to raise minimum capital requirements – face strong resistance from the banking industry lobby. Indeed, none of the ring-fencing

rules discussed above is fully in place yet. Implementation of the Volcker Rule in the United States has been postponed several times, and a further delay to 21 July 2016 set by United States regulators is being considered. In the United Kingdom, regulators expect to finalize rules in

2016, with banks fully complying by 2019, but there is considerable resistance from the sector.

It is still unclear whether these measures will be able to inhibit further expansion of large banks and make it easier for government authorities to manage or control them. Pressures from some financial actors have made the proposed regulations much more complex than they needed to be. Exceptions, loose definitions and supervisory judgements could weaken the outcomes of the reforms. In the United States, there are important exceptions to the prohibition of proprietary trading and other trading activities. The exceptions include permission to engage in hedging activities to mitigate risks, proprietary trading involving United States Government debt instruments

and market-making. The lack of a precise definition of proprietary trading enables banks to determine for themselves which trading activities are permitted, and which are not. And despite reforms in France and Germany, the intention seems to be to maintain the universal

... and facilitate the resolution of a banking group in difficulty, thus reducing the likelihood of expensive government bailouts.

banking model, although national supervisors will have the discretion to separate certain activities from core banking, but only when they judge a financial institution's solvency to be under threat.

Therefore, it remains to be seen to what extent the various regulatory and structural reform measures will be sufficiently effective in reducing the complexity and interconnectedness of large banks so as to make them safer, and whether they will discourage these banks from becoming even larger, or help reverse long-term trends in banking concentration.

C. The rise of the shadow banking system

1. The emergence and principal features of the shadow banking system

After the 2008–2009 global financial crisis, large banks reduced some of their lending activities to repair their balance sheets and adapt to tighter regulations. As a result, banks' credit to the private sector in developed countries has witnessed a downward trend.

Despite this movement, total global debt expanded by \$57 trillion between 2007 and 2014, which increased the ratio of global debt to GDP by 17 percentage points to 286 per cent of GDP (McKinsey, 2015). The growth in borrowing occurred principally outside the traditional regulated banking system. In developed countries, forms of non-bank finance, such as corporate bonds and credit issued by non-bank institutions, have soared since the global crisis. Meanwhile, bank managers have continued to move activities off their balance sheets, after packaging the loans into securities to sell in the markets. Although securitization has declined in importance compared with the pre-crisis period, it remains significant: in 2014, 32 per cent of the stock of household debt (mainly mortgages and credit card loans) in developed countries was securitized, against 36 per cent in 2007 (McKinsey, 2015).

The shift in credit intermediation from the banking to the non-banking sector reflects the larger role of the asset management industry (IMF, 2015). This industry is composed of institutional investors, including insurers, and investment funds such as hedge funds and mutual funds, as well as off-balance sheet entities such as special purpose entities, all of which buy and sell securities and other financial assets.¹⁷ Financing via capital markets involves both “direct finance” mechanisms, in which investors bear all the credit risk, and the so-called shadow banking

system. Both complement (but also compete with) traditional banking, and are alternative sources of funding for real economic activity. Shadow banking, however, poses a number of threats to financial stability, as it performs the same functions as traditional banking without appropriate regulation.

In the shadow banking system credit intermediation takes place with less transparency than traditional banking. Agents in that system take deposits (just as banks do) or accept deposit-like investments, extend credit and perform maturity and liquidity transformation, often relying on leveraging techniques to increase profitability. They convert short-term liabilities, such as deposit-like shares in money market mutual funds (MMMFs), into a wide range of long-term assets – from government securities to bonds issued by means of complex securitization techniques. Financial companies performing bank-like intermediation face fewer restrictions on their size and leverage, but lack access to explicit liquidity guarantees. This makes the shadow banking system inherently fragile.

The role of the shadow banking system in the 2008 financial crisis is well known, and has been documented and analysed in previous UNCTAD reports (e.g. *TDRs 2009 and 2011*). The G20 and the FSB have identified a number of problems with that system, which contribute to global financial fragility. However, not nearly enough has been done in terms of regulation of the shadow banking system. Clearly, more ambitious reforms are needed.

Shadow banking is the outcome of deregulation of the financial system over the past four decades. This market-based system developed mainly in the so-called Anglo-Saxon countries, and then expanded to most of the other countries, including the developing ones. In the process, institutional investors (including insurance companies, pension funds and

mutual funds) became major participants in global financial markets, and the size of their assets under management rapidly caught up with those of the banking system. Subsequently, most institutions turned to specialist asset managers to help them invest, which drove growth in equity markets during the 1980s and in the hedge funds industry in the 1990s. Direct investment by institutional investors provided a stable and reliable source of funding for borrowers and the opportunity for investors to hold a diversified portfolio of financial assets.

The development of innovative forms of market intermediation allowed many asset managers (such as hedge funds) and broker-dealers (often belonging to financial conglomerates) to expand investments by leveraging within the financial system and funding asset purchases with their debt. As a significant proportion of the debt issued by intermediaries was short term, the financial companies performed maturity transformation. In the traditional banking system, intermediation between depositors and borrowers occurs in a single entity. By contrast, the credit intermediation process performed by the shadow banking system can involve not just one, but a web of specialized financial institutions that channel funding from lenders to investors through multiple market-based transactions and lending vehicles.

A simple example facilitates an understanding of the basic functioning of the shadow banking system. The typical lender in the credit intermediation chain is a household investing its cash holdings in shares of an MMMF in search of a higher yield than the one typically offered by a deposit in a commercial bank.¹⁸ The lender may also be a treasurer of a large company seeking to invest available cash in a different form than bank deposits, which in most countries are not insured for large sums. The final borrower in the shadow banking system is any entity issuing securities (i.e. a government or private corporation) to fund its expenditures or investments. It can also be a household if its loans or debts (e.g. mortgage or credit card debt) are packaged into securities by banks or specialized financial institutions. Securitized bonds (including structured securities) are in fact a key component of the shadow banking system. The

cash resources from MMMFs and companies are invested in short-term debt securities (i.e. commercial paper and government bills or any debt about to reach maturity) and in short-term (often one day) repurchase agreements (repos). Repos are a form of secured lending backed by collateral, so that they seem safer than non-insured bank deposits (see box 4.1).

Investments in bills or commercial paper do not carry significant maturity risk, as the short-term funding is matched with short-term investments. But the liquid resources provided through repos often end up being used by the borrower for the outright purchase of a long-term security or another asset in such a way that the system performs maturity trans-

formation, similar to what banks do but in a less transparent way. The broker-dealer may indeed use the funds it raises through repos to purchase high-quality securities, which it then uses as collateral for the transaction.¹⁹ Hedge funds are typically engaged in repos and other kinds of short-term borrowing for leveraged investing.

Shadow banking is growing strongly in developing economies, although the steps involved in the chains of credit intermediation tend to be simpler. That said, it can still pose systemic risks, both directly, as its importance in the total financial system grows, and indirectly through its interlinkages with the regulated banking system (Ghosh et al., 2012).

2. How big is shadow banking?

The perimeter of the shadow banking system and its overall size are currently under debate. The FSB, engaged since 2011 in a global project to monitor and measure shadow banking, originally defined it as “credit intermediation activities involving entities outside the regular banking system” (FSB, 2014c). Following this definition, the size of the system is determined by the volume of total financial assets of non-bank financial intermediaries, excluding insurance companies, pension funds and public financial institutions (which are regulated). Many judged this definition as being too broad.

In the shadow banking system, credit intermediation takes place with less transparency and regulation and higher leverage than traditional banking.

Box 4.1**REPOS: THE CORE TRANSACTION OF THE SHADOW BANKING SYSTEM**

A repurchase agreement (or repo) is an acquisition of funds through the sale of securities, with a simultaneous agreement by the seller to repurchase them – or substantially similar ones – at a later date, often overnight. The borrower pays interest at a rate negotiated with the lender, and retains the risk and return on that collateral, so that the role of the security involved in the transaction is only to provide collateral to the lender. Repos are therefore a means of secured lending of short-term funds. In practice, however, a sizeable portion of the funds used remains in repos for relatively long periods, as the daily contracts are rolled over. In that sense, repos are a deposit-like funding source for the borrower. Meanwhile, the owners of the funds can treat them virtually as demand deposits, as they have ready access to the cash, should the need arise, by not renewing or rolling over the repo.

Repos are attractive to corporate treasurers and other holders of large cash balances because they can earn a secured market rate of return until they are used for payments. In addition, repos may seem safer than bank deposits, which are not protected by deposit insurance for large amounts. Repos, along with commercial paper, are also a typical investment product for MMMFs, whose shareholders are also ultimate lenders in the shadow banking system.

The borrower in the repo transaction may use the cash to finance a long position in the asset involved in the collateral, in amounts and at prices that reflect the security provided to the lender (ICMA, 2015). Broker-dealers also frequently arrange reverse repos in order to borrow the securities with which to engage in a repo; by matching a repo and a reverse repo transaction, they may profit by the difference in interest rates. Dealers also use reverse repos to acquire securities to make a short sale.

The advantage for borrowers through repos, including commercial banks and broker-dealers, is that they are not required to hold reserves against funds obtained through the repos.^a Another advantage is the flexibility in recording these transactions in the books, at least for firms operating in the United States under the Generally Accepted Accounting Principles (GAAP). For instance, some lenders choose to record their ownership of securities rather than their ownership of repos, which may be considered a better risk and thus less costly in terms of capital requirements. For borrowers, assets sold in repos may be removed (temporarily) from the balance sheets, thereby disguising the true level of the leverage (ICMA, 2015).^b

The bankruptcy “safe harbour” for repos has been a significant factor contributing to the growth of shadow banking (Gorton and Metrick, 2009). In the United States, repos are exempt from core bankruptcy rules such as the automatic stay on debt collection under Chapter 11 of the United States Bankruptcy Code. Under New York law (the main jurisdiction for United States repos), a party to a repo contract is allowed to unilaterally enforce the termination provisions of the agreement as a result of a bankruptcy filing by the other party by selling the collateral to recover the deposit. Without this protection, a party to a repo contract would be a debtor in bankruptcy proceedings (Gorton and Metrick, 2009).^c In Europe, the repo transfers legal title to collateral from the seller to the buyer by means of an outright sale. Therefore in major financial centres, for large depositors, repos can act as substitutes for insured demand deposits.

It encompasses non-leveraged activities by fund managers that administer investments on behalf of their clients, who bear gains and losses directly, so that there is no intermediation per se. In response to this, the FSB started reporting on a narrower measure, filtering out non-bank financial activities that have no direct connection with credit intermediation (e.g. the

transactions of non-leveraged equity funds) or that are prudentially consolidated into banking groups (e.g. securitized products held by banks and assets from the broker-dealer activities of the universal banks).

The IMF has proposed measuring the volume of the “non-core” liabilities of both banks and

Box 4.1 (concluded)

An interesting feature of repos is that the collateral posted by a client to its broker may be used as collateral also by the broker for its own purposes with an unrelated third party. The same collateral can therefore support multiple transactions. Indeed, brokers may rehypothecate the assets received as collateral, for instance from a hedge fund, to gain access to the money they lend to its customer. The client that borrowed the money (the hedge fund) can use its increased assets for a new repo transaction. The dealer uses the security to raise more funds, and so on, *ad infinitum* (Singh and Aitken, 2010). Unlimited leverage has practical constraints. Market participants tend to apply haircuts (a percentage discount) to the collateral in a repo in order to calculate its purchase price. Applying haircuts is equivalent to asking for an overcollateralization. The adjustment is intended to take account of the unexpected losses that one party to the repo trade might face in buying (or selling) the securities if the other party defaults. Haircuts limit the leverage. For instance, a hedge fund financing its asset position through a repo (and using the purchased asset as collateral) will need to buy part of its position with its own resources. An infinite multiplier would also come up against the credit limits imposed by financial institutions on their counterparties and, if applied, against limits due to regulatory constraints.

According to the International Capital Market Association (ICMA), there are large repo markets in Europe, the United States, Latin America and Japan, as well as rapidly emerging (although still relatively small) repo markets in China and a number of African countries. Outstanding repo contracts in the European repo market totalled an estimated 5.5 trillion euros in December 2014, but this estimate is not comprehensive as it only includes the most active participants in the European repo market (ICMA, 2015). The Federal Reserve Bank of New York reported that the outstanding repo business of primary dealers (who may account for as much as 90 per cent of the United States market) amounted to almost \$5 trillion in 2014. The ICMA Centre at Reading University has suggested that, although the global market for repos has contracted since 2007, it may have amounted to 15 trillion euros in 2012. Gorton and Metrick (2009) suggest an amount up to three times larger for the United States.

- ^a If they are banks, the leverage ratio may apply, depending on the accounting rules of the jurisdictions where they are based.
- ^b The firms often use loopholes specific to the United States GAAP. In order to ensure that the balance sheet makes clear which assets have been sold in repos, the International Financial Reporting Standards (IFRS) requires that securities against a repo be reclassified from “investments” to “collateral” and balanced by a “collateralized borrowing” liability.
- ^c According to Morrison et al. (2014), evidence shows that exemptions from the Bankruptcy Code’s normal operation for repos distort the capital structure decisions of financial firms by subsidizing short-term financing at the expense of other, safer debt channels, including longer term financing. When financial firms prefer volatile short-term debt to more stable long-term debt, they (and markets generally) are more likely to experience a “run” in the event of a market shock, such as the downturn in housing prices witnessed during the global financial crisis.

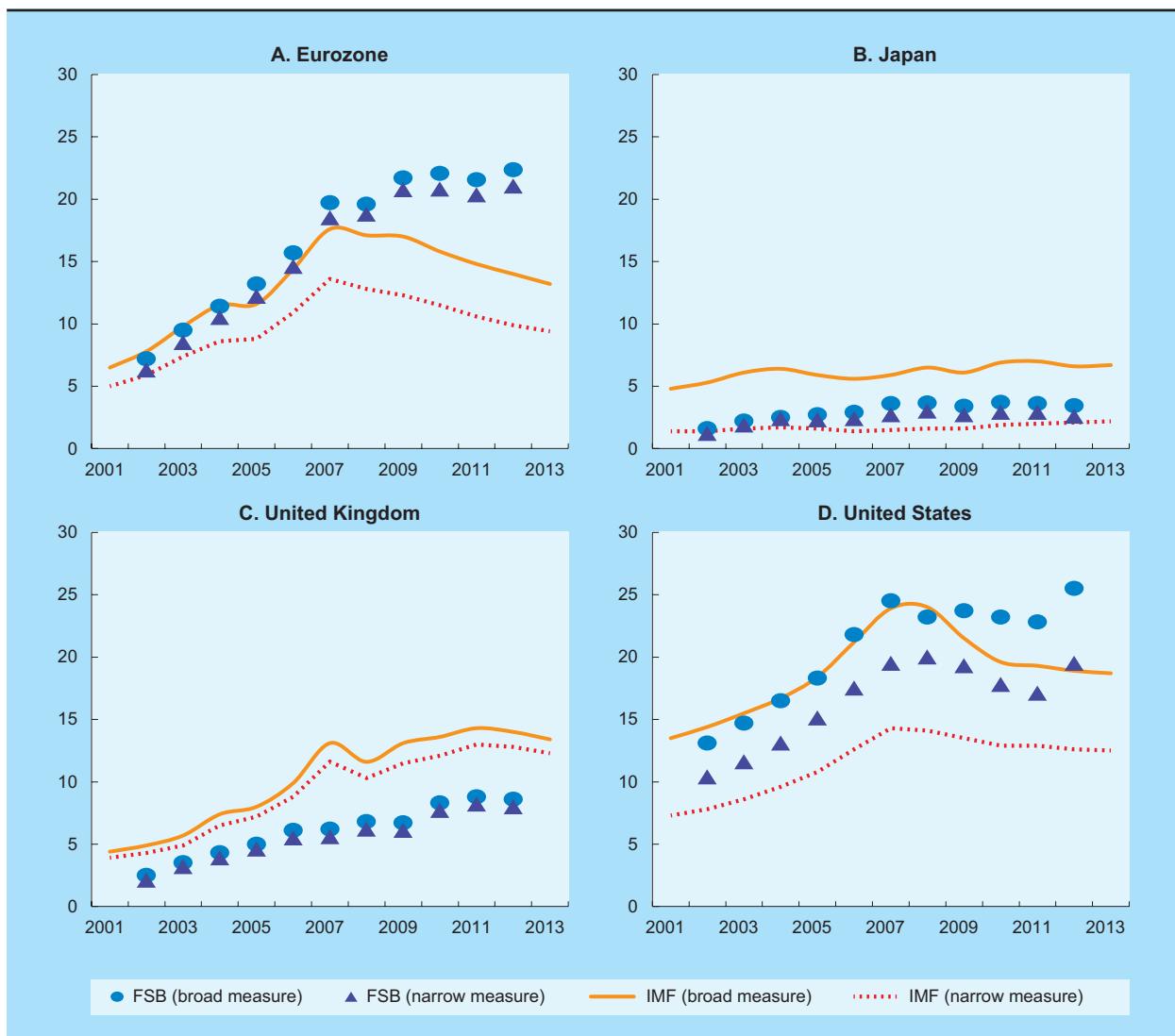
non-bank financial institutions to estimate the size of the shadow banking system (IMF, 2014). Non-core liabilities are all the funding sources of financial firms that differ from bank deposits. According to this definition, which includes all non-traditional financial intermediation, securitization is also part of shadow banking, regardless of whether it is

conducted directly on balance sheet by a bank or indirectly through a special purpose entity (SPE). The IMF has also suggested a narrower measure of shadow banking which excludes interbank debt.

Based on the FSB’s broad measure, shadow banking activity has expanded significantly since

Chart 4.2**SIZE OF SHADOW BANKING BY DIFFERENT MEASURES, 2001–2013**

(Trillions of dollars)



Source: Harutyunyan et al., 2015; and FSB, 2014c.

2002, particularly in developed economies, and, notably, it continued rising after the financial crisis. Its overall size in terms of assets was an estimated \$75.2 trillion, or about one fourth of total financial intermediation worldwide at the end of 2013, a sharp rise from \$67 trillion in 2011 and \$71 trillion in 2012. The largest shadow banking systems are located in the United States, the eurozone and the United Kingdom (chart 4.2), but shadow banking intermediation has been also expanding in a few developing countries such as China (see box 4.2).

Other forms of shadow banking exhibited a similar growth trend until 2007, but the pattern changed after the crisis, when it stagnated or declined, according to IMF measures.²⁰ The main reason for this, both in the United States and in the eurozone, was sluggish activity among issuers of asset-backed securities and a fall in commercial bank debt issuance. MMMFs' shares, which also shrank after the crisis, further contributed to the drop in total non-core liabilities. In contrast, FSB estimates point to a pick-up of shadow banking activity after the mild

Box 4.2**SHADOW BANKING IN CHINA**

In China, the rise of a shadow banking system is quite recent, as banks have completely dominated the credit system since the market reforms of the late 1970s. Even as recently as the end of 2008, bank loans represented almost 90 per cent of outstanding credit in China (Elliott et al., 2015; Elliott and Yan, 2013). Reforms in the country's finance and banking sectors over the 1990s and 2000s (Okazaki, 2007; Kruger, 2013) resulted in greater sophistication of financial instruments and also made it more possible to avoid regulatory controls.

Shadow lending in China takes place through a wide range of entities involving five main sources of financing: wealth management products, entrusted loans, trust loans, financing companies and informal loans. Many shadow banking activities are specifically designed to circumvent banking regulations, and can therefore be interpreted as forms of internal regulatory arbitrage (Chandrasekhar and Ghosh, 2015). For example, despite caps on lending volumes of banks and limits on loans to potentially risky borrowers (such as local government financing vehicles, real estate developers, coal miners and shipbuilders), those loans actually continued to increase, because they were routed through shadow lending.

Wealth management products (WMPs) provide a return based on the performance of the underlying assets (a single loan or a pool of loans), typically higher than bank deposit rates to which monetary authorities apply caps, thereby enabling interest rate liberalization "by stealth" (Kruger, 2013). They are promoted as low-risk instruments, and a significant number of them offer guaranteed returns (IMF, 2014). Entrusted loans are inter-company loans in which one firm serves as the ultimate lender and records the loan asset on its balance sheet, while banks act as intermediaries and collect fees. Funds of entrusted loans typically flow into assets such as property and stocks, and they are a potential risk to financial stability since they generate a new round of credit and increase leverage. There are other channels through which non-financial firms offer credit to one another, such as corporate discounting of bank acceptance bills, which can also be used to add to leverage (Elliott et al., 2015).

Guarantee companies, originally created to help SMEs obtain access to bank loans, charge prospective borrowers a fee, and in exchange serve as a guarantor to a bank, pledging to pay for any losses in the event of a default. In effect, the "credit guarantee" company sells insurance to the bank for a risky loan, with the borrower having to take on the premium. Like any insurance scheme, this arrangement may be risky if the risks are correlated between borrowers. Finally, other forms of intermediation consist of informal lending by individual money lenders (such as pawn shops and kerb lenders) to households and small businesses.

Independent estimates of the extent of shadow banking in China vary wildly from a low of 8–22 per cent of GDP to a high of as much as 70 per cent of GDP in 2013 (Chandrasekhar and Ghosh, 2015). According to the IMF (2014), social financing through shadow banking had risen to 35 per cent of GDP by early 2014, and it is expanding at twice the rate of bank credits. The value of total assets of WMPs accounted for 25 per cent of GDP, having grown by 50 per cent since early 2013, and threefold since early 2011. Under the broadest definitions of shadow banking, China's shadow banking sector remains much smaller relative to the size of its GDP than those of the United States (150 per cent), the United Kingdom (378 per cent) and many countries of the eurozone.

As part of their efforts to curb the risks associated with the informal financial sector, the Chinese authorities introduced insurance for bank deposits of up to 500,000 renminbi per depositor per bank in April 2015, covering both individuals and businesses. This should make the distinction between bank deposits and unprotected wealth management products clearer, but there is still likely to be intense political pressure to step in and rescue unprotected investors when such schemes fail (EIU, 2015). Officials have frequently stated that the Government will not back shadow banking transactions undertaken by banks, although the issue is complex, since bank ownership in China is held by the Government in the form of shares.

drop in 2008, reflecting growth in the volumes intermediated by investment funds and positive valuation effects following the recovery of asset prices from their low values in 2008–2009.

However, the size of shadow banking tends to be grossly underestimated, as most measures exclude the shadow banking entities domiciled in many offshore financial centres, or tax havens. The FSB recognized that incorporating data from these offshore centres, which are non-FSB member jurisdictions, would help fill gaps in the current global monitoring exercise. Such gaps may be large, as financial entities move sizeable portions of their shadow activities to offshore centres to avoid regulations in their home countries.

3. Risks associated with shadow banking

The specialization of each institution participating in the chain of intermediation of the shadow banking system allows borrowers and lenders to avoid credit spreads and other fees charged by traditional banks. In that sense, shadow banking may bring efficiency gains from specialization with lower costs for clients and healthy competition for banks. It has been argued that securitization enables the mobilization of illiquid assets, thus broadening the range of potential lenders, and that structured finance techniques can be used to tailor the distribution of risk and returns to better fit the needs of ultimate investors (IMF, 2014). However, activities that resemble banking, particularly by taking deposits, create specific financial risks. Unlike banks, to which authorities apply capital requirements and other rules, the transactions

in the shadow banking system are not regulated and lack explicit public sector credit guarantees or access to central bank liquidity backstops. Problems in the intermediation chain can therefore trigger a systemic crisis in the whole financial system.

Since the 2008 crisis, various features of the shadow banking system have been highlighted as highly problematic for financial stability. A leading

concern is the quality of some financial products traded in that system. Some of the loans packaged into securities to be sold in the market (i.e. asset-backed securities) have often been poorly underwritten, with issuers not recording the risks in their balance sheets, and instead transferring them to the buyers (Coval et al., 2008).²¹ As the 2008 crisis has shown, the “originate and distribute model” carries moral hazard. Banks are likely to be more careful in evaluating risk when they plan to keep a loan on their books, while securitization may lead to weakened lending standards and a deterioration of credit quality. A particular concern relates to complex securitization structures (e.g. collateralized debt obligations), for which risks are particularly difficult to assess.

A second concern, directly related to macroeconomic stability, is that shadow banking is highly procyclical. When asset prices are high, the value of the collateral for repos increases, enabling more leverage. Shadow banking therefore contributes to asset price bubbles (Pozsar et al., 2013), and also to a credit crunch when a financial cycle comes to an abrupt end. Some types of collateral used for transactions may even become unacceptable during periods of turmoil.

Indeed, a third concern is that shadow banking is particularly prone to risks of clients’ sudden and massive withdrawals of funds originating from market-based transactions instead of from a run on deposits. Indeed, the panic of 2007–2008 originated in a securitized bank run (a repo run) driven by the withdrawal of repurchase agreements (Gorton and Metrick, 2009). Uncertainty as to the real value of the assets serving as collateral led to massive redemptions on the repo market.

Shadow banking may bring efficiency gains from specialization, with lower costs for clients and healthy competition for banks, but many of its features are highly problematic for financial stability.

A fourth concern relates to contagion effects from runs on the shadow banking system to the rest of the financial system. One mechanism of contagion is through asset prices. In the event of a run on the shadow banking system, massive sales of assets may have repercussions for prices of financial and real assets and a direct impact on the mark-to-market valuation of securities in the books of the traditional banks. A second mechanism of contagion relates to

the fact that banks also fund activities in the wholesale market, where illiquidity caused by shadow banking activities may induce the banks to engage in rapid deleveraging. This can lead to a further fall in prices and create negative feedback loops. Such spillovers also take place internationally. Finally, since banks and insurance companies provide shadow entities with back-up liquidity lines and implicit guarantees to special purpose vehicles, incidents in shadow banking may directly affect traditional intermediaries (Greene and Broomfield, 2014).

4. Insufficient reforms

It is surprising that, so far, regulatory reforms have paid relatively little attention to the many entities and activities of shadow banking. Indeed, focusing mainly on reforming the regulated financial sector may even be inducing a large migration of banking activities towards the shadow banking system, as hinted earlier (see also IMF, 2014).

At the G20 Seoul Summit in November 2010, leaders requested the FSB to develop recommendations to strengthen oversight and regulation of shadow banking activities.²² In response, the FSB developed a framework for conducting annual monitoring exercises to identify entities and activities in credit intermediation and assess global trends and risks posed by the shadow banking system.²³ FSB recommendations to improve the market infrastructure and the resilience of institutions are now under consideration by national authorities. They address a number of identified concerns, including a heavy reliance on short-term wholesale funding for some intermediaries, weakened lending standards due to some securitized assets and structured products, and a general lack of transparency that hides growing amounts of leverage and maturity mismatches, as well as the ultimate bearer of the associated risks.

The proposed reforms cover four areas (discussed below), and some countries have already adopted new regulations.

- (i) In order to mitigate risks in banks' interactions with shadow banking entities, there are recommendations to set risk-sensitive capital requirements for banks' investments in equity

funds and a proposed supervisory framework for measuring and controlling banks' large exposures, including to shadow banking activities. Countries that are members of the Basel Committee have agreed to fully implement the framework by 2019.

- (ii) In order to limit massive and sudden redemptions, the following measures are proposed: limit the use of constant net asset value to allow the share prices of those funds to fluctuate in line with the market value of the funds' assets, impose capital buffers, require redemption restrictions, establish liquidity and maturity portfolio requirements, and require stress testing.²⁴
- (iii) In order to improve transparency in securitization, it is recommended that risk retention requirements be included for entities sponsoring securities, and that banks and other financial sponsors of securitization transactions be required to retain part of the loans on their books. The latter was approved by the United States in 2014.
- (iv) Regarding repo agreements, in October 2014 the FSB published a regulatory framework for securities financing transactions in order to limit excessive leverage as well as maturity and liquidity mismatched exposures. It consists of minimum qualitative standards for methodologies used by market participants that provide securities financing to calculate haircuts on the collateral received, and numerical haircut floors that will apply to non-centrally cleared repos, in which financing against collateral other than government securities is provided to entities other than banks and broker-dealers.

Additional work on other shadow banking entities is also under way within the FSB in order to list the entities that could be covered, map the existing regulatory and supervisory regimes in place, identify gaps in those regimes, and suggest additional prudential measures for those entities, where necessary.

The aim of these regulatory reform proposals is to transform shadow banking into a resilient market-based system of financing. However, while they address particular risks, the proposed actions appear to be insufficient to deal with the system's inherent systemic risks. A major challenge to regulatory

reform of the shadow banking system is how to ensure appropriate oversight and minimize risks to financial stability while not inhibiting sustainable non-bank financing conduits that do not pose significant risks, particularly where shadow banking fills a gap.

In the case of securitization, the balance sheet capital retention requirements of less than 5 per cent seem arbitrary and small; investors may still confuse MMMFs with deposits and be susceptible to panics. For repos, the proposed haircuts are only for bilateral transactions, leaving open the possibility of large rehypothecation (and leverage) in centrally cleared markets. The FSB even dropped the minimum haircuts requirement on repos with government bonds that it had initially suggested to make repo-supported leverage more expensive (FSB, 2012). In addition, the FSB monitoring exercise is not comprehensive, as data collection from offshore financial centres is lacking.

Measures such as a financial transactions tax (FTT) applied to repos, which would significantly reduce leverage in the shadow banking system, are

missing from the FSB reform agenda, and have been fiercely opposed by most market participants (including central banks).²⁵ Other ambitious reforms more consistent with a market-based approach have been suggested, but they have not received proper consideration. For instance, Gorton and Metrick (2009) have proposed principles for regulation of shadow banking entities based on the premise that any kind of banking should be brought under the regulatory umbrella. On this premise, regulators would have to provide strict guidelines on what kinds of collateral may be used for repos and on minimum haircuts (to limit leveraging and reduce rehypothecation). Totally unregulated repos may still be authorized, but authorities would have to make it clear that the buyer of the repo will not receive special bankruptcy protection.

To sum up, despite some moves towards tightening rules relating to specific activities, shadow banking remains largely unregulated, probably because of the pressure to avoid impacts on the price of financial services or on the profitability of financial institutions. This means that the systemic risks arising from the very nature of shadow banking could continue to pose a threat to global financial stability.

D. Other important issues in financial regulation

The global financial crisis raised unprecedented concerns about the governance of financial institutions and the lack of transparency of information in financial markets. The list of distorted incentives at the root of the crisis is long, but at the top of that list are the role of credit ratings in regulations for risk assessment (discussed below) and, of particular importance for developing countries, the absence of international macroprudential regulations to tame speculative international capital movements. In this context, foreign banks with branches and subsidiaries in developing countries are important channels for transmitting global financial spillovers to these economies, and therefore pose specific regulatory challenges.

1. Credit rating agencies: The need for more than a code of conduct

Credit rating agencies (CRAs) are a fundamental institution of today's financial markets.²⁶ By rating large corporate borrowers, sovereign bonds, municipal bonds, collateralized debt obligations and other financial instruments, CRAs provide prospective investors with guidance on the borrower's creditworthiness. The role of ratings is to provide investors with information and opinions on whether a bond issuer may renege on its commitments. The rating services cater to both non-specialist bondholders (e.g. the general public and small financial firms) and specialist

investors (i.e. financial intermediaries such as banks, insurance companies and pension funds). They help the former by providing the necessary information to assess the creditworthiness of borrowers; and they can help the latter obtain information concerning unfamiliar bond markets or new lending activities.

The activities of CRAs, as expressed through news about ratings, have an impact on asset allocation, as ratings contribute to the determination of the interest rate – or price – the borrower must pay for obtaining financing. Reliance on credit ratings has increased over time with the development of financial markets and the use of ratings in regulations, standards and investment guidelines, both at the national and international levels, as evidenced by their frequent references to CRAs' ratings. They constitute a key component of regulatory risk measurement, and can be used to determine capital requirements for banking institutions. They also influence decisions on whether the rated assets can be used as collateral, and determine benchmarks for asset managers' strategies. The Basel II capital adequacy framework allows banks to consider external credit assessments of the borrower – or the specific securities issued by the borrower – for the determination of risk weight for the banks' exposures. Another example is the reliance by many central banks on CRAs' assessments of the financial instruments they accept for open market operations, both as collateral and for outright purchase.

However, the wide use of CRA ratings has now come to be recognized as a threat to financial stability and a source of systemic risk.

The 2008–2009 global financial crisis served as a reminder of a number of serious problems in the ratings industry. It became clear that many ratings, such as those relating to subprime collateralized debt obligations and other securities – including from governments – had been artificially inflated. This was related to the business models of the rating agencies, which contain serious conflicts of interest: essentially, rating agencies are paid by the very issuers whose securities they are rating.²⁷ Overrating debts and underestimating the default risk allows the issuer to attract investors. “Buy-side” investors

may have incentives to accept inflated ratings, as this increases their flexibility in making investment decisions and reduces the amount of capital to be maintained against their investments. This also explains why institutions buy overpriced securities (Calomiris, 2009).

The overreliance on CRAs' assessments of structured financial products contributed significantly to the 2007–2008 subprime crisis, as well documented, for instance by the IMF (2010). However, the debate considerably pre-dates the 2008 global crisis, when CRAs clearly performed badly in measuring the risk of subprime debts. They were heavily criticized for their role in the 1997 Asian financial crisis and the 2001 dot-com bubble for

having been slow to anticipate these crises, and then for having abruptly downgraded the debtors.

Downgrades in ratings have triggered large sell-offs of securities as a consequence of market participants adjusting to regulations and investment policies (“cliff effects”). The high volatility in the European sovereign debt market in 2011 after a number of rating downgrades is an example of the linkages between downgrades and the prices of debt instruments. Conversely, rating upgrades can contribute to mechanistic purchases of assets in “good times”, which can fuel financial bubbles. Another major concern with CRAs is related to deficiencies in their credit assessment process. An additional source of unease is that CRAs' ratings, which are based on subjective criteria rather than on economic fundamentals for determining sovereign debt sustainability, exercise a strong influence on markets, issuers of securities and policymakers (see also box 4.3).

Overreliance on ratings has therefore become a concern for international regulatory authorities. The FSB published its *Principles for Reducing Reliance on Credit Rating Agency Ratings* in 2010, which were endorsed by the G20. The goal of the principles is to reduce the use of CRAs, and to provide incentives for improving independent credit risk assessments and due diligence capabilities. Member jurisdictions have committed to presenting a timeline and specific actions for implementing changes in the regulations. At the same time, the FSB has suggested that

In assessing sovereign debt sustainability, credit rating agencies follow ideological prejudices rather than economic fundamentals.

Box 4.3**BIASING INFLUENCES ON CRAs' RATINGS OF SOVEREIGN DEBT**

Ratings of sovereign debtors involve considerable judgement about country factors, including economic prospects, political risk and the structural features of the economy. CRAs provide little guidance as to how they assign relative weights to each factor, though they do provide information on what variables they consider in determining sovereign ratings. Broadly speaking, the economic variables aim at measuring the creditworthiness of an economy by assessing the country's external position and its ability to service its external obligations, as well as the influence of external developments.

CRAs' assessments appear to be based on a bias against most kinds of government intervention. In addition, they often associate labour market "rigidities" with output underperformance, and a high degree of central bank independence as having a positive impact on debt sustainability (Krugman, 2013).

Sovereign ratings of the three major rating agencies are strongly correlated (see table), possibly signalling a very low degree of competition in the CRA market. At the same time, their ratings are significantly correlated with indicators that measure the extent to which the economic environment is "business-friendly", regardless of what impact this might have on debt dynamics.

CORRELATION BETWEEN SOVEREIGN RATINGS OF THE "BIG THREE", JANUARY 1990 TO MARCH 2015			
	Fitch	Moody's	Standard and Poor's
Fitch	1	0.955	0.970
Moody's		1	0.956
Standard and Poor's			1

Source: UNCTAD secretariat calculations, based on *Thomson Reuters Eikon* database.

Note: The sample includes 129 issuers. The number of observations are: Fitch vs. Moody's: 17,908; Fitch vs. Standard and Poor's: 18,317; and Moody's vs. Standard and Poor's: 23,258.

An econometric model, based on a pooled sample of the average value of the "Big Three's" sovereign ratings of 51 developing countries for the period 2005–2015, indicates a close linear fit (R^2 of 44 per cent) between those ratings and the following variables estimated by the Heritage Foundation: "labour freedom", "fiscal freedom", "business freedom" and "financial freedom" (chart 4B.1A). However, these variables appear to have barely any relation to the countries' fundamentals, which would determine their ability to service their sovereign debt.

For instance, "financial freedom" is considered a measure of independence from government control and "interference" in the financial sector. Consequently, an ideal banking and finance environment is believed to be one where there is a minimum level of government intervention, credit is allocated on market terms, and the government does

not own financial institutions. Also, in such an environment, banks are free to extend credit, accept deposits and conduct operations in foreign currencies, and foreign financial institutions can operate freely and are treated in the same way as domestic institutions. The "labour freedom" index is a quantitative measure that considers various aspects of the legal and regulatory framework of a country's labour market, including regulations concerning minimum wages and layoffs, severance requirements, measurable regulatory restraints on hiring and hours worked. "Fiscal freedom" is a measure of the tax burden imposed by the government, based on a combination of the top marginal tax rates on individual and corporate incomes, and the total tax burden as a percentage of GDP. Finally, "business freedom" refers to the ability to start, operate and close down a business (Heritage Foundation, 2015).

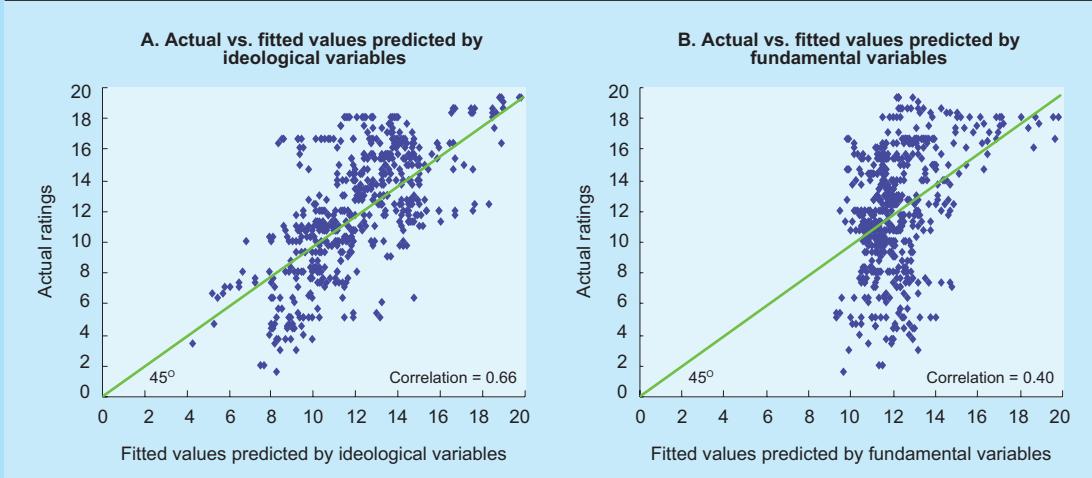
By contrast, the econometric estimates show a much weaker correlation (R^2 of 16 per cent) when CRAs' ratings are regressed on the four most relevant variables used in the standard macroeconomic literature to assess debt dynamics (chart 4B.1B). Those variables are: the level of the primary budget surplus, the government-debt-to-GDP ratio, economic growth and the current account balance.

These estimates show that CRAs' sovereign ratings are based much more on subjective assessments and prejudices (for instance, that government intervention reduces growth and efficiency) than on the "fundamental" variables related to debt sustainability.

There is a strong risk that alternative approaches to credit assessment might reproduce the same flaws of the underlying CRA models. Indeed, other CRAs, including the Chinese firm, Dagong, have produced judgements similar to those of the "Big Three": Moody's, Standard and Poor's and Fitch (chart 4B.2). This suggests either that other participants base their judgments on similar models, or that the "Big Three" are market makers in the ratings industry. As such, there is the added concern that internal credit risk assessments made by risk departments of investors' institutions also deliver ratings with similar flaws.

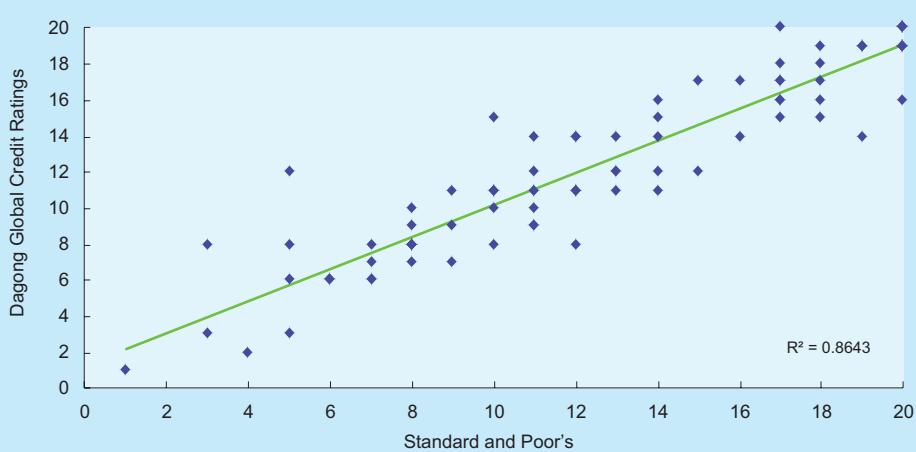
Box 4.3 (concluded)**Chart 4B.1**

**SOVEREIGN RATINGS OF DEVELOPING COUNTRIES,
ACTUAL AND FITTED VALUES, 2005–2015**
(Average of the ratings of the “Big Three”)



Source: UNCTAD secretariat calculations, based on *Bloomberg* and *Heritage Foundation* databases; and IMF, *World Economic Outlook*, 2015.

Note: Countries covered are those for which data were available from all the selected CRAs. Country ratings have been converted into numerical order, ranging from 0 (defaulted security) to 20 (highest rating). For chart A, fitted values correspond to the best possible prediction of the average rating based on a linear regression against four variables taken from the Heritage Foundation Index of Economic Freedom: “labour freedom”, “fiscal freedom”, “business freedom” and “financial freedom”. For chart B, fitted values are the best possible prediction of the average rating based on a linear regression against four macroeconomic variables: budgetary primary surplus, ratio of public debt to GDP, current account balance and GDP growth rate.

Chart 4B.2**CORRELATION BETWEEN COUNTRY RATINGS OF SELECTED CRAs**

Source: UNCTAD secretariat calculations, based on Standard and Poor's; and Dagong.

Note: Country ratings have been converted into numerical order, ranging from 0 (defaulted security) to 20 (highest rating). Countries covered are those for which data were available from both CRAs. Data are as on July 2015.

references to CRA ratings be removed or replaced once alternative provisions in laws and regulations have been identified and can be safely implemented.

Regulatory efforts have also sought to establish a code of conduct for CRAs. A report by the International Organization of Securities Commissions (IOSCO, 2015) focuses on the quality and integrity of the rating process, avoidance of conflicts of interest, transparency, timeliness of ratings disclosures and confidential information. Regional and national regulators have the discretion to adopt more stringent regulations for CRAs. For example, in the United States, the Dodd-Frank Act has attempted to address problems relating to CRA ratings by requiring that banks no longer use those ratings in their risk assessments for the purpose of determining capital requirements. Recent European Union regulations require greater disclosure of information on structured financial products and on the fees that CRAs charge their clients (EC, 2013 and 2014). Nevertheless, the pace of regulatory change has been slow.

Credit rating agencies are still of relevance for the financial sector, despite their disastrously inaccurate ratings assessments prior to major crises. Following widespread recognition that the concentration of the sector in the three biggest international CRAs has created an uncompetitive environment, and that it is therefore necessary to reduce their power, there have been different suggestions for more substantial changes. The OECD highlighted the need to curb conflicts of interest, an issue that CRAs could address, for instance by moving from an “issuer pays” to a “subscriber pays” business model (OECD, 2009). But this new model would require some kind of public sector involvement to avoid free-rider issues. Others have suggested more radical measures, such as completely eliminating the use of ratings for regulatory purposes (Portes, 2008), or transforming the CRAs into public institutions, since they provide a public good (Aglietta and Rigot, 2009). Also, banks could pay fees to a public entity that assigns raters for grading securities. Alternatively, banks could revert to what has historically been one of their most important tasks, namely assessing the creditworthiness of the

potential borrowers and the economic viability of the projects they intend to finance (Schumpeter, 1939; Brender, 1980).

Policymakers should be made aware of the current flaws in the construction of risk measures, and a conceptual framework for an alternative approach should be designed. Alternative sources of credit assessment should avoid repeating the same kinds of mistakes that led CRAs to underestimate risk.

2. The negative impacts of speculative international capital flows

Another major concern about the new financial reforms is the virtual absence of concrete international regulations to tame speculative, short-term international capital flows. Over the past few decades, many countries have experienced strong macroeconomic and financial volatility as a result of capital inflows driving exchange rates away from fundamentals followed by capital reversals triggered by changes in international monetary conditions (*TDRs 2009 and 2011*). Some proposals that could have addressed this issue, such as an international agreement for a tax on international currency transactions, have been discussed at a policy level, but have received little political support from developed countries so far.

Financial reforms have not included concrete international regulation to tame speculative cross-border capital flows.

Risks related to international capital flows are not only a concern for developed countries and for the larger developing economies that are viewed as emerging markets. Increasingly, many middle- and low-income countries that are considered “frontier markets” may also have to cope with volatile capital flows. Their growing reliance on international capital markets to raise finance, which was made possible by low international interest rates and investors’ growing appetite for risk, makes them vulnerable to sudden reversals of foreign capital. It was such reversals that triggered several financial crises in large developing countries in the late 1990s.

Capital account management to regulate the amount and composition of foreign capital flows

can help mitigate such risks. Brazil, Indonesia and the Republic of Korea, among others, have introduced measures to reduce excessive capital inflows with reasonable degrees of success. Further, not all developing countries have promoted rapid international financial integration. While some have sought to enhance their integration into the global financial system, favoured the installation of foreign banks and started issuing commercial external debt, others have preferred delaying such integration. Ethiopia, for instance, has not resorted to easily available foreign capital, and has imposed restrictions on the capital account in its balance of payments. Foreign banks are not allowed to operate in that country. This strategy does not impede the development of a domestic financial system to serve the needs of the real economy because of a strategy for long-term credit provision through its development bank, along with considerable funding from private domestic banks (Alemu, 2014). As a result, its financial system is able to channel funds to priority sectors, including manufacturing and infrastructure.

3. Foreign bank presence in developing countries

A related issue has been the growing commercial presence of foreign-owned banks in developing countries. This trend started in the late 1990s and continued with full force in the new millennium until the global financial crisis. Initially, in the 1990s, privatization of State-owned banks was an important factor in the growing presence of foreign banks in developing countries. Subsequently, joint ownership with local private banks and fully owned subsidiaries gained importance.

According to one recent estimate, the current share of foreign banks in the total number of banks averages 24 per cent in OECD countries and around 40 per cent in developing countries (Claessens and van Horen, 2014). Between 1995 and 2009, foreign banks as a percentage of the total number of banks doubled in such countries, and a large majority of them are from developed economies (Buch et al., 2014). Moreover, this proportion is typically higher in poorer and smaller countries than in the major developing economies, reaching in some cases 100 per cent. Among the major developing countries, there

are considerable variations in foreign bank presence. The Republic of Korea, which had no foreign banks before it joined the OECD in 1996, has seen the fastest increase in their presence over the past two decades, though their share in the total number of banks in the country is still lower than the average for other major developing countries. China, India and South Africa also have a lower foreign bank presence than other developing countries, both in terms of the number of banks and their shares in total banking assets.

In addition to joint ownership with local partners, foreign banks have entered host countries by establishing branch offices or full subsidiaries, the former being the more typical pattern in Asian and African countries, and the latter in Latin America. Foreign branches take the form of unincorporated banks or bank offices located in a foreign country. They are integral parts of their parent bank, and not independent legal entities with separate accounts and capital bases. They cannot incur liabilities and own assets in their own right; their liabilities represent real claims on their parent bank. They provide globally funded domestic credits. By contrast, foreign subsidiaries are stand-alone legal entities created under the law of the host country. They have separate accounts and capital bases from those of their parent company and are financially independent. They have to comply with the host country's regulations and supervision, and are covered by the host country's deposit insurance schemes.

Much has been written on the pros and cons of foreign banks in developing countries. One body of literature suggests that foreign banks may bring efficiency gains, improve competitiveness, reduce intermediation costs and generate positive spillovers to local banks in developing countries, and also enhance their resilience to external financial shocks.

However, their presence might also create challenges. For example, foreign banks often cherry-pick the best creditors and depositors, leaving smaller and marginal customers, including SMEs, to be served by local banks. Moreover, foreign banks tend to focus more on lucrative activities where they have a competitive edge, notably in trade financing, an area in which they enjoy a cost advantage over local banks in being able to confirm letters of credit through their head offices; and their international financial intermediation, rather than domestic intermediation,

often attracts the best customers in need of such services. They are also better able to benefit from regulatory arbitrage by shifting operations back and forth between the home and host countries. They can easily avoid the cost of legal reserves by moving large deposits to offshore accounts, which also enables them to offer higher interest rates. Since local banks cannot easily avoid these costs, they may face competitive disadvantages.

Moreover, foreign banks intermediate between international financial markets and domestic borrowers much more easily than local banks, funding local lending from abroad, including through their parent banks. During the recent surge in capital flows to developing countries, foreign banks have been extensively engaged in intermediations resembling carry-trade operations, benefiting from large interest-rate arbitrage margins between reserve-issuing countries and developing countries as well as currency appreciations in the latter, as discussed in chapters II and III.

Since the global financial crisis, it has been increasingly recognized that the large presence of foreign banks in developing countries could have implications for financial volatility (Fiechter et al., 2011). Indeed, because of their close international linkages, foreign banks in such countries act as conduits of expansionary and contractionary impulses from global financial cycles, particularly with the growing liberalization of international financial flows. Thus, when global liquidity and risk appetite are favourable, foreign banks can contribute to the build-up of excessive credit; and when global financial conditions become tight, these banks can intensify their destabilizing and deflationary impact on host countries, transmitting credit crunches from home to host countries, rather than insulating domestic credit markets from international financial shocks. The shift of international banks from cross-border to local lending implies that at times of stress in the home country, deleveraging by parent banks could result in credit contraction in host countries.

This was seen in Asia during the eurozone crisis, where lending by local subsidiaries and branches was a substantial part of overall European bank claims (Aiyar and Jain-Chandra, 2012; He and McCauley,

2013). Several other studies have also found that foreign subsidiaries cut lending more than domestically owned banks during the global crisis (Claessens and van Horen, 2014; Chen and Wu, 2014). This was particularly true where they funded a large proportion of their lending from abroad rather than from local deposits (Cetorelli and Goldberg, 2011). At the height of the crisis in 2008, in Brazil and China, the growth of foreign bank credit lagged behind that of domestic

banks, and “foreign banks in one [emerging market economy]... withdrew earlier than domestic banks from the interbank market” (BIS, 2010b). During both the Asian crisis in 1997 and the crisis in developed countries in 2008, foreign banks were slower than domestic banks to adjust their lending to changes

in host-country monetary policy, thereby impairing its effectiveness (Jeon and Wu, 2013 and 2014).

Recent experience suggests that local subsidiaries of foreign-owned international banks may not act as stabilizers of interest rate shocks to developing economies’ local bond markets. During the bond market collapse in 2008, rather than increasing their exposure to offset the impact of the exit of foreign investors, these banks joined them, reducing their holdings of local government bonds and scaling back their market-making activity (Turner, 2012).

Other challenges arising from the presence of foreign banks relate to the structure of the banking system. Such banks may be systemically important in the host country, even though their activities may represent only a small proportion of their global business. This creates regulatory difficulties for host supervisors, especially when there is a lack of home-host country coordination in the supervision of the transnational banks’ activities. This becomes a particularly serious issue when host supervisors have to deal with resolution problems arising from cross-border failures. One response to these challenges has been to ensure that foreign banks are effectively regulated by the host-country’s supervisors. Another is for the host country to require foreign banks’ branches to hold their own capital, as some countries have done. Other measures (introduced in Mexico, for example) impose higher capital requirements on foreign banks or transfer limits on revenues and asset purchases by a bank to its parent company (FSB, 2014b).

Foreign banks in developing countries act as conduits of expansionary and contractionary impulses from global financial cycles.

E. Fixing finance: The need for a more positive agenda

Reforms of the international financial system have certainly not gone far enough to enable it to forestall shocks and make it more resilient. Current regulatory practices and proposed reforms seem to be designed to preserve – with some fine tuning – the existing system rather than to transform it. The new Basel rules, which are supposed to make banks safer, still rely on risk-weighting for capital calculation and, more regrettably, may be based on the continued belief that private institutions can by themselves – or through CRA assessments – properly establish the level of capital to withstand unexpected losses. Furthermore, those rules do not address in a satisfactory manner concerns about moral hazard, which has become a significant issue with regard to systematically important institutions. Those institutions would still have to be bailed out to avoid possible contagion effects, and so the “market discipline” that underlies the Basel norms is unlikely to work. Meanwhile, the shadow banking system remains almost completely unregulated. With respect to the ring-fencing initiatives taken in a number of jurisdictions, the new rules are yet to be fully adopted, and in any case may not be effective, as the restrictions have been diluted with a host of exemptions, such as those applied to the Volcker Rule’s ban on proprietary trading in the United States.

Part of the slow progress on reforms has been due to powerful interests linked to the financial industry systematically opposing more and stronger regulations – and also to ideological obstacles. The view that a freely operating private sector will find the optimal way to allocate financial resources remains deep-seated in national and international policy circles.

Slow progress on reforms has been partly due to systematic opposition to more and stronger regulations by powerful interests in the financial industry.

Since the various recent attempts at re-regulation of finance have not brought about fundamental changes in the financial system, the factors that contributed to financial crises continue to pose a constant threat to stability and growth. The system continues to rely on the interaction of too-big-to-fail financial institutions with very volatile capital markets, remains highly leveraged, and would still require large public bailouts in case of a crisis.

The Basel Accords are neither sufficient to bring about financial stability nor to ensure that financial institutions will pursue social and development goals. Therefore, the implementation of Basel rules should

not be the main focus or priority in improving the financial system for developing countries. One major shortcoming of the incentive structures created by regulatory practices and deregulation in the financial sector has been the homogenization of financial institutions and the proliferation of “universal banks”, which perform both

retail and market activities. When all banks, regardless of their purpose and ownership structure, are governed by a similar regulatory framework, such as the Basel rules that were originally designed for internationally active banks, they have incentives to adopt similar behaviour patterns.

In the past decade, in particular, banks collectively resorted to high-risk operations that were potentially more profitable, incorporating broker-dealers’ activities and investor practices resembling those of hedge funds undertaken by large proprietary trading desks (Haldane, 2009). As a result, many cooperative development banks, and even public banks, ended up behaving like commercial banks,

even though their sole motivation was not intended to be profitability, but rather to ensure certain kinds of financing in particular contexts.

This tendency towards homogenization has led to similar portfolios and exposures. In Europe, many banks became involved in risky activities that had little to do with their core business, and recorded significant trading losses in the 2008–2009 crisis (Ayadi, 2010). However, some institutions, such as cooperative and savings banks in Germany, which did not conform to universal banking models, withstood the crisis, and therefore did not require public bailouts (CEPS, 2010). And the large cooperative French bank, Crédit Mutuel, proved to be the best national performer in the stress test exercise coordinated by the European Banking Authority in 2014.²⁸

The concerns related to homogenization are equally relevant for all countries, although there are some additional issues for developing countries. The lack of diversity means that there is an insufficient variety of institutions to cater to different needs, especially to the requirements and interests of small producers and those who otherwise lack access to formal finance (Ghosh, 2012). It follows that the regulatory regime should recognize the importance of differences and regulate financial institutions according to their functions. Thus, the rules that apply to commercial banks or investment banks should not be the same as those applied to development banks, savings banks and cooperative banks.

Clearly, a more ambitious reform agenda is necessary if finance is to become less fragile and volatile, and better serve the needs of the real economy and society. Ongoing efforts to strengthen prudential regulation alone will not suffice; also necessary are structural reforms that focus both on financial stability and on social and development objectives. Such reforms should include the requirement of a strict separation of retail and investment banking. Such ring-fencing does not mean that large private financial institutions will no longer be able to decide what activities they

should engage in, but rather, that each activity should be institutionally separated into different legal entities and subject to specific regulations.

Structural reforms should also bring the shadow banking system under the regulatory umbrella, while allowing it to retain its intermediation functions. Money market mutual funds (or their equivalent) could become “narrow savings banks”, as suggested by Gorton and Metrick (2010). Accordingly, entities wishing to offer banking services, such as transaction accounts, withdrawals on demand at par and assurances of maintaining the value of the account, should be reorganized

as special-purpose banks, with appropriate prudential regulation and supervision. In exchange, such entities should have access to central bank lender-of-last-resort facilities. Alternatively, those funds may offer accounts that provide higher interest rates than deposits, but with a fluctuating value reflecting the market value of the asset portfolio, but of course with no access to public guarantees. With regard to securitization, only specific entities (what Gorton and Metrick term “narrow funding banks”) with charters, capital requirements and strict oversight should be allowed to buy asset-backed securities, while other institutions should be forbidden to do so. Final investors, instead of buying securitized assets, would buy the liabilities of these narrow banks. The regulator should also determine the criteria for narrow funding

banks’ portfolios and determine the amount of minimum capital they would need to operate.

However, ring-fencing alone will not ensure that the financial system will allocate enough resources to meet broad development goals. As risks involved in development finance are beyond the acceptance limits of commercial banks, the State should employ various tools to help shape a more diversified system, both in terms of its institutions and functions.

As is discussed further in chapter VI, the channelling of financial resources for socially productive purposes requires some amount of State intervention. This could include public incentives, when

A more ambitious reform agenda is necessary to make the financial system less fragile and volatile, and to ensure it better serves the needs of the real economy and society.

Shadow banking entities, like any kind of banking, should be brought under the regulatory umbrella.

profitability does not spontaneously attract the private sector. It also necessitates a broader role for central banks (*TDR 2011*). Beyond their focus on fighting inflation, they should be able to intervene in the provision and orientation of credit, as they did for decades in many successful industrialized countries in Europe but also in East Asia, and still do in a number of developing countries (*TDR 2013*). At the very least, regulation should not discourage the financing of long-term investments, innovation and SMEs just because they may appear to be more risky from a narrow, prudential point of view. Financing these activities and agents is essential for an economy's growth and development, which also improves the overall quality of banks' assets, whereas a lack of growth would result in the accumulation of non-performing assets.

The goals of a regulatory framework should therefore be more ambitious than ensuring stability based on rigid prudential norms; regulations should also encourage the proliferation of different types of financial products and organizations for catering to the different needs of the real economy (Kregel and Tonveronachi, 2014).

In conclusion, a more positive reform agenda is needed to establish a closer link between financial systems and the real economy. This is critical for ensuring sustainable economic growth and for supporting the global aspirations reflected in the post-2015 Development Agenda and its accompanying Sustainable Development Goals. ■

Notes

- 1 The BCBS was designed as a forum for regular cooperation on banking supervisory matters, but its membership originally was confined to central bank representatives of only 13 countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. Following a proposal by the G20 in November 2008, full membership was extended to representatives of the central banks of Argentina, Brazil, China, Hong Kong (China), India, Indonesia, the Republic of Korea, Mexico, the Russian Federation, Saudi Arabia, Singapore, South Africa and Turkey.
- 2 Other important initiatives coordinated by the FSB include the development of principles for sound executive compensation practices; the over-the-counter derivatives market reform, which aims at giving more transparency to regulate such transactions; and the implementation of the *Global Legal Entity Identifier System*, whose purpose is to uniquely identify legal entities involved in financial transactions.
- 3 It should be noted that Basel I and II Accords sought to establish a level playing field for internationally active banks, while Basel III aimed at improving the resilience of banks in the face of the global crisis.
- 4 For instance, before the subprime crisis, the calculation of regulatory capital on the basis of risk-weighted assets encouraged the accumulation by banks of triple-A tranches of the structured mortgage-backed securities.
- 5 The Basel framework gives a menu of options for minimum capital requirements for credit risk: (i) the Standardized Approach, which involves changing risk weights based on assessments made periodically by rating agencies; (ii) the simplified Standardized Approach quite similar to Basel I to which fixed weights are assigned as well; (iii) the Internal-Ratings-Based approach (IRB), which is based on banks' own risk assessment models for capital determination; and (iv) the advanced IRB approach (A-IRB), which is also based on banks' own risk assessment models for capital determination, but differing from the IRB approach in that it uses the loss given default as the input variable instead of the probability of default.
- 6 These disparities are confirmed by studies conducted by the BCBS (2013).
- 7 The prevailing economic orthodoxy claimed that lower capital requirements reduce the cost of financial services, and that banks can safely manage their affairs from a narrow capital base.

- 8 Alessandri and Haldane (2009) suggest that banks' capital should be at least 20–30 per cent of their total unweighted assets.
- 9 In October 2012, the Basel Committee, acknowledging that problems associated with the "too-big-to-fail" banks did not apply only to the large global banks, issued a set of principles on the assessment methodology and the higher loss absorbency requirement for *domestic systemically important banks* (D-SIBs).
- 10 Adoption of these rules is scheduled for 2019.
- 11 In terms of liquidity requirements, China, India, South Africa and Turkey were expected to have final rules in force as of January 2015, while Argentina, Brazil, Indonesia and Mexico had published draft regulations.
- 12 A survey by the BIS (2014) shows that only a few countries, such as Belarus, Colombia, Kenya, Liberia, Pakistan, Peru, Qatar, the former Yugoslav Republic of Macedonia and Zimbabwe, are partially incorporating the new guidelines into their regulatory frameworks.
- 13 The FSAPs are prepared jointly by the IMF and World Bank for developing and emerging economies, and by the IMF alone for developed countries.
- 14 The World Bank, which assesses the effects of reforms jointly with the FSB, reports that the capital and leverage ratios of banks in some developing countries are higher than those required under Basel III (World Bank, 2013).
- 15 Proprietary trading refers to a bank's trading of stocks, bonds and other financial instruments with its own resources, as opposed to trading on behalf of clients, so as to make a profit for itself.
- 16 Ring-fenced activities have to be legally, financially and operationally independent from the rest of the financial group (FSB, 2014a: 7).
- 17 A special purpose entity, or special purpose vehicle (SPV), is a legal entity that has been set up for a specific, limited purpose by another entity – the sponsoring firm, typically a bank. An essential feature of an SPV is that it is "bankruptcy remote" meaning that it cannot become legally bankrupt (Gorton and Souleles, 2005). SPVs are often domiciled in offshore financial centres in order to engage in financial activities in a more favourable tax environment. Financial institutions also make use of SPVs to take advantage of less restrictive regulations relating to their activities. Banks, in particular, use them to raise Tier I capital in the lower tax jurisdictions of offshore financial centres. SPVs are also set up by non-bank financial institutions to take advantage of more liberal netting rules than prevail in their home countries, thereby allowing them to reduce their capital requirements (FSF, 2000).
- 18 The shares of money market funds are redeemable at par, and are therefore widely (though sometimes erroneously) regarded as being as safe as bank deposits.
- 19 The broker-dealer may not hold directly the high-quality assets it needs for the repo funding, but may get it through a securities lending operation (a swap between two securities). Through the securities lending transaction, a third party (usually an institutional investor such as an insurance company or a pension fund) lends high-quality securities to the broker-dealer, as a way to "enhance" the yield of the portfolio, and receives as collateral high-yield securities. As these deals occur simultaneously, the broker-dealer gets the funding to purchase the risky asset. If the return on the high-yield asset is high enough, the broker-dealer will be able to pay the interest rates of the repo and of the securities lending, and still make a profit. For a discussion on securities lending, see Pozsar and Singh, 2011; and Adrian et al., 2013.
- 20 See Harutyunyan et al. (2015).
- 21 What triggered the 2008 global crisis was precisely a series of defaults on collateralized debt obligations, a particular type of structured debt assembled from subprime mortgages. In the case of these structured securities, even the "senior" tranches, expected to be safer because they had first priority to receive cash flows from ultimate borrowers and had triple A ratings by the main credit rating agencies, had to be written off by final investors (see TDRs 2009 and 2011).
- 22 Before the FSB received its mandate from the G20, the United States' Dodd-Frank Act of July 2010 addressed issues related to shadow banking. The EC set up a parallel process, publishing a green paper in 2012 and its own action plan in 2013 (EC, 2012).
- 23 See FSB, 2012 and 2014c.
- 24 For example, in July 2014 the United States Securities and Exchange Commission adopted amendments to the rules that govern MMMFs, to be implemented by 2016. These require a floating net asset value for prime funds with institutional investors. For funds with only retail investors, the new rules include liquidity fees and redemption gates to manage redemption pressures, enhanced diversification, disclosure and stress testing requirements, as well as updated reporting.
- 25 The draft directive for FTT implementation issued by the EC in 2011 caused an uproar among some market participants, and was eventually dropped in 2013. Financial institutions declared that the initiative would hurt the competitiveness of European banking, increase financial instability by making risk management more expensive and reduce investment in fast-growing companies (Gabor, 2014).
- 26 Although there is a plethora of CRAs across the globe – more than 70, according to the IMF (2010) – the global market is dominated by the "Big Three":

- Standard & Poor's and Moody's, with market shares estimated at 40 per cent each, and Fitch with an estimated market share of 15 per cent (Schroeter, 2011).
- 27 Excluding those of sovereign debtors.
- 28 The 2014 stress test was carried out in cooperation with the European Systemic Risk Board, the EC and the European Central Bank, as well as competent authorities from all relevant national jurisdictions across the European Union plus Norway (EBA, 2014).

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EXTERNAL DEBT AND DEBT CRISES: GROWING VULNERABILITIES AND NEW CHALLENGES

A. Introduction

The preceding chapters analysed the major weaknesses in the existing international monetary and financial system, which limit its ability to promote and maintain global economic stability. They also constrain the efforts of policymakers, in developed and developing countries alike, to achieve more inclusive and sustainable growth paths. At the macroeconomic level, the current system has failed to substantially reduce volatility in financial markets and to correct persistent global imbalances. In addition to the often high social and economic costs to individual countries, this has also led to the continued accumulation of large external debts. At the micro-economic level, as discussed in the previous chapter, regulation has failed to curb the high risk-taking and procyclical behaviour of various financial institutions, which was at the root of the 2008–2009 global financial crisis. Thus the risk of future financial and debt crises persists.

This chapter addresses a long-standing deficiency in the international monetary and financial system, namely the lack of an effective mechanism to better manage external debt crises. It pays particular attention to sovereign debt, since, as discussed in chapter II, even when financial crises originate in the private sector, as is often the case, they usually result in public overindebtedness and a prolonged period of economic and social distress.¹

In the run-ups to the last eight major crises in emerging economies (beginning with Mexico in

1994, followed by Thailand, Indonesia, the Republic of Korea, the Russian Federation, Brazil, Turkey, and finally, Argentina in 2001), sovereign debt was a problem only in four economies – Argentina, Brazil, Mexico and the Russian Federation. But in almost all these instances, sovereign debt increased abruptly with the crisis. Several factors contributed to this increase. In most of these economies, a major share of private debt, both domestic and external, was socialized through government bailouts. Public funds were also used for recapitalizing insolvent banks and assuming the costs of devaluations that otherwise would have had to be borne by the private financial and non-financial sectors. And, following these crises, fiscal revenues were lower and interest rates on the public debt rose. Much the same pattern was repeated more recently in Ireland and Spain during the eurozone crisis.

The next section of this chapter provides a brief introduction to the challenges raised by external sovereign debt. This is followed by an overview of recent aggregate and regional trends in developing countries' external debt volumes and composition (section C). Section D summarizes basic characteristics of existing financial and debt crises in developing economies, in general, and examines historical approaches to sovereign debt resolution, in particular. Section E analyses current proposals for reform of the present, fragmented system of sovereign debt resolution.

B. Sustainability of external debt: Main issues

External debt is not a problem in itself; indeed, debt instruments are an important element of any financing strategy. But it can become a problem when the foreign borrowing is unrelated to productive investment, or when a net debtor country is hit by a severe shock to its key macroeconomic variables.

Under these circumstances, the claims on the debtor can quickly exceed its capacity to generate the required resources to service its debts. If these claims are not matched by new credit inflows (or by higher interest receipts from investments abroad) servicing the external debt amounts to a transfer of resources to the rest of the world, which, if significant, reduces domestic spending and growth, thus further compromising its ability to make payments when they fall due.

High external debt has diverse causes and varied impacts in different groups of economies. In most low-income countries, it is the result of chronic current account deficits, primarily reflecting limited export capacities and high dependence on imports for both consumption and investment purposes. The bulk of direct debt-generating capital flows to these economies has come from official sources. By contrast, a large proportion of the external debt of middle-income countries has come from private creditors since the mid-1970s as a result of their greater integration into the international financial system, which gives them easier access to international financial markets.

The sustainability of such an external debt burden depends on the relationship between the growth of domestic income and export earnings, on the one hand, and the average interest rate and maturity of the debt stock on the other. Thus, to the extent that foreign

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capital inflows are used for expanding production capacities – directly or indirectly through improved infrastructure, especially in the tradable sector – they contribute to boosting the domestic income and export earnings required to service that debt. However, external debt has increasingly resulted

from private capital inflows that were largely unrelated to current needs for the financing of trade and investment. And as their volume has frequently been very large compared to the size of the recipient economies, such flows have led to asset bubbles, currency overvaluation, superfluous imports and macroeconomic instability, thereby increasing the risk of defaults. They also expose those economies to the vagaries of international capital markets, as they facilitate or even encourage the build-up of external debt during the expansionary phase of the financial cycle, but may easily trigger a debt crisis when there is a sudden stop or reversal of those capital flows.

In addition to these basic macroeconomic relationships, the sustainability of external debt also depends on its structure and composition. The commonly used definition of gross external debt, including in this chapter, adopts the residence criterion, which consists of non-resident claims on the resources of the debtor economy. Specifically, gross external debt here corresponds to the outstanding amount of “liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future, and that are owed to non-residents by residents of an economy” (TFFS, 2013: 5). Other possible criteria to qualify debt as either “domestic” or “external” are whether it is denominated in domestic or foreign currency, the jurisdiction under which debt is issued and where a legal dispute will be settled in case of a default.

When most external debt consisted of loans, as opposed to bonds, the residence, currency and jurisdiction criteria tended to coincide: the lender was a non-resident and the loan was issued in a foreign currency under foreign law. This has changed significantly since the early 1990s. Over the past two decades, increases in the stock of outstanding debt have been accompanied by a process of disintermediation (i.e. a shift in debt instruments from syndicated bank loans to more liquid bond debt). Since bonds issued in local currency and under local law may be held by foreign investors, and conversely, sovereign debt denominated in a foreign currency may be held by residents, a significant share of debt could be considered “external” under some criteria and “domestic” under others.

The amount of debt issued in foreign-denominated currencies could significantly affect debt sustainability. This is because, in order to service such debt, the debtor must not only generate the required income, but also obtain the corresponding foreign exchange. This depends on the state of a country’s balance of payments. However, there may be a trade-off between the conditions needed for extracting trade surpluses, on the one hand, and those determining debtors’ profits (or primary surpluses in the case of governments) on the other. For instance, domestic currency devaluations and recessionary adjustment policies might be needed to improve export performance and reduce imports, but they will also have the effect of increasing the real value of the foreign-denominated debt and reducing the debtor’s income.

In mostly higher income developing countries, a recent trend has been a shift in the denomination of debt from foreign to local currency. This has been made possible largely as a result of a strong expansion of global liquidity and concomitant surges of capital inflows into these economies, reflecting lenders’ willingness to assume the exchange-rate risk and operate under local jurisdictions. But in this case, the residence criterion is relevant for debt sustainability, because investments in local bonds and securities by non-residents make domestic debt markets more liquid. Moreover, growing non-resident participation in these markets also means less stability of holdings relative to participation by domestic institutional

investors, as the latter are usually subject to regulations that oblige them to hold a given percentage of their assets in local debt instruments. By contrast, when non-resident creditors liquidate their local-currency-denominated debt, they are likely to convert the proceeds into foreign currencies and repatriate their earnings.

Finally, the jurisdiction of debt issuance affects debt sustainability, since it defines the rules under which any disputes between debtors and creditors are negotiated, in particular the extent to which non-cooperative creditors will be allowed to disrupt agreements on debt resolution between debtor States and a majority of their private creditors. More generally, where developing countries’ external debt has mostly been issued under foreign jurisdictions as a supplementary guarantee for investors that are distrustful of the judicial system of the debtor country, this has the potential to complicate crisis situations, since the debtor economy may have to contend with multiple jurisdictions and legal frameworks.

In addition, countries that have signed international investment agreements, including those providing investor-State dispute settlement mechanisms, may be sued in arbitration tribunals such as the International Centre for Settlement of Investment Disputes (ICSID) or the United

Nations Commission on International Trade Law (UNCITRAL). The nature of such arbitration has tended to be ad hoc, and mostly biased in favour of investor claimants. Moreover, it is generally based on a private commercial logic, without consideration for the long-term social and economic impacts on the debtor economy as a whole (Van Harten, 2007; see also *TDR* 2014).

... but external debt can become a problem if foreign borrowing is unrelated to productive investment.

Sovereign debt deserves special attention for a number of reasons. In some instances, governments may encounter difficulties in servicing the external debts they have incurred to finance their public expenditures. In times of easy and cheap access to credit, they may underestimate the risk of their exposure to the volatility of the international financial system and to financial shocks arising from monetary policy changes abroad. In many other instances, however, the initial cause of a sovereign debt crisis is the imprudent behaviour of private agents, on both the borrowers’ and the creditors’ sides. In principle,

private debtors' defaults on their external debt fall under the insolvency law of the jurisdiction where the debt was incurred. This legal framework typically provides for a certain degree of debtor protection and debt restructuring (with or without a partial debt write-off), or for the liquidation of a debtor's assets in case of bankruptcy. But when a wave of private defaults threatens to disrupt the financial system, the public sector often assumes the private debt, especially that of large banks, and as a consequence becomes over-indebted itself (see chapter II of this *Report*).

However, sovereign debt problems are not subject to the legislation that governs private defaults. They therefore necessitate specific treatment, not least because governments and public administrations are tasked with the role of providing public goods through appropriate macro- and microeconomic policies designed to achieve long-term development objectives. Therefore, any impediment to fulfilling these duties due to debt overhang or to conditionalities associated with support to debt restructuring would have significant social, economic and political impacts. This raises the question of how best to approach sovereign debt restructurings in an increasingly globalized economy.

Sovereign debt crises are often caused by private agents' imprudent behaviour, on both the borrowers' and the creditors' sides.

Concern about the lack of a resolution mechanism for external sovereign debt is not new.² Since the early 1980s UNCTAD's *Trade and Development Reports* have repeatedly argued for replacing creditor-led, ad hoc and arbitrary debt workout mechanisms, both for official and commercial debt, with statutory mechanisms that would permit an impartial assessment of a country's debt situation, and promote fair burden-sharing and a restoration of debt sustainability. *TDR 1986* stated: "The lack of a well-articulated, impartial framework for resolving international debt problems creates a considerable danger ... that

international debtors will suffer the worst of both possible worlds: they may experience the financial and economic stigma of being judged de facto bankrupt ... At the same time, they are largely without the benefits of receiving the financial relief and financial reorganization that would accompany a *de jure* bankruptcy handled in a manner similar to chapter 11 of the United States Bankruptcy Code". As with other needed reforms of the international monetary and financial system, there may be a trade-off between desirability and feasibility, at least in the short term. Consequently, a range of options to deal with sovereign debt problems needs to be considered.

C. Trends in the volume and composition of external debt

1. Evolution of external debt in developing and transition economies

Measured in nominal terms (and following the residence criterion explained above), the external debt of developing countries and transition economies has displayed a rising long-term trend. With the exception of Africa, which remained a less attractive market for private investors and greatly benefited from debt reduction programmes, all other regions

exhibited a significantly higher debt stock in 2013 than in the 1990s (chart 5.1). This was not a steady trend, however: Latin America and South-East Asia – the two developing regions most integrated into the international financial system – had relatively stable external debt levels between 1997–1998 and 2006–2007. This was the result of their own debt crises in the second half of the 1990s, which created a temporary restriction on their access to new private foreign credit. But it was also partly due to their subsequent efforts to reduce their dependence on

capital inflows by avoiding recurrent current account deficits, or even generating significant surpluses. In this regard, they benefited from the real devaluation of their currencies during their crises and, in some cases, from gains in their terms of trade after 2003. Since the 2008 global financial crisis, however, the stock of their external debt has been rising again, in some cases dramatically, as a result of both worsening current accounts and renewed inflows of foreign capital driven by expansionary monetary policies in developed countries.

The ratio of external debt to gross national income (GNI), declined at varying rates in all developing regions from the late 1990s until the 2008 crisis (chart 5.2), thanks to favourable macroeconomic circumstances and robust economic growth. The biggest reduction in that ratio occurred in Africa, where it fell, on average, from more than 100 per cent in 1994 to below 20 per cent in 2013. In addition to growth acceleration in the 2000s, this region benefited more than any other from official debt relief programmes. However, after 2008 this trend came to a halt, with the ratio of debt stock to GNI rising slightly again. In the transition economies, external debt stocks have gradually increased from their low base of the early 1990s to reach about 60 per cent of GNI in 2013 if the Russian Federation is excluded, and only 15 per cent of GNI if it is included.

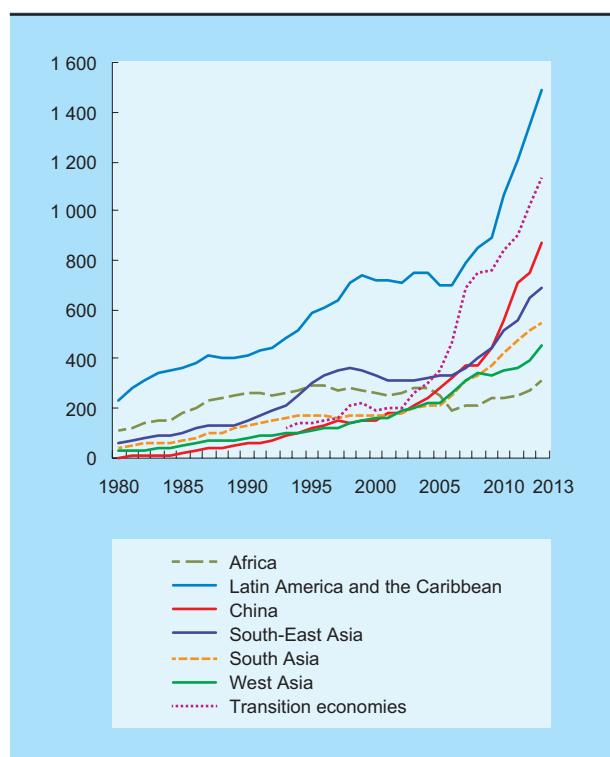
This overall reduction in the relative size of external debts, combined with overall falling interest rates on external debt since the late 1990s, largely explains the diminishing weight of interest payments as a share of exports in all developing regions. In Africa, this share fell from 13 per cent, on average, during the 1980s to around 1 per cent in 2012–2013, in South-East Asia and South Asia it fell from 11 per cent to less than 2 per cent, in West Asia, from 18 per cent to 6 per cent, and in Latin America, from 28 per cent to 6 per cent over the same period (chart 5.3).

As a result, developing countries, including emerging economies, faced the global financial crisis with relatively strong public sector balance sheets and historically low levels of external debt, which helped them, initially, to recover well from this shock. They also became attractive destinations for capital in search of higher returns than those available in the developed economies. This apparent macroeconomic robustness and stability, was,

Chart 5.1

EXTERNAL DEBT, SELECTED COUNTRY GROUPS AND CHINA, 1980–2013

(Billions of current dollars)

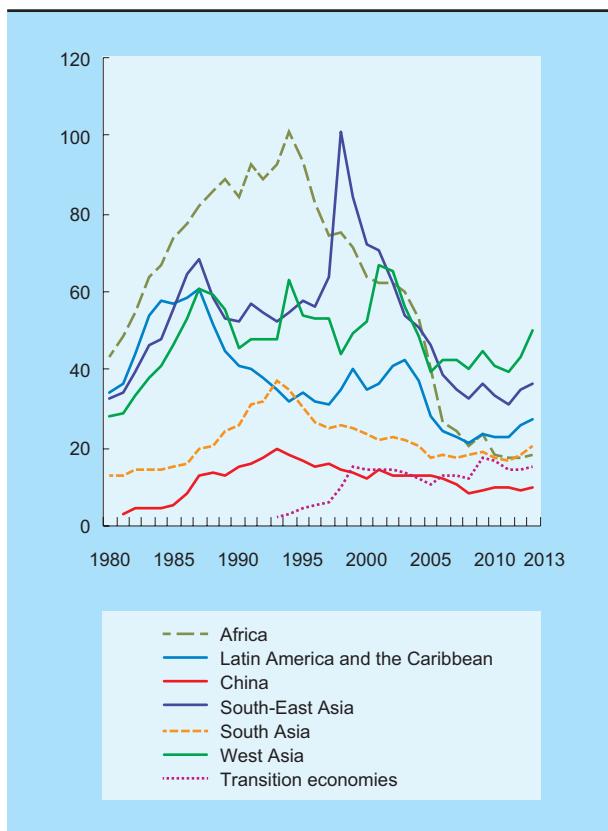


Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators* database; and national sources.

Note: Aggregates are based on countries for which a full set of data were available since 1980 (except for the transition economies where the cut-off date was 1993). Africa comprises Algeria, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comoros, the Congo, Côte d'Ivoire, the Democratic Republic of the Congo, Djibouti, Egypt, Ethiopia, Gabon, the Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Morocco, Niger, Nigeria, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, Somalia, Sudan, Swaziland, Togo, Tunisia, Uganda, the United Republic of Tanzania, Zambia and Zimbabwe. Latin America and the Caribbean comprises Argentina, Belize, Bolivia (Plurinational State of), Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Peru, Saint Vincent and the Grenadines and Venezuela (Bolivarian Republic of). South-East Asia comprises Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines and Thailand. South Asia comprises Bangladesh, India, Iran (Islamic Republic of), Maldives, Nepal, Pakistan and Sri Lanka. West Asia comprises Jordan, Lebanon, Syrian Arab Republic, Turkey and Yemen. Transition economies comprise Albania, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, the Russian Federation, Serbia, Tajikistan, the former Yugoslav Republic of Macedonia, Turkmenistan, Ukraine and Uzbekistan.

Chart 5.2**EXTERNAL DEBT STOCK AS A PROPORTION OF GNI, SELECTED COUNTRY GROUPS AND CHINA, 1980–2013**

(Per cent)

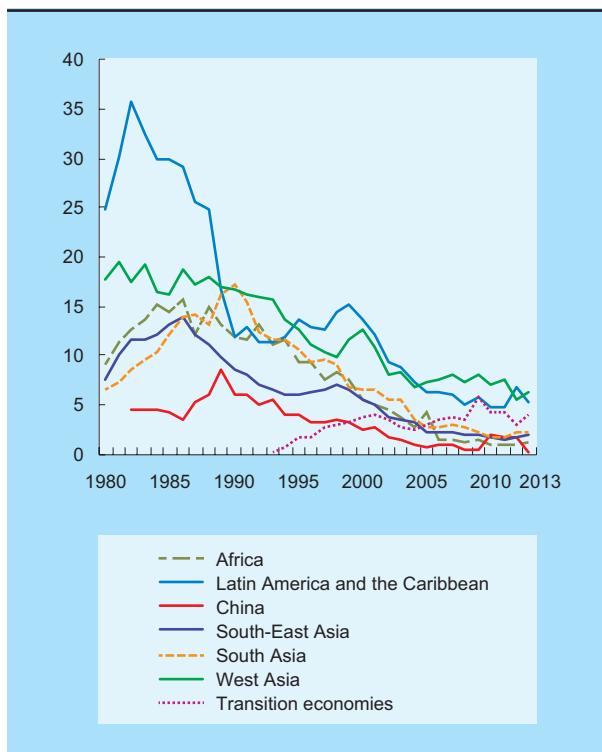


Source: UNCTAD secretariat calculations, based on *UNCTADstat*, World Bank, *World Development Indicators* database; and national sources.

Note: See chart 5.1. Regional aggregates refer to the same countries as in chart 5.1, except for Ethiopia and Yemen, for which GNI data were not available.

Chart 5.3**INTEREST PAYMENTS ON EXTERNAL DEBT AS A PROPORTION OF EXPORTS, SELECTED COUNTRY GROUPS AND CHINA, 1980–2013**

(Per cent)



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators* database.

Note: Regional aggregates refer to the same countries as in chart 5.1, except for Djibouti, Ethiopia, Guinea, Guinea-Bissau, Guyana, Haiti, Iran (Islamic Republic of), Lao People's Democratic Republic, Lebanon, Paraguay, the Russian Federation, Sao Tome and Principe, Somalia, Syrian Arab Republic, Thailand, the United Republic of Tanzania and Yemen, for which data were not available.

however, short-lived: recent episodes of turmoil in international financial markets – triggered by expectations of a winding down of quantitative easing in the United States and of a normalization of interest rates there – have adversely affected emerging economies (UNCTAD, 2014). More generally, the recent excessive increase in liquidity in international financial markets that remains largely unrelated to long-term development finance, combined with rising foreign-currency-denominated private sector indebtedness, has increased developing countries' exposure to the volatility of international financial markets.

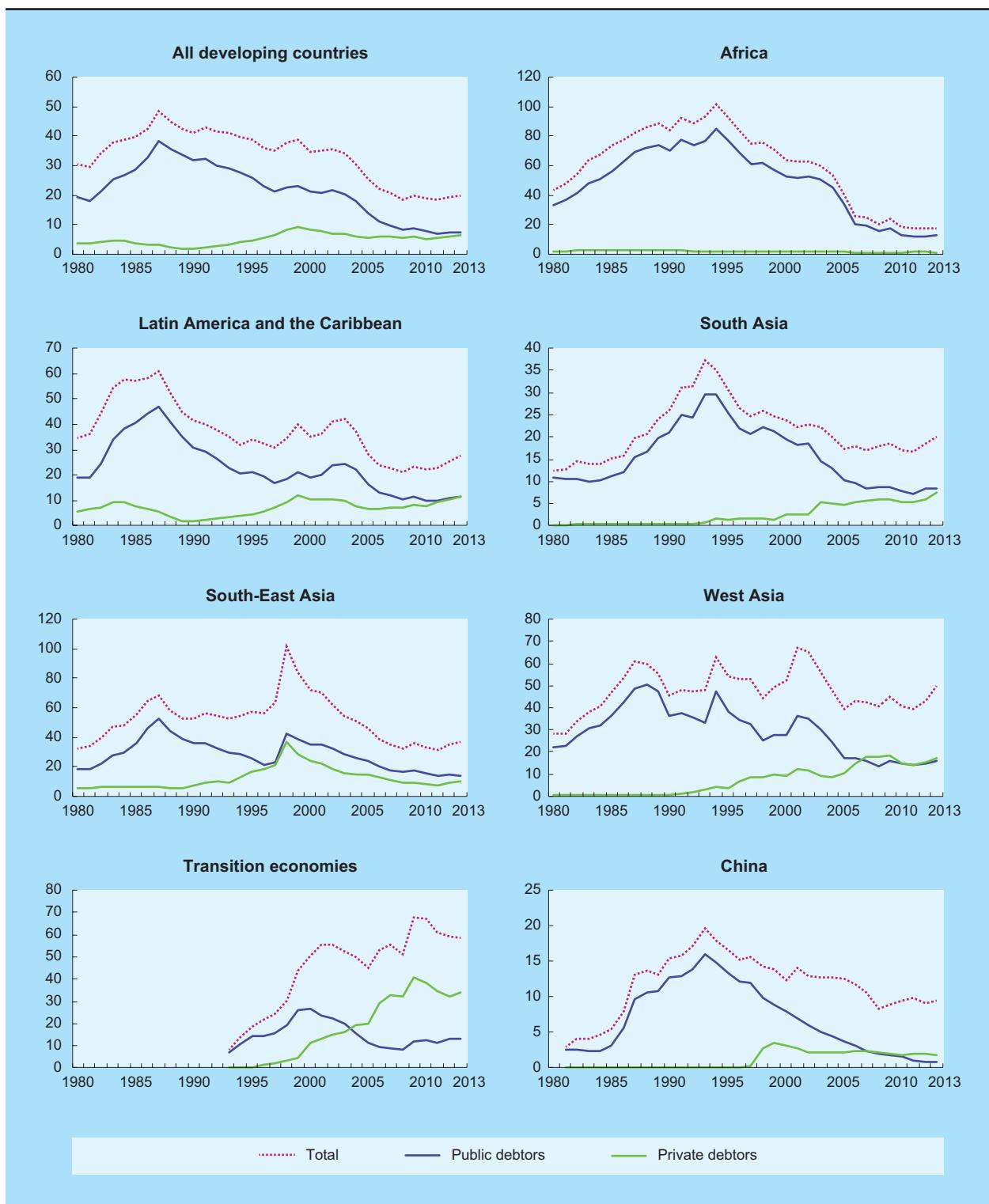
2. Public and private borrowing and lending

The relative share of external debt owed by public and private debtors has an important bearing on debt sustainability.³ Historically, public debt constituted the bulk of external debt in developing countries. In 2000, for instance, its share in long-term external debt stocks of all developing countries was 72 per cent, but by 2013, this share had declined to nearly half of the total stocks (chart 5.4).

Chart 5.4

EXTERNAL DEBT BY TYPE OF DEBTOR, SELECTED COUNTRY GROUPS AND CHINA, 1980–2013

(Per cent of GNI)



Source: UNCTAD secretariat calculations, based on *UNCTADstat*; and World Bank, *World Development Indicators* database.

Note: Regional aggregates refer to the same countries as in chart 5.1, except for Ethiopia, the Russian Federation and Yemen, for which data were not available. The chart shows total external debt to be larger than the sum of public and private debtors, because external debt is not always fully disaggregated by public and private debtors.

External private debt, on the other hand, was historically quite limited. Thus it attracted little attention from oversight bodies. Moreover, those bodies tended to be influenced by free market advocates, who opposed government intervention in growing private external liabilities on the grounds that such liabilities resulted from the actions of so-called “rational agents” with respect to private saving and investment decisions, and therefore would not lead to financial distress. However, experience, particularly in the aftermath of the global financial crisis, when high external private debt became a main driver of public sector debt crises, has challenged the validity of such an argument.⁴

Policymakers should therefore not be too complacent about the overall lower levels of public debt in many developing economies; rather, they should be wary of the significant risks to financial stability associated with the increasing ratios of private external debt to GNI (chart 5.4). This includes rising levels of private external borrowing by non-financial corporations, primarily for purposes of financial operations via the offshore issuance of debt securities over the past few years (Avdjiev et al., 2014). This is compounded by exchange-rate risks and the danger of sudden reversals of capital flows, for example in the wake of a normalization of United States interest rates, and/or volatile commodity prices. Hence, a rapid expansion of private external debt could be followed by debt crises and a rapid increase of public external debts. Indeed, following the Latin American debt crisis in the 1980s, a large share of the external debt owed by the private sector was transferred to the public sector. Similarly, during the build-up to the Asian financial crisis of 1997, a significant proportion of the debt incurred in the region was in the form of bank loans to private borrowers that were de facto nationalized after the onset of the crisis.

The structure of external debt has also evolved significantly on the creditors’ side. In most developing countries, until the 1970s, and sometimes in subsequent decades, a large proportion of long-term external debt was owed to official creditors mostly on a bilateral basis. This was the case, in particular, for developing countries whose economic links with their former metropolitan centres had remained strong and for the less developed countries to which commercial banks were reluctant to lend. In the early 1970s, in all developing regions other than Latin America, external debt owed to official creditors outpaced that owed

to private creditors. In the period 1970–1972, 67 per cent of African external debt was owed to bilateral or multilateral official creditors; in West Asia this share was 92 per cent, climbing to 93 per cent in South Asia. By contrast, 70 per cent of Latin American debt and almost half that of South-East Asia was contracted with private creditors (chart 5.5). In recent years, the share of official debt in developing and emerging economies has remained below 20 per cent of the total external debt.

Throughout the 1970s, developing countries’ external debt rose sharply (mainly on account of Latin American borrowers). Their total long-term external debt increased from about 13 per cent of their combined GNI in 1970 to 21 per cent in 1980, due primarily to a surge in their debt owed to private creditors, from 6 per cent to 13 per cent of their GNI. Capital account liberalization and commercial banks’ efforts to “recycle” petrodollars played an important role in this development. It was further facilitated by legislation in developed economies to strengthen and clarify creditors’ rights in case of foreign sovereign defaults, such as the United States Foreign Sovereign Immunities Act of 1976 and the State Immunity Act 1978 of the United Kingdom (Bulow and Rogoff, 1990).

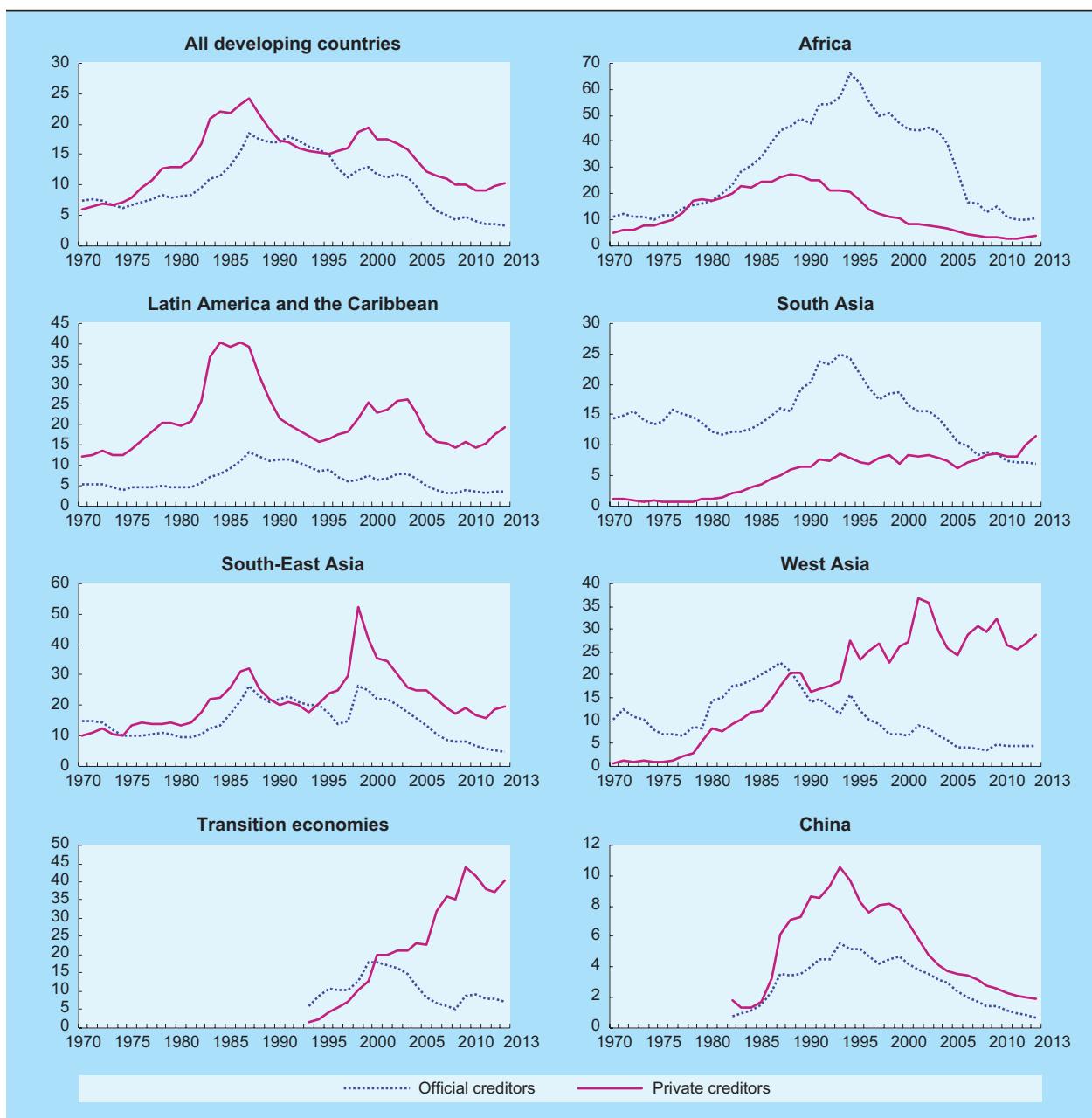
While the Federal Reserve interest-rate shock in the United States and subsequent debt crises in developing countries virtually stopped new private capital flows to these economies, private debt kept increasing as a percentage of GNI until 1987 due to low (or negative) output growth and sharp devaluations in the crisis-hit economies. Official debt – both bilateral and multilateral – as a share of their GNI also rose rapidly, mostly due to the interventions of official creditors to avoid massive defaults. As a result, between 1979 and 1987, developing countries’ external debt owed to official bilateral and multilateral creditors increased from 8 to 19 per cent of their GNI.

After 1987, the stock of debt owed by borrowers in developing countries to private creditors declined from its peak of 24 per cent of their GNI in 1987 to 9 per cent in 2011. This overall decline was punctuated by a number of boom and bust episodes in several large developing economies, which led to new financial crises and were reflected in temporary but sharp increases in the external debt owed to the private sector (reaching 19 per cent of developing countries’ GNI in the late 1990s). External debt owed

Chart 5.5

**LONG-TERM EXTERNAL DEBT BY TYPE OF CREDITOR,
SELECTED COUNTRY GROUPS AND CHINA, 1970–2013**

(Per cent of GNI)



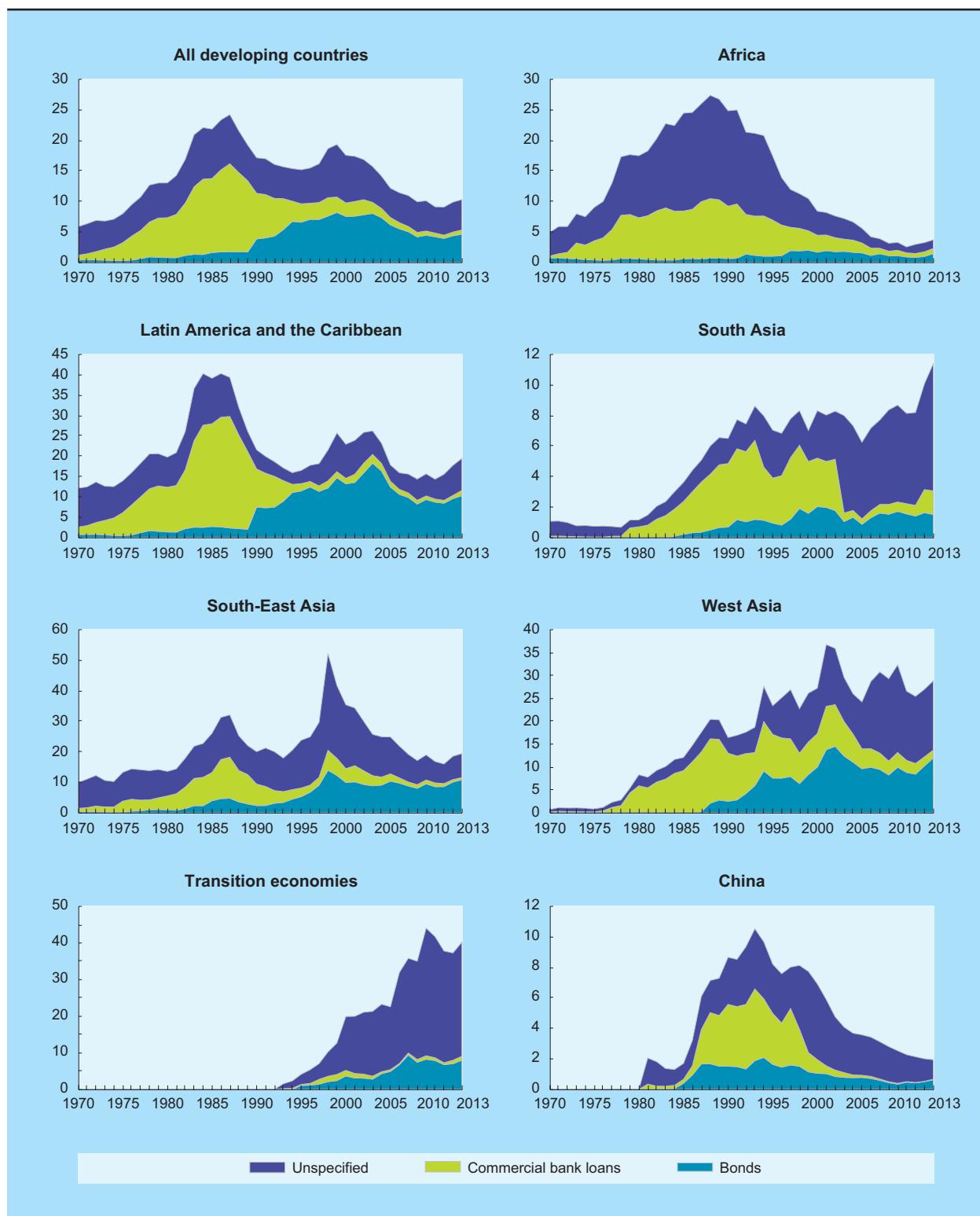
Source: UNCTAD secretariat calculations, based on *UNCTADstat*; and World Bank, *International Debt Statistics* database.

Note: Aggregates are based on countries for which a full set of data were available since 1980 (except for the transition economies where the cut-off date was 1993). Africa comprises Algeria, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comoros, the Congo, Côte d'Ivoire, the Democratic Republic of the Congo, Djibouti, Egypt, Gabon, the Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Mauritius, Morocco, Niger, Nigeria, Rwanda, Senegal, Seychelles, Sierra Leone, Sudan, Togo, Tunisia, Uganda, Zambia and Zimbabwe. Latin America and the Caribbean comprises Argentina, Belize, Bolivia (Plurinational State of), Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Jamaica, Mexico, Nicaragua, Panama, Peru, Saint Vincent and the Grenadines, and Venezuela (Bolivarian Republic of). South-East Asia comprises Indonesia, Malaysia, the Philippines and Thailand. South Asia comprises Bangladesh, India, Nepal, Pakistan and Sri Lanka. West Asia comprises Jordan, Lebanon and Turkey. Transition economies comprise Albania, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, Tajikistan, the former Yugoslav Republic of Macedonia, Turkmenistan, Ukraine and Uzbekistan. Data refer to all disbursed and outstanding debt at year-end.

Chart 5.6

**LONG-TERM EXTERNAL DEBT OWED TO PRIVATE CREDITORS, BY TYPE OF DEBT,
SELECTED COUNTRY GROUPS AND CHINA, 1970–2013**

(*Per cent of GNI*)



Source: See chart 5.5.

Note: See chart 5.5.

to official creditors declined more steadily, due partly to debt relief for the poorer countries, and partly to the deliberate policy by middle-income countries of limiting their recourse to multilateral financing.

The accumulation of quasi-accepted arrears on debt service – including the IMF’s policy of “lending into arrears” – plus the fact that large private banks in the financial centres had become solid enough to be able to sustain selling their portfolio of loans at a discount, led the Government of the United States to adopt the 1989 Brady Plan. This was an implicit recognition that troubled debtors could not fully service their debts and restore growth at the same time, thus paving the way for negotiations between the creditor banks and debtor nations to shift the primary focus from debt rescheduling to debt relief. Most Brady restructurings included the exchange of bank loans for bonds, of either equal face value but with a fixed and below-market rate of interest, or a lesser face value. The plan thus initiated a process of “financial disintermediation”, that is, of more direct borrowing from the capital markets via bonds instead of borrowing from commercial banks. This has been on an accelerating trend ever since (chart 5.6). While this change in financing instruments has rendered developing countries’ debt more liquid, it has also resulted in more complex debt renegotiations with a myriad of bondholders, in addition to increasing developing countries’ exposure to higher risk external debt.

3. **Currency-related issues**

The currency in which external debt is denominated significantly affects debt sustainability. Debt denominated in foreign currency is more risky than one denominated in domestic currency, because in case of currency devaluation, the burden of the former kind of debt in domestic currency terms would immediately increase, sometimes very significantly. More generally, even without devaluation, debtors would only be able to repay their external debt if they generated enough revenue (and, in the case of governments, if they realized a large enough primary budget surplus) and if the economy as a whole achieved a trade surplus. However, it may be difficult to meet both conditions simultaneously. Higher private and public revenues require output growth that generally is not possible without expanding imports, but

this affects the ability to generate a trade surplus. Conversely, deflationary adjustment with a decline in imports as a way to rapidly achieve a trade surplus makes it very difficult to achieve fiscal primary surpluses, and private debtors may become insolvent. This trade-off between trade and fiscal balances is another factor that explains why sovereign debt denominated in foreign currency tends to be less sustainable than that denominated in domestic currency.

Importantly, debtors facing solvency or liquidity problems vis-à-vis foreign currency liabilities cannot rely on the support of a domestic lender of last resort (e.g. national central banks); and even solvent debtors may be forced to suspend their debt repayments if they are unable to obtain enough hard currency due to balance-of-payments restrictions that are beyond their control. By contrast, debt in local currency reduces the risk of a currency mismatch between debt, on the one hand, and assets and revenues on the other, and the exchange-rate risk rests with the creditors. Moreover, with this kind of debt it is possible for the national central bank to step in when an emergency situation arises.

Consequently, a growing number of developing economies have been shifting towards local-currency-denominated debt. Nevertheless, the drawbacks of foreign-currency-denominated debt remain a relevant issue for them as well, since a large proportion of their gross external debt is still in the form of bank loans and official debt, and is thus denominated in foreign currency. This is particularly the case in poorer developing countries with small domestic debt markets, a heavy dependence on official lending and low credit ratings, but also in some larger middle-income developing countries and transition economies. For instance, in 2013, the share of external debt denominated in foreign currency, was 95 per cent in Argentina, 93 per cent in Turkey, 80 per cent in India, 74 per cent in the Russian Federation, 70 per cent in the Republic of Korea and 64 per cent in Mexico.⁵ Among the developing and emerging market economies that are members of the G20 (and for which data are available), only South Africa had a larger share of external debt denominated in domestic rather than foreign currency (i.e. 55 per cent of its gross external debt position). Even though these figures represent relatively low percentages of GNI, the risk remains that external debt could grow significantly in the event of domestic currency depreciations.

As a result of the considerable advantages associated with debt in domestic currency, developed countries whose currency is accepted in international payments and for constituting international reserves, and which have the possibility of issuing bonds and loans in their own currency, tend to incur larger amounts of external debt, including in difficult times. For instance, between 2003 and 2013, the gross external debt of the United States increased from 60 per cent of GNI to almost 100 per cent. Between 2001–2003 and 2013, this ratio rose from 31 to 55 per cent in Japan, from 113 per cent to 144 per cent in Germany and from 114 per cent to 194 per cent in France. Last but not least, in the United Kingdom, it rose from 198 per cent in 1999 to 354 per cent in 2013.⁶ An important counterpart to these significant increases in external debt in developed countries is the accumulation of foreign reserve holdings in many developing countries since the late 1990s. This creates an avenue for some of these countries – particularly those running a current account deficit – to accumulate debt at a low cost.

4. The jurisdiction for debt issuance

The jurisdiction under which a debt contract is issued is relevant in case of a default, because it defines the courts and the legislation under which the process of debt restructuring is ultimately decided. Schumacher et al. (2014) note that in recent years,

almost 50 per cent of sovereign defaults involved legal disputes abroad, compared with just 5 per cent in the 1980s; and 75 per cent of these litigations involved distressed debt funds, also known as “vulture funds”.

Formerly, there was a close match between the place of issuance, the jurisdiction for the debt, the residence of the ultimate holder and, to a lesser extent, the currency denomination of the debt. However, some recent indications suggest that more and more international investors are entering domestic debt markets of developing countries, and that domestic investors often hold bonds issued in international markets (Panizza, 2008). Such information, which is critical for identifying external debt through the residence of the creditor, is sometimes difficult to obtain.

Looking at all the outstanding public bonds (irrespective of the residence of the creditors and the currency of denomination), recent data show that the majority of these have been issued in domestic markets. In some developing subregions, such as East and South Asia, the percentage of domestic public bond issuance has been as high as the average for developed economies. In the transition economies, in Latin America and the Caribbean, and in West Asia, 28, 28 and 32 per cent, respectively, of outstanding public bonds at the beginning of May 2015 were issued in foreign markets (and normally under foreign jurisdictions).⁷ This leaves room for vulture funds to pursue holdout litigations in foreign jurisdictions in future debt restructurings.

D. External debt resolution

Given the frequent occurrence and continuing vulnerability of the globalized and financialized economy to debt crises, national and international policymakers require more appropriate instruments to handle such crises in a way that will minimize their costs. In principle, debt resolution mechanisms should help prevent the threat of financial or debt

crises when countries experience difficulties in meeting their external obligations, pre-empting the kind of sudden collapse of market confidence which can have catastrophic long-term consequences for the debtor economy. But debt resolution mechanisms should also aim at a fair distribution of the burden of debt restructurings between debtors and creditors once a

crisis does erupt. Finally, they should respect national sovereignty and preserve domestic policy space with a view to enabling a debtor economy to grow, achieve improved debt sustainability and design and implement its own development strategies. This section summarizes the main characteristics of external debt crises, followed by an analysis of the historical evolution of sovereign debt problems, and, in particular, approaches to resolving them.

1. External debt crises: A recurrent problem

While the structural causes of developing countries' debt crises vary, recent crises have been closely linked to the rapid liberalization of financial markets, their inherent instabilities and the "global financial cycles" these have produced (UNCTAD, 2014). Generally, debt crises occur at specific junctures in financial cycles. They start when a significant number of debtors (or some large ones) are no longer able to service debt accumulated during an expansionary phase. As a result, risk perception shifts from overconfidence to extreme unease, leading to liquidity shortages, asset price collapses and an economic downturn. Eventual asset liquidations further depress asset prices, in particular prices of those assets that were the primary object of speculation during the boom period and served as a guarantee for the debt. This not only causes the bankruptcy of highly indebted agents, but also affects more prudent agents who would be solvent in normal times. Once a debt crisis occurs, a potentially long process of financial consolidation must take place before the economy can begin to recover, lending can resume and an eventual exit from the crisis can be achieved.

The specificities of external debt, discussed in the preceding sections of this chapter, tend to increase the vulnerabilities associated with financial cycles. The greater openness of many developing economies to poorly regulated international financial markets is largely responsible for the build-up of their external debt and their concomitant exposure to high risks

of macroeconomic instability. In theory, openness to capital flows can have a countercyclical effect by allowing developing countries to borrow during economic slowdowns and repay during expansions. But this would require capital flows to respond passively to demand from developing countries, and for them to be used effectively for countercyclical purposes. In reality, "push" factors in the developed economies, such as their monetary policies, risk perceptions and the leverage cycles of their banks, are often the driving forces (O'Connell, 2014). Indeed, all major waves of capital flows to developing countries since the mid-1970s have been prompted by expansionary monetary policies aimed at mitigating economic recessions in the major developed countries (Akyüz, 2012). With limited credit demand and low interest rates in their own markets, financial institutions from developed countries have channelled part of their credit to developing or emerging economies in search of higher yields (*TDR 2014*). These flows have frequently exceeded the amount that most developing countries could use productively (Haldane, 2011).

Very large capital inflows entering relatively small economies have thus tended to generate domestic credit booms, strong asset price increases and currency appreciations. They have also facilitated

sizeable imports of consumer goods and services, leading to current account deficits and overindebtedness, particularly in the private sector. When economic conditions and risk perception in developed countries change or indebted developing countries experience repayment difficulties, capital movements can reverse suddenly and trigger external debt crises.

Steep currency depreciations increase the value of external debt in the domestic currency, resulting in insolvency for those agents whose incomes are mainly denominated in domestic currency and whose external liabilities are not matched by external assets. Widespread bankruptcies, affecting not only the real economy but also the financial sector, typically prompt central bank interventions to try to contain the crisis, including through bailouts, emergency financing and countercyclical measures. As a result, external debt crises are often also public sector crises. Even where governments themselves have not engaged in extensive foreign borrowing during

Recent external debt crises have been closely linked to the rapid liberalization of financial markets and to the global financial cycles they produce.

the boom period, they are frequently forced to absorb bad private debts.

Private external debt defaults do not pose a specific problem in themselves: so long as the debt does not affect the wider economy in a systematic manner, managing private defaults only requires applying the private commercial law in the jurisdiction where the debt was issued. By contrast, sovereign external debt problems present particular features that, in case of a default, require specific arrangements to manage them. The systemic issues raised by sovereign debt and default, and the legal as well as economic challenges they pose, are discussed in the remaining sections of this chapter.

Even when governments have not engaged in foreign borrowing during the boom period, they are frequently forced to absorb bad private debts. Thus, external debt crises are often also public sector crises.

2. Sovereign debt issues in historical perspective⁸

In some respects, sovereign debtors are more vulnerable than private debtors: unlike private debtors, if they are unable to service their debt by the due date, they cannot seek the protection of bankruptcy laws for restructuring or delaying their repayments. In another respect, they are less vulnerable than private debtors, because creditors cannot seize most public assets in payment for a defaulted debt. In fact, most of these assets are located in the sovereign's jurisdiction and protected by domestic laws. Those that are located abroad benefit from sovereign immunity clauses that limit the kinds of assets a foreign tribunal can confiscate. Only assets linked to commercial activities can be seized, and not the ones related to the intrinsic role of a State, which include international reserves. As a consequence, the main way of resolving sovereign debt issues has historically been through renegotiation between debtor governments and their creditors, broadly following a private-law paradigm.

Hence, throughout the nineteenth century, debt restructurings were a bilateral matter, dealt with exclusively between the debtor and the creditor. Crisis resolution was not always swift or smooth,

but mutual self-interest helped the parties to reach agreement. In general, domestic currency devaluation was not an option, since debt instruments frequently included gold clauses, which obliged the debtor State to make payments in gold, or the equivalent thereof.

Creditors, on the other hand, were in a weak bargaining position at a time when the respect for sovereign immunity was stronger than it is today, and they lacked an effective means to coordinate their claims. Even after the formation of support structures, such as the Corporation of Foreign Bondholders (in the United Kingdom), and later the

Foreign Bondholders' Protective Council, they frequently lacked government support (Eichengreen and Portes, 1986; Feldmann, 1991; Adamson, 2002). Moreover, legal enforcement was virtually impossible for them, since sovereign immunities were more strictly observed than they are today, and effectively protected States against such enforcement, if not against legal proceedings. International arbitration was rare, in general, and even more so for sovereign debt, while military intervention and gunboat diplomacy remained the exception.⁹ Debt restructurings thus followed a private-law paradigm, characterized by horizontal dialogues between relatively equal parties, and they did not require the intervention of international institutions representing some wider public interest.

This changed after the First World War, when sovereign debt issues acquired a new dynamic in the context of German defaults on reparation payments, the wider economic impact of the First World War on other economies and, more generally, the detrimental effects of an increasingly fragile international monetary system. Multilateral efforts to prevent sovereign debt crises, and to solve these where they had already occurred, played an important role throughout this period in elevating debt sustainability and resolution to the level of an international concern, and in raising international awareness of the public interests at stake in sovereign debt negotiations. The United States took the lead in designing ways to settle Germany's First World War reparation debt without risking the latter's total economic collapse and political disintegration, through the 1924 Dawes Plan and its successor, the 1929 Young Plan. Other

multilateral attempts to deal with sovereign debt problems were made by the League of Nations. The League did not have funds to provide financial support for troubled debtor States, but it scrutinized the development of contractual provisions used for sovereign bonds, advised member States on economic reform, and monitored the implementation of its recommendations with the aim of helping indebted States regain access to capital markets (Myers, 1945; Florez and Decorant, 2012). It even established a Committee for International Loan Contracts, which systematically investigated sovereign debt issues between 1935 and 1939. At the same time, the Permanent Court of International Justice helped French creditors to enforce contractual rights to repayment in gold by Brazil and Serbia (Waibel, 2011). Overall, and while sovereign debt restructurings largely maintained their consensual and horizontal structure of negotiations between debtor States and creditors' committees, the need for debtor States to quickly return to capital markets seems to have been generally recognized, not least in the wake of the Great Depression and the many sovereign defaults this entailed (Lindert and Morton, 1989; Feldmann, 1991; Reinhart and Rogoff, 2009).

With the emergence of the Bretton Woods System after the Second World War, a new international economic order emerged, which had a greater capacity to deal with sovereign debt problems, although these became much less frequent throughout the Bretton Woods period. While some countries, such as the United Kingdom and the United States, refuted their way out of their mostly domestic debt (Grossman 1988),¹⁰ other debt restructurings became a concern for international law. Most famously, the 1953 London Agreement (see box 5.1) to restructure the German external debt – both official and private – from the interwar period underlined the importance of substantial debt relief, not only for the economic prosperity of the debtor country and its economic partners, but also for global political stability and peace.

For developing and emerging economies requiring a restructuring of their bilateral official debt, the Paris Club has provided a fairly comprehensive forum for negotiations since the mid-1950s (Cosio-Pascal,

2008). However, over many years, the restructurings achieved through this institution seemed to give precedence to repayments to creditors rather than to debt relief (Eskridge, 1985).

Thus, on the whole, the private-law paradigm still prevailed, although a global public concern for debt sustainability was now more recognizable than at the turn of the century. Within this framework, the bargaining power of debtors and creditors shifted in favour of the latter. Laws such

as the United States Foreign Sovereign Immunities Act of 1976, the United Kingdom State Immunity Act of 1978 and other similar acts passed by most countries in Western Europe ended the concept of absolute sovereign immunity. This meant that a government whose activities were considered to be "commercial" and not intrin-

sic to the State was not entitled to claim sovereign immunity and could be subject to litigation in foreign courts.¹¹ These changes became particularly relevant with the return of sovereign debt crises in the early 1980s, after almost 30 crisis-free years (Reinhart and Rogoff, 2009).

Since the 1970s, the bargaining power in debt restructuring has shifted in favour of the creditors, both private and official.

3. *Emergence of a fragmented resolution system for external sovereign debt*

The 1989 Brady Plan was based on recognition that a sustainable solution to debt overhang in developing countries would require debt restructuring and relief. To this end, it initiated a shift from syndicated bank loans to disintermediated bond financing of external debt.

By the end of the 1980s, renewed concerns on debt sustainability also led the Paris Club (see below) to incorporate special treatment for the debt of poor countries owed to official creditors. The "Toronto terms" approved in 1988 granted, for the first time, debt relief of up to 33 per cent of non-ODA credit received by poor countries. The levels of debt cancellation were subsequently increased with the "London terms" in 1991, the "Naples terms" in 1994 and the "Cologne terms" in 1999, to 50, 67 and 90 per cent,

Box 5.1**THE LONDON AGREEMENT ON GERMAN EXTERNAL DEBT**

The London Agreement between the Federal Republic of Germany (FRG) and its then creditors, concluded in London on 27 February 1953, was a debt relief agreement. It was indispensable for the rebuilding of the West German economy soon after the Second World War, and was a major factor contributing to that country's so-called "post-war economic miracle".

The agreement covered both the pre- and post-Second World War German debt. Just over 20 billion deutsche mark of this debt, including interest, stemmed from loans taken prior to 1939 to pay reparations agreed after the First World War; the remainder of just over 16 billion deutsche mark represented United States reconstruction loans after the Second World War. While the negotiations took place only with the FRG, they covered the entire German debt with Western debtors that the FRG had inherited in full after the end of the Second World War. Under the London Agreement, West German debt was cut by just over 60 per cent (including interest payments) to 14.5 billion deutsche mark.

The London Agreement needs to be understood in the context of the wider United States policy concerning West European reconstruction after 1945. Already in October 1950, the Western Allies signed a declaration on the German debt problem in which "the three countries agree that the plan include an appropriate satisfaction of demands towards Germany so that its implementation does not jeopardize the financial situation of the German economy through unwanted repercussions nor has an excessive effect on its potential currency reserves. The first three countries are convinced that the German federal Government shares their view and that the restoration of German solvability includes an adequate solution for the German debt which takes Germany's economic problems into account and makes sure that negotiations are fair to all participants" (cited in Toussaint, 2006). Substantial debt cancellation for West Germany ranked high in the Western Allies' priorities for post-war reconstruction as a means to ensure the country's future economic and political stability and its firm integration into the emerging bloc of anti-Soviet Cold War allies. Beyond these political considerations, the economic logic underlying the agreement is in sharp contrast to the austerity conditionalities that characterize contemporary approaches to debt restructuring, such as for Greece. Apart from debt cancellation per se, this is evident in the specific measures and arrangements included in the London Agreement:

- *Debt servicing and trade:* The agreement limited the amount of export revenues that the FRG could spend on debt servicing to 5 per cent of the total in any one year. This is markedly lower than the percentages allowed for developing-country debt servicing since the 1980s, which have ranged between 8 and 20 per cent of export revenues. In addition, debt payment was linked to trade surpluses, and could be postponed if the country ran a trade deficit, so that there was no need for it to resort to new sources of borrowing, thus avoiding the creation of a potentially vicious circle of debt accumulation. At the same time, this also ensured that it was in the creditor nations' interests to increase their demand for German exports.
- *Interest rates and currency denomination:* Interest rates on the FRG's debt ranged between 0 and 3 per cent, again substantially lower than average interest rates on debt incurred by today's developing countries. Importantly, the debt could be paid in deutsche mark rather than in any creditor currency, thus freeing that country from the need to use its foreign export earnings for debt repayments.
- *Comprehensiveness of debt restructuring:* The London Agreement brought together the vast majority of the FRG's creditors around a single table, including official and private creditors. This ensured equal treatment of creditors as well as swift decision-making that provided a clear, comprehensive and long-term plan for debt repayment. There was no possibility for private creditors to opt out of the arrangement with a view to speculating on German debt and obliging the country to engage in long processes of renegotiation and litigation.
- *Renegotiation option:* The London Agreement explicitly included the option for the FRG to suspend debt servicing and seek renegotiated terms in the event of any substantial changes to its situation.

The agreement was thus clearly informed by an economic rationale based on the view that safeguarding and promoting the future growth potential of the debtor economy was essential for enabling it to service its debt. Expansionary economic policies, actively supported by the creditors, were the precondition for debt repayment. Given the FRG's remarkable success with post-war reconstruction, arguably the London Agreement provides a constructive template for today's creditors, both private and official.

respectively.¹² The Paris Club also extended the possibility of debt relief to non-HIPC developing countries, on a case-by-case basis, under the “Evian terms” in 2003 (Paris Club, 2015).

Furthermore, regarding the multilateral official debt of poor countries, in 1996 the IMF and the World Bank launched the Heavily Indebted Poor Countries (HIPC) initiative, which was enhanced in 1999. Under this initiative, poor countries that bore a very high debt burden were offered multilateral debt relief and access to credit on concessional terms. In addition, the IMF progressively liberalized its lending practices by introducing a “lending into arrears” policy for States that were in arrears on payments to their private creditors, provided they were involved in bona fide negotiations with their creditors. Hence, specific tools were gradually introduced to handle sovereign external debt distress with bilateral or multilateral creditors, and involved case-by-case negotiations between official counterparts.

By contrast, the series of emerging market crises, which began in Mexico in 1994, elicited traditional policy responses from these same institutions. Their new lending was conditional on the recipient’s commitments to austerity, the adoption of “appropriate” macroeconomic policies and structural reforms. Since these official credits were used largely to prevent countries defaulting on their debts to private creditors, they did not mitigate the countries’ economic slowdown or diminish their debt burden; rather, they appeared to be rescuing the creditors. The high cost of these policy responses in terms of lost output and excessive constraints on national policy space generated widespread dissatisfaction with sovereign debt resolution mechanisms, leading the IMF to propose the creation of a sovereign debt resolution mechanism (SDRM) for debt held by private investors. Following the failure of this initiative – which was rejected not only by private creditors, but also by the Governments of the United States and some emerging market economies – private external debt issues have remained the prerogative of commercial courts and direct debtor-creditor negotiations.

The current fragmented sovereign debt resolution system applies different procedures to handling diverse kinds of external sovereign debt.

These developments have given rise to a fragmented sovereign debt resolution system, with different procedures for handling diverse kinds of external sovereign debt (bilateral and multilateral debt, bank loans and external bonds) when difficulties arise (UNCTAD, 2015). The Paris Club provides the main negotiating forum for restructuring the *official bilateral debt* of its creditor member States. This group is comprised of 19 developed countries that are the major providers of official credit to developing countries. Negotiations, which cover medium- and long-term debt, including export credits whose terms exceed one year, normally take place after the debtor government has agreed to an IMF loan and its associated conditionality, although a few exceptions have been accepted recently. Negotiations result in “agreed minutes” which include the general terms of debt

restructuring. This is followed by bilateral agreements with each participating government that may present some differences, as long as they follow the general guidelines. The Paris Club has sought to establish a framework for debt restructuring by seeking “comparability of treatment”, whereby the debtor government commits to seeking similar treatment from other official creditors that are not members of the Paris Club, and also from foreign private creditors.¹³ Domestic debt and multilateral debt are excluded from this requirement.

Multilateral institutions play a key role in sovereign debt resolution, despite the fact that *multilateral debts* have generally been exempted from debt restructuring or relief. The involvement of the IMF, the World Bank and multilateral development banks typically consists of providing exceptional financing when voluntary private sources dry up or are no longer available. In compensation, these institutions have benefited from the status of preferred creditor. Their financing has generally been conditional upon strict and comprehensive policy requirements, originally intended to ensure that countries would be able to correct their imbalances and repay their loans.¹⁴ Therefore, securing a credit agreement with these institutions (and particularly with the IMF) has been a precondition for negotiating debt restructuring

or relief with other creditors, as the associated conditionality has been viewed as a commitment from the debtor country to address the causes of its debt problems.

The main exception to the rule that exempts multilateral debt from restructuring or a haircut is the debt owed by poor countries, mainly through the HIPC Initiative launched in 1996, broadened in 1999, and deepened through the Multilateral Debt Relief Initiative (MDRI) in 2005. The original HIPC Initiative was aimed at providing the poorest countries with an exit from the repeated debt rescheduling process. It was designed to coordinate the efforts of involved creditors through broad and equitable participation, most prominently by multilateral institutions and Paris Club official creditors, but also by non-Paris Club bilateral official creditors and commercial lenders.¹⁵ Subsequent iterations that have extended relief in various ways, have been linked to country performance. They have also developed a more systematic approach to the quantitative evaluation of debt sustainability through the formulation of threshold values for standard debt indicators based on historical experience, and the inclusion of an adjustment for external shocks. Subsequent efforts to refine this evaluation methodology have been tried, but continue to be dogged by criticism about the lack of transparency in the underlying assumptions of what constitute “good” or “bad” policies and the institutional arrangements, as well as persistent problems in differentiating effectively between liquidity and solvency characteristics of impending debt crises (Ocampo et al., 2007).

Hence, overall debt restructuring with official creditors follows a pre-established procedure with little room for negotiation. This contrasts with the treatment of sovereign debt with private creditors, which consists of bank loans and external bonds. *Bank loans* are subject to negotiations at the London Club, an informal group of international commercial banks established in 1976. When a sovereign debtor requests debt restructuring, a bank advisory committee (BAC) is created within the London Club process and chaired by a lead bank – generally the one with the largest exposure – whose main task

is to coordinate the creditors’ bargaining position. The BAC eventually reaches an agreement with the debtor government and seeks to convince all the bank creditors (even those that are not members of the BAC) to sign on. Since the London Club does not establish binding resolutions or have defined voting procedures, agreements have sometimes required long negotiations, and free-riders have posed a recurrent problem. Although the negotiation process allows considerable flexibility within the private-law paradigm, it has maintained some links with negotiations on official bilateral and multilateral debt. For instance, reaching a credit agreement with the IMF is a de facto requirement for a government that is seeking to restructure its debt with the London Club, and reciprocally, avoiding arrears in payments with private banks is a usual condition for signing an agreement with the IMF. Regarding Paris Club agreements, commercial banks are normally asked to offer “comparable treatment” (i.e. debt

relief) to that offered by official creditors. This latter approach has repeatedly been criticized for its lack of transparency about the underlying methodology for determining comparability as well as for its lack of enforceability (UNCTAD, 2015).

The substantial shift from syndicated bank loans to external bond financing over the past two decades has significantly increased the complexity of debt restructuring.

The substantial shift from syndicated bank loans to *external bond* financing over the past two decades has significantly increased the complexity of debt restructuring. Thousands of bondholders with diverse interests can face divergent regulatory constraints, and bond series can be issued in different jurisdictions. Usually, an informal negotiation takes place in committees where different groups of bondholders are represented.¹⁶ The debtor country eventually proposes bond swaps with lower face values, longer maturities and/or lower interest rates. Other basic characteristics of the bonds may also be altered: new bonds may be denominated in a different currency, be subject to a different jurisdiction, and incorporate new clauses, such as collective action clauses (CACs). Bondholders then vote for or against accepting the swaps. If the old bonds included CACs, a qualified majority may make the vote binding on all bondholders. If no such CACs are included, or the required majority is not obtained through voting, creditors that have not accepted the swap (“holdout

bondholders” or “holdouts”) may seek better terms or even full repayment through litigation.

Debtors can try to obtain wider acceptance of their proposal by promoting “exit consents”, through which bondholders who accept the swap are asked to vote to alter the non-repayment terms of old bonds to make them less liquid and attractive to holdouts. They can also establish minimum participation thresholds, meaning that their restructuring offer only holds if a minimum number of bondholders accept it. In this case, creditors wishing to end a moratorium and start receiving a payment may try to convince other creditors to accept the deal. However, many bondholders may also prefer to sell their bonds at a discount in the secondary market rather than wait for the conclusion of the negotiation process. Increasingly, conventional bondholders are being replaced by specialized investors not interested in reaching a settlement, but seeking to obtain full payment through litigation (including the so-called “vulture funds”). As discussed further below, this has become the most serious challenge for debt restructuring.

The present scheme of debt resolution has tended to delay the swift and comprehensive action needed to prevent a debt crisis from spiralling out of control.

to recognize a situation of overindebtedness and take early and comprehensive action (Buchheit et al., 2013). For debtor governments, a major disincentive is the likelihood that declaring a debt moratorium will have a self-fulfilling effect by triggering an economic crisis. Furthermore, defaulting “too early”

may be viewed by creditors as a strategic (avoidable) default aimed at lowering debt servicing costs. Governments may want to avoid the consequent reputational costs – which would result in lower access to credit – that may outweigh the benefits. Therefore, they may postpone a needed default until it becomes

clearly “unavoidable” so as not to raise doubts about their good faith and willingness to pay. Finally, governments quite frequently fail to fully perceive the increasing risks, and only react when crises have already started.

Creditors also have an interest in delaying explicit recognition of a solvency crisis, as opposed to a mere liquidity crisis, since, in case of a solvency problem, no creditors can expect to recover their loans in full (except, to some extent, multilateral institutions with preferred creditor status). Private lenders therefore tend to initially minimize the extent of the debt problems. This can receive official endorsement from an initial diagnosis by the IMF which agrees emergency support (as has happened in all the major debt crises since the 1980s), and forecasts a rapid recovery following the implementation of adjustment policies. Those forecasts in general have been too optimistic (IMF, 2003b; *TDR 2011*, chap. III), but have provided the rationale for the “liquidity problem” hypothesis. As a consequence, debtor governments have received credit from official

sources, while private creditors have been reluctant to renew credit lines and have opted for immediate repayment. One implication has been the so-called “revolving door” process, with official credit funds being used to repay debts to private agents, instead of supporting the real economy and helping to restore growth. Precisely to

4. An inefficient and unbalanced approach to debt resolution

(a) Too little, too late

An early diagnosis that determines, in particular, whether a country is facing a liquidity or solvency crisis is essential for the orderly management of a debt problem. The present fragmented scheme has proved inefficient in providing such early diagnoses, and has tended to delay often urgently required swift and comprehensive action to prevent a debt crisis from spiralling out of control.

Since solvency crises were treated as liquidity crises, official credit extended to indebted governments was used to repay debt to private agents, instead of helping to restore growth.

It appears, under the current system, that neither debtor governments nor creditors have an incentive

to avoid such inefficient use of exceptional financing, the IMF’s Articles of Agreement include a rule to

the effect that “a member may not use the Fund’s general resources to meet a large or sustained outflow of capital”(Article VI). Since the 1980s, this rule has been overlooked repeatedly in the managing of sovereign debt crises.

(b) Asymmetric and procyclical resolution processes

Unlike private firms, indebted States cannot go bankrupt. Ultimately, debt resolution processes need to focus on a debtor economy’s ability to recover as quickly as possible and on minimizing social, political and economic adjustment costs. This requires a supportive international framework that allows the debtor country to conduct countercyclical policies which will enable it to restore its debt servicing capacity through investment, output and export growth, rather than import contraction. National policy should also ensure that government debt can be reduced by increasing public revenue rather than reducing expenditure.

The current international financial and monetary system is lacking in this regard, and is characterized by a contractionary bias. This is evidenced by the IMF’s “stand-by agreements” (SBAs) under which standard associated credits typically include the requirement for fiscal and monetary austerity measures based on the “absorption approach”. Such an approach is based on the view that current account deficits and the resulting external debt result from a level of “absorption” (i.e. domestic consumption and investment) in excess of total output (Mussa and Savastano, 1999).

A new form of conditionality imposed by subsequent IMF lending programmes, in addition to conventional macroeconomic adjustments, is the requirement for structural reforms. In their various manifestations, these have continued to focus on contractionary measures, as well as on a general roll-back of State intervention in economic and financial areas through far-reaching liberalization and privatization policies. Besides macroeconomic adjustment and structural reforms, a third core component of the IMF-supported programmes has been to secure a

sustainable flow of foreign financing. Consequently, these programmes usually also include the requirement for the recipient economy to remain current on government debt service and to eliminate any debt arrears accumulated prior to programme approval. Hence, rather than involving private creditors in a debt restructuring process, the IMF has included the servicing of private debt among its usual conditions.

Arguably, such conditionalities have done little, if anything, to promote debt sustainability through growth, and have mostly been counterproductive. The IMF has progressively acknowledged mistakes in its policy conditionalities under crisis conditions. It

now argues that fiscal austerity during recessions is more costly than was previously assumed, because fiscal multipliers are higher, the assumption of a trade-off between public and private demand is questionable, and public spending cuts are not automatically offset by higher private demand (IMF, 2012).

It has also recognized that its strict conditionality and a cumbersome process for delivering credit support were inappropriate for preventing or addressing external debt crises triggered by gyrations in the capital account. Consequently, it has created new credit lines with lower conditionality that would provide a “precautionary line of defense” for members that might suffer from contagion effects (IMF, 1997 and 2004; Ocampo, 2015).¹⁷ However, so far its new credit lines have not been used much,¹⁸ and do not address the needs of the most vulnerable countries, including those hit by an external debt crisis (*TDR 2001*).

Debt resolution processes should focus on economic recovery and on minimizing adjustment costs. ...

(c) The rise of non-cooperative creditor litigation

The rapid rise of bond financing in external debt markets following the Brady Plan was widely expected to stabilize external debt through market discipline, coupled with sufficient legal guarantees for creditors. Thus, for instance, enforcement clauses containing a waiver of sovereign immunity were included in bond contracts. As mentioned earlier (see subsection D.2) under a number of jurisdictions, sovereigns could no longer claim immunity for what was deemed to be commercial activity. In

addition, in 2004 the New York Legislature opened new opportunities for the so-called “vulture funds” when it greatly restricted the scope of the Champerty Doctrine which forbids purchasing a debt with the sole purpose of future litigation.¹⁹

In this context of strengthened creditor rights, vulture funds have flourished. Their strategy consists of buying defaulted bonds at a significant discount only to aggressively sue governments thereafter for repayment of their debts at face value plus interest, arrears and litigation costs, with gains of between 300 and 2,000 per cent.²⁰ According to Schumacher et al. (2014), such holdout litigation has become a common and increasing practice in debt restructurings, from only about 5 per cent in the 1980s to almost 50 per cent in 2010, and the total volume of principal under litigation reached \$3 billion in 2010. Between 1976 and 2010, there were about 120 lawsuits by commercial creditors (against 26 defaulting Governments) in the United States and the United Kingdom alone, the two jurisdictions where most sovereign bonds are issued. This trend has since continued, with suits being filed against Ecuador²¹ and Greece, among others.²²

Holdout litigation has been particularly disruptive in the context of multilateral debt relief efforts to reduce the external debt burden of heavily indebted poor countries.²³ In practice, such litigation has significantly eroded the limited fiscal space created by debt relief to alleviate poverty and foster economic development in these countries. At least 18 heavily indebted poor countries have been threatened with or subjected to legal actions by these commercial creditors since 1999, leading to an estimated number of more than 50 lawsuits of the kind described.²⁴ For example, in a case against Zambia, Donegal International, a vulture fund based in the British Virgin Islands, having bought debt instruments for \$3.28 million, sued the debtor for their nominal value of \$55 million. The High Court of Justice of England and Wales, with notable political and moral disapproval, ruled that the Government must pay the vulture fund \$15.4 million, which represented 65 per cent of what Zambia had saved in debt relief delivered through the MDRI in 2006.²⁵ In reaction, the United Kingdom passed legislation preventing

claims against heavily indebted poor countries that exceed the amount which a holdout creditor would have received had it accepted the restructuring.²⁶

Action by vulture funds highlights the conflict between a purely private-law paradigm that seeks to enforce contracts at any cost and the logic of public law which is supposed to take into account the wider economic and social consequences of legal actions. Courts have generally endorsed holdouts’ views, even at the expense of sovereign debt sustainability and the interests not only of the debtor country, but also of bondholders willing to reach a viable agreement. The main argument is that the majority of cooperative

creditors must not be allowed to modify the financial terms of other creditor contracts, unless specific contractual clauses allow this possibility. United States courts have consistently ruled that, in the absence of contractual clauses providing for majority voting, the “sanctity of contracts” prevails, so that unanimity among creditors is required to make a restructuring

agreement binding on every creditor.²⁷ Debtor States’ invocation of a state of necessity has mostly been rejected by courts around the world, be they national courts or arbitration tribunals acting within an investor-State dispute settlement mechanism (ISDS).²⁸

In rare cases, courts have taken into account debt sustainability concerns. Depending on the potential global effects of the restructuring at stake, in a few cases courts in the United States have acknowledged that there can be a legitimate interest in debt restructurings on the grounds of safeguarding financial stability.²⁹ In other jurisdictions, courts have given broader recognition to the principle of debt sustainability, by granting immunity to debt repudiation aimed at safeguarding the basic human rights of citizens in the debtor States.³⁰ However, these cases have not had any wider impact, and have been overshadowed more recently by the well-known ruling in the case of *NML Capital, Ltd. et al. v. The Republic of Argentina* that has been strongly supportive of the holdouts.

This case highlights two major factors that facilitate holdout litigation and threaten debt sustainability.

... However, such processes are characterized by a contractionary bias through the conditionality attached to lending programmes by the IMF and other official sources.

The first is the so-called “forum shopping”, that refers to the ability of holdout creditors to shop around for favourable judges. Thus, Argentina’s creditors found sympathetic judges not only in the United States, but also at the German Constitutional Court,³¹ the Supreme Court of the United Kingdom,³² and the ICSID tribunal,³³ as well as a judge in Ghana.³⁴ The second factor arises from the very wide interpretation of the *pari passu* clause that is widely used in sovereign debt contracts. According to a conventional reading, its purpose is to ensure that no priority ranking is established for unsecured creditors (Buchheit and Pam, 2004). By contrast, the sitting judge in the case of *NML Capital, Ltd. et al. v. The Republic of Argentina*, following an earlier Belgian case,³⁵ interpreted the *pari passu* clause as an obligation by Argentina to make rateable payments to NML each time it pays its restructured bondholders.³⁶ More specifically, the District Court’s injunctions forbid any financial intermediaries from collaborating with Argentina in paying exchange bondholders unless they are notified that the holdouts have received rateable payment.

This ruling threatens debt sustainability in at least three ways. First, it makes future debt restructurings much more difficult than they already are by strengthening creditors’ incentives not to consent to debt restructuring agreements. Not only can creditors now expect to have more leverage to seek full repayment, but those agreeing to a debt restructuring can no longer be sure that they will actually be paid. Second, given the global scope of the many financial intermediaries involved in this case, the judgment potentially has universal reach. Third, the ruling focuses exclusively on creditors’ rights and disregards any wider socio-economic implications of requesting rateable payments from the debtor country, to the extent of risking an Argentine debt default and, in any case, severely undermining its future access to external financing, and thus its growth prospects.

Beyond Argentina, holdout creditors also have complicated recent Greek debt restructurings. Normally, holdout litigation is limited to debt issued

under foreign law which the debtor State cannot modify unilaterally. In 2012, under the auspices of the European Financial Stability Facility, Greece restructured \$206 billion of its debt by offering bondholders new bonds with a 75 per cent haircut, lower interest rates and longer maturities. The new bonds were accepted by 97 per cent of the creditors. Bonds governed by Greek law were also subject to an ex-post legislative introduction of a CAC to facilitate restructuring of the debt portfolio. Just before the haircut took place, vulture funds bought Greek bonds issued under United Kingdom legislation that did not allow Greece to activate the CACs. A month after the completion of the haircut, the Greek Government decided to pay 435 million euros to investors who had refused to participate in the restructuring. In June and July 2013, the Greek Government made two additional and higher payments, of 790 million euros and 540 million euros, respectively, to holdout creditors.

Holdout litigation and recent rulings that forbid governments to pay the restructured debt make debt restructurings more difficult than they already are. ...

(d) The role of contingent liabilities in sovereign debt

...Such rulings show a total disregard for the sovereignty of the debtor, for third-parties’ interests and for the socio-economic impacts they might have on a debtor economy.

Finally, a brief mention is warranted of another recent and growing area of concern, namely the problem of contingent liabilities of a sovereign and their treatment in processes of debt restructuring (see Buchheit and Gulati, 2013). Contingent sovereign liabilities refer mostly to third-party debt guarantees, granted either explicitly through a formal undertaking, or implicitly through informal or semi-formal arrangements that signal to the creditor the sovereign’s awareness and implicit approval of a transaction. Another, even less formally acknowledged form of contingent liability of a sovereign arises from its role as lender of last resort during debt crises. As already pointed out, given the characteristics of recent developing-country debt crises, there is a relatively high probability that, in the event of such a crisis starting in the private sector of an economy, at least part of privately owed debt will be de facto “nationalized”.

Third-party debt guarantees are, almost by definition, kept off the public balance sheets precisely because they constitute liabilities that are contingent on the primary debtors' ability to service the debt. At the same time, this practice keeps the sovereign State's official debt ratios low, thus facilitating continued access to future borrowings, in particular where a sovereign already has high levels of indebtedness, at least as viewed by market participants. Preliminary evidence suggests that, since the 2008–2009 global financial crises, sovereign contingent liabilities have grown

significantly, although mostly in Western Europe (Buchheit et al., 2013).

How such growing contingent liabilities might be included in sovereign debt restructurings is currently unclear, since there is hardly any relevant precedence. While sovereign States might temporarily benefit from the novelty of this issue and the lack of established ways to address it in the context of restructurings, in the longer run ignoring contingent liabilities will prove very costly, not only to sovereign States but to all parties to a debt restructuring.

E. Alternative mechanisms for debt restructuring³⁷

Since the global financial crisis, there has been growing recognition of the need to facilitate sovereign debt restructuring. Such concerns are not new. However, in the years prior to 2008, the dominant view was that the more costly a sovereign debt default, the less likely it would be to occur (see Buchheit et al., 2013). According to this view, any reduction in the costs of default would discourage governments from paying their debts and encourage over-borrowing, thereby increasing perceived creditor risks and reducing access to foreign credit. Instead, as argued above, recent experience has shown that the more likely scenario is not that governments may restructure their debts too easily, but, on the contrary, that they will delay necessary debt restructurings.

This section analyses existing proposals for a more effective approach to sovereign debt restructuring, and the extent to which they would facilitate successful and comprehensive sovereign debt resolution while also remaining politically feasible. There are broadly three types of approaches to sovereign debt restructuring mechanisms (SDRMs): a market-based approach that focuses on legal improvements to the existing contractual system; a semi-institutional approach that advocates the use of soft-law international principles to help inform and guide a

restructuring process; and a statutory approach that aims to establish internationally binding rules and procedures on sovereign debt restructuring. A legally binding multilateral treaty is the ultimate objective of this approach.

These proposals differ on a number of key aspects of sovereign debt restructuring, such as which types of debt should be included, the degree of coordination and centralization of SDRMs, how participatory and transparent these should be, whether or not SDRMs should include adjudication possibilities in cases where no voluntary agreement is reached, and how consistent outcomes have to be across debt restructurings.

1. Contractual or market-based approaches

A number of prominent proposals to facilitate sovereign debt restructuring seek to maintain the integrity of existing market-based approaches by clarifying and strengthening their legal underpinnings, in particular by improving CACs in bond contracts (IMF, 2014). Other approaches include

contingent payment provisions, clarification of the *pari passu* (equal treatment of bondholders) provision, in particular following the ongoing Argentine case, and mechanisms to limit creditor participation in restructurings by addressing the issue of sovereign credit default swaps. Contingent payment provisions are not primarily concerned with the SDRM itself; instead, they would allow future payments by sovereign debtors to be made contingent on observable economic conditions, for example through the use of GDP-indexed bonds or contingent-convertible bonds.

The main advantage of such market-based approaches is that debt restructurings remain voluntary and, at least potentially, consensual. They also open the way to gradual reform, in the sense that widespread use of such contractual proposals might help to promote debt sustainability, reduce uncertainty about outcomes and prepare the ground for more far-reaching reforms.

This said, the case of the CACs also highlights major limitations. As the example of Greece has shown, conventional, single-series CACs, which require the consent of a qualified majority of bondholders of every single issue, can easily be disabled by holdout creditors who buy a blocking minority. Aggregated CACs, which require a twofold qualified majority – that of the holders of each bond issue as well as of the holders of all covered bond issues – can reduce, but not eliminate, the risk of such behaviour. Yet, even the best, single-limb CACs that do not require voting by bond issue cannot guarantee that holdouts will not find ways to block the required consent (Galvis and Saad, 2004).

These CACs require the participation of 75 per cent of all covered categories of outstanding debt. While it might be difficult even for very large investors to acquire a blocking minority, the operation of such clauses – which are yet to stand the test of practice – requires that all creditors be offered identical conditions under the restructuring agreement, regardless of the conditions of their old bonds. Without this, there would be a high risk that the restructuring is achieved at the expense of some bond series. However, this condition provides a basis for inter-creditor discrimination. One-size-fits-all

restructuring agreements will necessarily disadvantage those who enjoyed better conditions before the restructuring than the majority, such as creditors holding instruments with long maturities. In the end, even third-generation single-limb CACs remain structurally deficient (Bohoslavsky and Goldmann, 2015).

A purely contractual approach focused on CACs suffers from a number of additional limitations. The introduction of certain CACs might require legislative amendments in some jurisdictions in order to protect them against standard term reviews by courts. Many legal orders protect contractual parties against boilerplate terms used by one party which unduly compromise the rights of another party. Legislation would have to determine that certain CACs do not fall into this category. Moreover, CACs only apply

to bond debt; if the debtor State has significant outstanding multilateral, bilateral or bank debts, they will be of little help. Coordination among different categories of creditors and the risk of free-riders taking advantage of a lack of such coordination has been an ongoing concern. CACs also adopt a very narrow approach to sovereign debt issues. They

do not prevent crises, nor do they provide the tools necessary for exiting them, or interim financing during debt restructuring (Krueger and Hagan, 2005). Furthermore, CACs do not guarantee that the outcome of negotiations – which will depend on the relative bargaining powers of the parties – will be consistent with a durable solution based on a return to growth.

Market-based instruments such as collective action clauses may improve debt restructuring, but they do not prevent crises, nor do they provide the tools necessary for exiting them.

2. Need for internationally accepted principles for SDRMs

This approach aims, in principle, at an internationally accepted solution for SDRMs, and thus at a higher degree of their coordination, and possibly centralization, than the market-based contractual approach. Unlike the statutory approach (see below), it focuses on soft-law principles or guidelines, drawn from international public law. General Assembly resolutions on external debt and development have

repeatedly called for consideration of such enhanced approaches to SDRMs based on existing frameworks and principles, with the broad participation of creditors and debtors.³⁸ An example of such principles is to be found in UNCTAD's roadmap and guide for sovereign debt workouts (UNCTAD, 2015).

Generally speaking, a soft-law approach might define a number of principles to guide sovereign debt restructurings and address the challenges to debt sustainability. Such general principles of law usually refer to unwritten rules of behaviour or customary practices. They should be recognized in most domestic legal systems, and they should be applicable in the context of existing international law. The following are the core principles under discussion for SDRMs:

- **Sovereignty**, which establishes the right of governments to set policies and regulate their internal affairs independently, and implement them in the public interest. This is a fundamental principle underpinning any domestic legal system, and remains the basis for economic and political interactions at the international level. The conditions under which international bodies may adopt decisions affecting States or individuals is an ongoing debate.
- **Legitimacy**, which refers to the basic justification of a government's authority over its citizens (or of an international or supranational body over its members) and the procedures by which that authority is created, exercised and maintained. In the context of SDRMs, this principle is understood to refer to such requirements as comprehensiveness, inclusiveness, predictability and ownership. It broadly reflects the idea that SDRMs need to take into account and rectify the trend of States being less and less protected by sovereign immunities and more and more subject to the decisions of international organizations and other structures such as creditor committees.
- **Impartiality**, which refers to the absence of bias. As such, it fosters the acceptance of decisions by generating or reconfirming trust in actors and

Basic principles to guide sovereign debt restructuring and recover debt sustainability can be incorporated into domestic legal systems and be applied in the context of international law.

institutions. It is closely related to the principle of legitimacy. In the context of sovereign debt workouts, the principle of impartiality refers to institutions involved in debt workouts, and includes their financial situation, the choice and actions of their personnel and the information at their disposal. The fundamental idea is that sovereign debt workouts require a neutral perspective, in particular with regard to debt sustainability assessments and decisions about restructuring terms.

- **Transparency**, which has two dimensions of particular relevance for sovereign debt workouts: data transparency on debtor and creditor positions, projections underlying proposed restructurings and any indicator used in the context of debt restructurings; and institutional transparency so as to avoid the backroom nature of some past debt workout negotiations.
- **Good faith**, which encompasses basic requirements of fairness, honesty and trustworthiness, and is widely accepted as a general principle of law. Good faith implies that the legal and economic outcomes of sovereign debt workouts meet legitimate expectations. As such it has a particularly important impact on all procedural elements of a debt workout – from a standstill on payments, through a stay on litigation to restraining holdouts.
- **Sustainability**, which considers that sovereign debt is sustainable if it can be serviced without seriously impairing the social and economic development of society. In economic terms, this means that only sustained and inclusive growth creates the conditions for servicing external debt in the long run, and that conditionalities for the restructuring of sovereign debt must not undermine growth-enhancing dynamics. Sustainability constitutes an (at least emerging) general principle of law. In the course of the last few decades, the concept of sustainability has spread from environmental regulation to other policy fields, including political economy. It now characterizes large segments of domestic policy, and has received recognition in many international forums and resolutions.

Box 5.2**BELGIAN LEGISLATION RELATING TO VULTURE FUND ACTIVITIES**

In July 2015, the Belgian parliament overwhelmingly adopted a bill “to combat vulture fund activities”. At the heart of the new law is the introduction of a ceiling for the amount the so-called vulture funds can reclaim from government bonds bought at highly discounted prices in secondary bond markets from economies close to default. The law allows Belgian judges to stop vulture funds from claiming repayment above the discounted market price it paid for government bonds, for example at original face value.

It follows earlier Belgian legislation, adopted in March 2013, to prevent creditors’ seizure of funds earmarked for development (Art 36, Loi relative à la Coopération au Développement). More specifically, the new legislation targeting vulture funds provides a legal framework to prevent non-cooperative bondholders taking “illegitimate advantage”, which is defined as a manifest disproportion between the amount claimed by a creditor and the notional face value of the debt. A significant merit of this legislation is that it defines essential characteristics of vulture funds and the contexts in which their actions are not acceptable. Under the law’s provisions, once a creditor’s “illegitimate advantage” has been established, based on the above definition, a Belgian court can deny any order of payment that would give the creditor an illegitimate advantage if at least one of the following criteria is met: (i) the debt buy-back took place when the sovereign debtor was insolvent or in default, or when insolvency or default were imminent; (ii) the creditor’s legal headquarters are in a recognized tax haven; (iii) the creditor has a track record of using litigation to obtain repayment of repurchased debts; (iv) the sovereign debtor has taken part in debt restructuring that the creditor refused; (v) the creditor has taken advantage of the sovereign debtor’s debt distress to obtain a clearly unbalanced debt settlement in the creditor’s favour; and (vi) full reimbursement by the debtor has adverse socio-economic impacts and/or negatively affects the debtor economy’s public finances.

The law clearly undercuts any incentive for non-cooperative creditors, holdout bondholders and vulture funds to start litigation in Belgium, and makes Belgium a pioneer in government efforts to curtail the activities of such funds. This is particularly significant, as Belgium is home to Euroclear, one of the world’s largest clearing houses for global financial transactions. For example, under the new law, earlier demands by NML Capital, Ltd. to freeze Argentine accounts in Belgium in the context of its holdout litigation in the United States against Argentina, would no longer be allowed, since a Belgian judge can refuse to abide by legal decisions made in other jurisdictions.

The only other national initiative relating to vulture funds to have passed the test of a parliamentary vote is the United Kingdom Debt Relief Act (Developing Countries) of 2010, which prevents vulture funds from gaining massive profits from debt restructuring in developing economies. Other national legislative initiatives to this effect, and with a particular focus on developing-country debt, have been proposed in several European countries and in the United States, but so far they have not been enacted. The United Kingdom Debt Relief Act is less stringent and comprehensive than the new Belgian legislation in a number of respects: it is limited specifically to the heavily indebted poor countries. Also, it has less stringent caps on profits that can be made from debt distress in such economies by linking those caps to the “relevant proportion” of any debt relief obtained under the HIPC initiative’s formula (usually between 67 and 90 per cent). Creditors that reach a compromise agreement relating to claims for qualifying debts are exempt from this automatic debt reduction system. Overall therefore, this legislation is limited to addressing “disproportionate” profits by vulture funds rather than curbing their activities per se. By contrast, the Belgian law explicitly takes account of the wider socio-economic impacts of vulture fund activities and of their potential illegitimacy.

Proponents of such an approach based on semi-institutional, general principles have developed a range of suggestions on how to structure the institutional aspects of promoting general principles or guidelines for sovereign debt restructuring. One view is that restructuring negotiations will continue to take place in established forums or on an ad hoc basis, but will be supervised and coordinated by a new independent body, such as a sovereign debt forum (a private organization) or a debt workout institute (endorsed through a multilateral process).³⁹ A second, but complementary, view highlights the usefulness of semi-institutionalizing SDRMs at the level of adjudication or arbitration, but falls short of an approach based on a multilateral treaty. This includes mainly the promotion and use of specific rules and procedures, or applications of the general principles, across ad hoc arbitration processes.

One way of promoting the application of general or soft-law principles for SDRMs is through domestic legislation, such as the United Kingdom's Debt Relief (Developing Countries) Act of 2010, to tackle problems arising from non-cooperative bondholder litigation. Similarly, the Belgian parliament has only very recently (in July 2015) passed a law "in relation to the fight against the activities of vulture funds",⁴⁰ which is intended to curtail harmful speculation by such funds (box 5.2). This avenue of working through national legislation could be particularly effective if core principles were adopted in those jurisdictions in whose currencies most debt is currently issued. An obvious limitation is, of course, the danger of a lack of uniformity, coordination and consistency across different jurisdictions, as well as the possibility that only very few States will pursue this course.

Overall, a semi-institutionalized approach based on soft law but also rooted in international public law is clearly a further step towards a more permanent, less fragmented, more transparent and predictable framework for SDRMs. It has the advantage of building, for the most part, on existing mechanisms of negotiation and restructuring. Moreover, it could be scaled up in the future if it attracts enough parties. However, the main limitation of the contractual approach applies to this approach as well, if to a lesser degree: the principles are not binding, and there is no guarantee that a critical mass of parties will be willing to make more permanent commitments to these principles. This problem can only be solved through a full-fledged multilateral and statutory approach.

3. Statutory approaches to multilateral debt restructuring

In September 2014, the United Nations General Assembly passed Resolution 68/304 that called for the establishment of a "multilateral legal framework for sovereign debt restructuring processes". This represents a first possible step towards the final option, namely an international formal and statutory approach to establish binding regulations for all parties through a multilateral process. This is certainly the most far-reaching proposal for sovereign debt resolution, as well as the most challenging.

Advocates of multilateral debt workout procedures often draw attention to the asymmetry between strong national bankruptcy laws, as an integral part of a healthy market economy, and the absence of any counterpart to deal with sovereign debt restructuring. Given the unique role of sovereign actors with respect to economic, legal and political outcomes, any such procedures should meet two objectives. First, they should help prevent financial meltdown in countries facing difficulties servicing their external obligations. Such a meltdown often results in a loss of market confidence, currency collapse and drastic interest rate hikes that inflict serious damage on public and private balance sheets and lead to large losses in output and employment, not to mention a sharp increase in poverty. Second, they should provide mechanisms to facilitate an equitable restructuring of debt that can no longer be serviced according to the original contract. Meeting these goals implies the application of a few simple principles:

- (a) Allowing a temporary standstill, regardless of whether debt is public or private, and whether the servicing difficulties are due to solvency or liquidity problems (a distinction which is not always clear-cut). In order to avoid conflicts of interest, the standstill should be decided unilaterally by the debtor country and sanctioned by an independent panel, rather than by an institution (e.g. the IMF) which is itself also a creditor. Such a sanction should provide an automatic stay on creditor litigation.
- (b) Standstills should be accompanied by exchange controls, including the suspension of convertibility for foreign currency deposits and other assets held by both residents and non-residents.

- (c) Debtor-in-possession financing should be provided, automatically granting seniority status to debt contracted after the imposition of the standstill. The IMF should lend into arrears for financing imports and other vital current account transactions.
- (d) Enabling debt restructuring, including rollovers and write-offs, based on negotiations between the debtor and creditors, and facilitated by the introduction of automatic rollover and CACs in debt contracts.

There are currently two main sets of proposals for a formal statutory approach that could achieve these objectives. The first of these foresees the development, in some form or other, of a sovereign debt restructuring facility under the auspices of the IMF. This would require an amendment to the IMF's Articles of Agreement. A second set of suggestions emphasizes the need for a more permanent and impartial international institution, not itself involved in sovereign lending, and favours the establishment of an independent tribunal, whether housed in existing courts (such as the Permanent Court of Arbitration or the International Court of Justice) or newly established in its own right. In either case, any fixed institutional base would need to be established through a multilateral treaty (or the relevant modification of an existing treaty).

The essential feature shared by all proposals for a statutory approach to sovereign debt restructuring is, however, that legal decision-making in debt restructuring cases would be governed by a body of international law agreed in advance as part of the international debt workout mechanism. Also, the core purpose of any sovereign debt restructuring facility or tribunal would be to provide transparent, predictable, fair and effective debt resolution, with its decisions binding on all parties as well as universally enforceable, regardless of jurisdiction.

Clearly, establishing such a statutory solution for debt restructuring would be extremely challenging, as well as a rather lengthy process, from treaty

negotiation to eventual ratification. To be effective, a statutory approach would need a critical number of signatories to its underlying multilateral treaty. In particular, it would need to take on board those economies under whose jurisdiction most external debt is currently issued. This is bound to be difficult, and there are also likely to be legitimate concerns about the nature of the powers to be vested in such an international tribunal or IMF facility, and how the powerful institutional interests that may already exist or may develop within such an entity will be governed.

The main and very important advantage of such a multilateral statutory approach is that, if successfully established, it would promote a set of regulations and practices that embody long-term objectives

and principles – such as sustainable development, equity and fairness of outcomes, and transparency of process – over and above particular interests. Given the deep-seated problems of lack of accountability, partiality and an absence of legitimacy that characterize many existing debt restructuring mechanisms, as well as their fragmentation, the mere provision of a stable and clear institutional framework for sovereign debt restructuring could help render debt resolution more effective

and outcomes to become more predictable through the promotion of consistency in judging cases. In addition to the obvious macroeconomic benefits from early diagnoses of sovereign debt problems and the implementation of swift action towards their resolution, the importance of a high degree of legitimacy of a well-functioning SDRM with global reach – and which has been established with the active participation of all member States and other relevant stakeholders – cannot be emphasized enough.

It goes without saying that the approaches surveyed here need not be mutually exclusive. It is perfectly possible to pursue improvements in existing contractual approaches, while also promoting national legal projects and soft-law principles for sovereign debt resolution, and simultaneously pushing for longer term plans for a more permanent, legally binding and institutional solution.

A multilateral legal framework for debt restructuring should allow temporary standstill, stay of litigation, exchange controls and lending into arrears to prevent a financial meltdown in countries facing a debt overhang, and allow them to reach a debt restructuring agreement that helps restore growth and debt sustainability.

F. Conclusions

Recurrent external debt crises are likely to remain a major challenge to global financial governance. As shown above, a major driver of this growing indebtedness is the push factor of fast-rising financial capital inflows in the context of rapid and excessive global expansion of liquidity. Moreover, the concomitant growth of often complex and opaque financial and debt instruments, along with substantial changes in the structure and composition of developing-country external debt, have rendered their debt highly vulnerable to the vagaries of private financial markets, in particular, and in the present global economy, more generally. Even for the larger and more advanced developing economies, it is not clear to what extent they are prepared to face the manifold challenges stemming from a much higher market risk exposure of their external debts, a fragmented and ad hoc system of debt restructuring mechanisms and an overall economic and institutional environment that

introduces a recessionary bias to macroeconomic adjustment processes.

Therefore, the persistent vulnerabilities and challenges posed by international financial markets make it all the more important to ensure that the debate about enhanced debt restructuring mechanisms is taken seriously. The different approaches to this issue reflect wide variations in the understanding of an economy's functioning and needs, as discussed in this chapter, which may not be easily reconcilable. Consequently, it might be prudent to adopt a gradual approach to change in this area, proceeding from the more minimalist to more far-reaching proposals. What seems clear is that, despite obvious difficulties in political consensus-building, a comprehensive, predictable, equitable and consistent framework for effective and efficient sovereign debt restructuring is indispensable and will be to the long-term benefit of sovereign debtors as well as the great majority of their creditors. ■

Notes

- 1 Though other estimates vary, according to Furceri and Zdienicka (2011) of the IMF, such crises can reduce output growth by 5 to 10 percentage points. Moreover, the authors found that after 8 years output remains by some 10 per cent below the country pre-crisis trend.
- 2 See, for example, *TDR 1986*, annex to chap. VI; *TDR 1998*, chap. IV; *TDR 2008*, chap. VI; Radelet, 1999; IMF, 2001.
- 3 In this document, "public debt" includes publicly guaranteed private debt, and "private debt" only refers to non-publicly-guaranteed private debt, following the classifications in the World Bank's International Debt Statistics.
- 4 The cases of Spain and the United States provide a good illustration of this phenomenon. In 2007, the external debt held by the private sector (excluding debt related to deposit-taking corporations and direct

- investment) represented 50 per cent of GNI in Spain and 48 per cent in the United States. After a sharp deleveraging process, it fell to 31 per cent in Spain and to 34 per cent in the United States. Meanwhile, general government external debt increased from 20 to 42 per cent in Spain and from 18 to 34 per cent in the United States.
- 5 Source: World Bank, *Quarterly External Debt Statistics – Special Data Dissemination Standard (QEDS–SDDS)* database.
- 6 Source: World Bank, QEDS–SDDS database.
- 7 Source: UNCTAD secretariat calculations, based on Thomson Reuters' *EIKON* debt structure analysing tool.
- 8 This subsection partly draws from Bohoslavsky and Goldmann, 2015.
- 9 The most noteworthy was the invasion of Mexico by France after the government of Benito Juárez suspended interest payments on its external debt in 1861. Another was the blockade of Venezuelan ports by the fleets of Germany, Italy and the United Kingdom in 1902–1903 to force the Venezuelan Government to pay its foreign debt to their nationals. This prompted the Drago-Porter Convention of 1907, which established the universal principle that States may not use force in order to collect claims arising from the sovereign debt of a State held by their nationals (Benedek, 2007).
- 10 The United Kingdom also suspended the convertibility of the pound; this forced its foreign creditors to use the resources obtained from United Kingdom debt repayments in purchases of goods or assets within the pound area.
- 11 See also the decision, *Republic of Argentina v. Weltover, Inc.*, 1992, under which issuing bonds was considered a “commercial activity”.
- 12 In all these schemes, creditors could choose between a “debt reduction option”, which applied the appropriate debt cancellation rates and rescheduled the remaining debt, including ODA credits, or other options that reduced the debt burden by extending the repayment period and reducing interest rates.
- 13 For instance, the Paris Club obliged Pakistan and Ukraine to obtain a level of debt relief from private creditors equivalent to the Club’s concessions.
- 14 Conditionality (especially that involving structural reforms) by the IMF and World Bank has, in fact, followed some additional goals, such as redefining national development choices according to creditors’ views and interests (Akyüz, 2005). Some IMF reports have acknowledged that there are “legitimate concerns that in many instances structural conditionality may have gone beyond what can be justified in relation to the intended purpose of conditionality in safeguarding Fund resources” (IMF, 2001: 27). Moreover, a report by the Independent Evaluation Office of the IMF stresses that “the crisis should not be used as an opportunity to seek a long agenda of reforms with detailed timetables just because leverage is high, even though such reforms may be beneficial to long-run economic efficiency” (IMF, 2003a: 50).
- 15 Success in associating commercial creditors has been limited, and some of them have initiated litigation against HIPC countries to obtain full debt repayment.
- 16 In the Greek debt restructuring of 2012, for instance, commercial banks holding Greek bonds were represented by the Institute of International Finance, whose members include banks, insurance companies, asset managers, sovereign wealth funds, pension funds, central banks and development banks.
- 17 In 1997, the IMF launched the Supplemental Reserves Facility to help countries cope with “large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member’s reserves” (IMF, 1997). Subsequently, countries meeting pre-established eligibility criteria could have rapid access to short-term precautionary credit lines. The Contingent Credit Line was made available in 1999, followed by the Reserve Augmentation Line in 2006 and the Short-term Liquidity Facility (SLF) in 2008, immediately after the collapse of Lehman Brothers. As potential users did not apply to this precautionary financing, the IMF had to propose new credit lines to finally receive a number of requests: the Flexible Credit Line (FCL) in 2009 and the Precautionary Credit Line (PCL) in 2010 – with larger access, longer repayment periods and more flexibility, and without ex-post conditionality.
- 18 Colombia, Mexico and Poland applied for the IMF’s FCL, and the former Yugoslav Republic of Macedonia and Morocco for the IMF’s PCL.
- 19 The new legislation did not totally override the Chamberry principle, but added a “safe harbour” provision for litigation claims where the aggregate purchase price was at least \$500,000.
- 20 See African Development Bank website at: <http://www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-legal-support-facility/vulture-funds-in-the-sovereign-debt-context> (accessed on 10 August 2015).
- 21 *GMO Trust v. The Republic of Ecuador*, (1:14-cv-09844), United States District Court for the Southern District Court of New York (settled in April 2015).
- 22 See, for example, European Court of Justice, *Fahnenbrock et al. v. Greece*, C-226/13 et al., judgment pending; *Poštová banka, a.s. and Istrokapital SE v. Hellenic Republic*, ICSID Case No. ARB/13/8.
- 23 See the report on vulture funds and human rights of the UN Independent Expert on Foreign Debt and Human Rights, A/HRC/14/21, 2010, available at: http://www2.ohchr.org/english/bodies/hrcouncil/docs/14session/A.HRC.14.21_AEV.pdf.

- 24 Affected countries are: Angola, Burkina Faso, Cameroon, the Congo, Côte d'Ivoire, the Democratic Republic of the Congo, Ethiopia, Honduras, Liberia, Madagascar, Mozambique, Niger, Sao Tome and Principe, Sierra Leone, Sudan, the United Republic of Tanzania, Uganda and Zambia.
- 25 *Donegal International Ltd. v. Zambia*, High Court of Justice (England and Wales), [2007] EWHC 197 (Comm.).
- 26 United Kingdom Debt Relief (Developing Countries) Act 2010.
- 27 See *Allied Bank International v. Banco Credito Agricola de Cartago*, United States Court of Appeals, 2d Cir., March 18, 1985 (757 F.2d 516); *Pravin Banker Associates v. Banco Popular del Peru*, 109 F. 3d 850, 854 (2d Cir. 1997); *Elliot Associates v. Banco de la Nación and the Republic of Peru*, 12 F.Supp. 2d 328 (S.D.N.Y. 1998).
- 28 See, for example, Federal Constitutional Court (Germany), cases 2 BvM 1-5/03, 1, 2/06, decision of 8 May 2007, BVerfGE 118, 124. For ICSID cases, see Waibel, 2007a.
- 29 Supreme Court of New York, *Crédit français, S.A. v. Sociedad financiera de comercio, C.A.*, 128 Misc.2d 564 (1985); *EM Ltd. v. Argentina*, Summary Order, 05-1525-cv, 13 May 2005 (obiter dictum lacking precedential value).
- 30 See, for example, the case concerning judicial immunity for Argentina in Italian courts (Corte Suprema di Cassazione, Sezioni Unite Civile, 21 April 2005), and the holdout litigation cases before Argentine courts (Juzgado Nacional en lo Contencioso Administrativo Federal N° 1, 12 October 2006).
- 31 Federal Constitutional Court, Case 2 BvM 1/03 et al., decision of 8 May 2007.
- 32 NML Capital Limited (Appellant) v. Republic of Argentina (Respondent) [2011] UKSC 31.
- 33 *Abaclat v. Argentine Republic*, ICSID Case ARB/07/5, Decision on Jurisdiction and Admissibility, 14 August 2011; see also Gallagher 2011; and Waibel, 2007b. On the question as to whether sovereign debt can be regarded as direct investment, see *Fedax v. Venezuela*, ICSID Case ARB/96/3; *Československa obchodní banka v. Slovak Republic*, ICSID Case ARB/97/4; however, see also the restrictive view of the tribunal in *Poštová banka, a.s. and Istrokapital SE v. Hellenic Republic*, ICSID Case No. ARB/13/8.
- 34 Cf. ITLOS Case No. 20, *ARA Libertad (Argentina v. Ghana)*, Order of 15 December 2012. The ITLOS ordered the release of an Argentine vessel sequestered by the Ghanaian authorities.
- 35 *Elliott Associates*, Brussels Court of Appeals, 8th Chamber, General Docket 2000/QR/92, 26 September 2000.
- 36 *NML Capital, Ltd. v. Republic of Argentina*, No. 08 Civ. 6978 (TPG), United States District Court for the Southern District of New York, Order of 23 February 2012: "Whenever the Republic pays any amount due under [...] the [Exchange Bonds]... the Republic shall concurrently or in advance make a 'Ratable Payment' to Plaintiffs. [...] Such 'Ratable Payment' shall be an amount equal to the 'Payment Percentage' multiplied by the total amount currently due to [Plaintiffs]. Such 'Payment Percentage' shall be the fraction calculated by dividing the amount actually paid or which the Republic intends to pay under the terms of the Exchange Bonds by the total amount then due under the terms of such Exchange Bonds."
- 37 This section partly draws on Lienau O, Institutional Options for Debt Restructuring, Background Paper for the UNGA Ad Hoc Committee on Sovereign Debt Restructuring, Revised draft 21 April 2015.
- 38 See General Assembly resolutions 64/191, 65/144, 66/189, 67/198, 68/202 68/304.
- 39 For the latter proposals, see UNCTAD, 2015.
- 40 See: www.dekamer.be/kvvcr/showpage.cfm?section=/flwb&language=fr&cfm=/site/wwwcfm/flwb/flwbn.cfm?legislist=legisnr&dossierID=1057.

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LONG-TERM INTERNATIONAL FINANCE FOR DEVELOPMENT: CHALLENGES AND POSSIBILITIES

A. Introduction

A concern that has emerged repeatedly in the previous chapters is the apparent inability of the current global monetary and financial systems to make available long-term finance for growth and development. This chapter considers some of the possible strategies for ensuring the provision of such finance. The focus is on the financing of productive capital formation, including for infrastructure, which helps, directly and indirectly, to accelerate growth and structural change. This effectively requires challenging the rationale underlying private financial flows that are driven by short-term profits and rents, and strengthening mechanisms for mobilizing and allocating both domestic and external finance for value creation and development over a longer time horizon. While domestic resources (both private and public) are likely to remain the most important (*TDRs 2008 and 2013*), international finance can play an important role when domestic funding is not available or is insufficient, particularly when a country is in need of foreign exchange to import capital goods and production inputs beyond what it earns through its exports of goods and services.

It is well known that private financial markets cannot be relied upon to fully fund long-term investment projects. This is because associated investments typically involve longer gestation periods and entail greater risk and uncertainty about eventual outcomes,

even while they create significant positive externalities for the rest of the economy and complementary investment projects. These factors generate differences between private profitability and social returns on such investment. It is also recognized that private financial markets, left to themselves, seldom direct finance to such classes of borrowers as small and medium-sized enterprises (SMEs) or start-ups, or to activities whose returns are not immediately evident and cannot be readily calculated. This negatively affects activities that could be crucial for future growth and which could produce considerable social benefits, such as innovation, technological progress and environmental protection. These features are equally characteristic of global financial markets. Thus, greater financial integration of developing countries has not delivered on expectations of easier access to the kind of long-term financing needed to boost growth and development. Consequently, there appears to be a need for State action to ensure the provision of both external and domestic long-term finance for these purposes.

The nature of such State involvement can vary according to the types of activities that are to be funded. Financing for purely public goods necessarily requires appropriate public domestic revenues, and in the context of external financing this is most likely to be supported by official development assistance

(ODA) or other forms of development cooperation. In the case of merit goods and services, as well as other activities with large positive externalities, a mix of public and private arrangements is conceivable, typically involving some degree of explicit or implicit government subsidies, which in turn would require either internal or external resources, usually channelled through the public coffers. Recent initiatives based on public-private partnerships (PPPs) are one possible response. Finally, there are some activities that generate changes in productive structures and are potentially profitable (such as some kinds of infrastructure investment), which are nevertheless avoided by private investors because of uncertainties associated with lumpy investment requirements with large initial costs, long gestation periods and associated risks. These call for a greater role by financial institutions that are specifically geared to making such long-term investments, such as development banks.

In this chapter, each of these types of external financing for long-term development is considered in turn. In section B, it is argued that, while official financing has increased in the past decade, it is still

well below desired levels, and there remain some concerns about its effectiveness and conditionalities sometimes incorporated in ODA. As a result, some developing countries seeking long-term external finance for development purposes have resorted to other arrangements, most notably through a greater emphasis on programmes and projects that involve PPPs, as examined in section C. However, while these provide opportunities to involve private firms

in infrastructure investment, there are also risks associated with them, particularly in terms of fiscal costs, which can be much greater than anticipated and may extend over a very long time horizon. Section D examines the role of sovereign wealth funds. Some of them control significant amounts of capital, and could conceivably play an important role in providing

some long-term development finance; but, thus far, their involvement in this area has been extremely limited. Section E analyses the use of national, regional and interregional development banks, which remain an effective option for mobilizing long-term finance. Recent new initiatives in this area are encouraging, but will need to be scaled up substantially to meet current and future development goals.

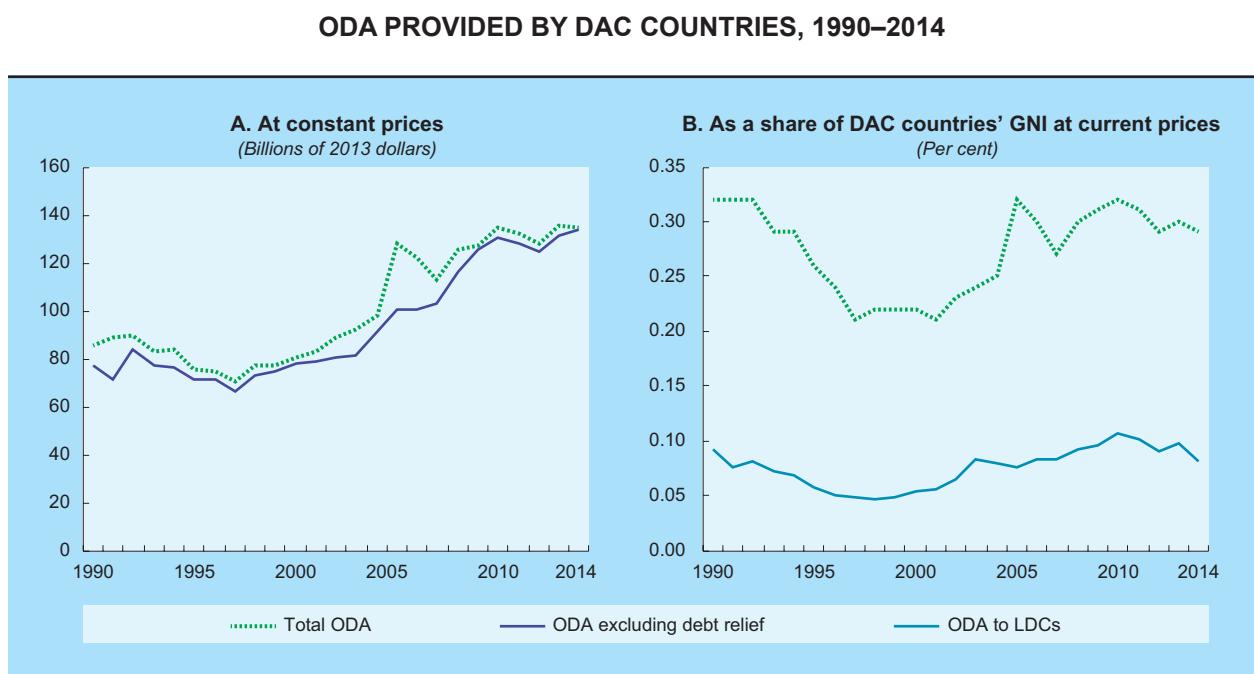
Financing productive capital formation requires challenging the rationale underlying private financial flows that are driven by short-term profits and rents.

B. Financing through official cooperation

Official development financing refers to expenditures directed at strengthening productive capacities, promoting structural change and enhancing social well-being in recipient countries. It does not include humanitarian or military aid of various types. It involves the provision of either grants or loans, which can be delivered bilaterally or channelled through multilateral agencies and non-governmental organizations (NGOs). Grants do not require repayment, whereas loans are extended with some element of subsidy but must be repaid, and

therefore imply a return to the donor in some form. This distinction is important to note, because different forms of development-related expenditures have different effects on countries' debt-servicing capacities, and therefore the use of loans that are part of development assistance should generate the income needed to repay the debt.

Official financing has traditionally been seen as a flow from developed countries to the developing ones, particularly the poorest countries. However,

Chart 6.1

Source: UNCTAD secretariat calculations, based on *OECD.stat* database.

recent trends indicate the growing importance of emerging developing countries as donors, although they provide different forms of development cooperation and assistance than the more traditional donors.

1. Official development assistance from developed countries

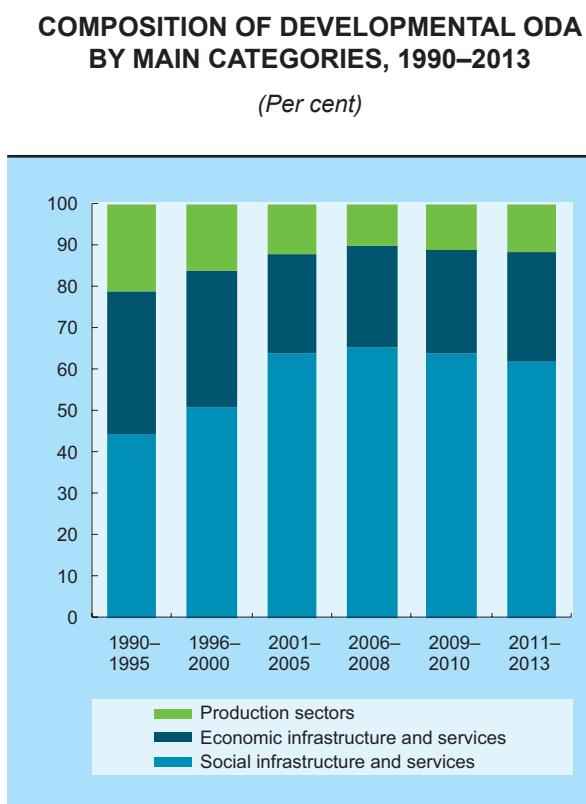
What is currently known as official development assistance is a subset of external official aid provided by developed to developing countries. The need for establishing a stable flow of ODA was already debated in the 1950s and 1960s. Negotiations within the United Nations system eventually led to developed countries committing to an annual transfer of at least 0.7 per cent of their gross national income (GNI) as foreign aid to developing countries.¹

Following a period of decline and stagnation in the 1990s, registered ODA flows to developing countries increased significantly in the 2000s (chart 6.1A). Net disbursements by members of the Development Assistance Committee (DAC) of the Organisation for

Economic Co-operation and Development (OECD) rose from \$89 billion in 2002 to \$134 billion in 2014 (in constant 2013 dollar terms) – a 51 per cent increase, though an amount slightly below the record levels in 2010 and 2013. However, this still represents only 0.29 per cent of their GNI, which is far short of their committed target of 0.7 per cent of GNI and is lower than the shares in the early 1990s.² Moreover, this percentage has been on a declining trend since 2010, both for total ODA and for ODA to the least developed countries (LDCs) (chart 6.1B). Around one third of ODA has been directed towards LDCs, where, on average, it accounts for over 70 per cent of external financing (United Nations, 2014a). In constant dollar terms, it more than doubled between 2000 and 2010, but it has been falling in recent years. Indeed, bilateral aid to LDCs declined by 16 per cent in 2014 (OECD, 2015). Moreover, spending plans by major donors suggest that there is unlikely to be a significant growth of ODA flows in the medium term (OECD, 2014a).

A growing proportion of OECD-DAC assistance has been directed to the social sector – partly as a consequence of the efforts towards achieving the Millennium Development Goals. ODA to this

Chart 6.2



Source: UNCTAD secretariat calculations, based on *OECD.stat* database.

sector increased by 117 per cent (in constant dollars) between 2000 and 2008. A similar increase was recorded for ODA to economic infrastructure and the services sector, while aid to the production sector registered a smaller increase of 78 per cent. Viewed from another perspective, the share of ODA oriented to the social sector in total developmental aid³ increased from less than 50 per cent in the 1990s to over 60 per cent in 2008, and has remained relatively stable since then. Conversely, the share of ODA flows to economic infrastructure and the services sector, as well as to the production sectors, declined (chart 6.2).

The effectiveness of ODA⁴ in supporting development varies considerably depending on its modalities, whether it consists of grants or loans, whether it is delivered bilaterally or through multilateral agencies and whether it takes the form of budget support (not earmarked for any specific purpose) or project financing. Donor countries generally prefer project financing through bilateral procedures because they can better control the use of the funds,

including by tying their delivery to the procurement of goods and services produced by the companies of the donor country. It has been estimated that tied aid raises the cost of goods and services, and reduces the potential for local development.⁵ Multilateral aid and budget support are in general better options for recipients because they reduce the possibility of donor preferences exerting distorting influences, and therefore increase the ownership of aid by the recipient country. They may also help to improve predictability, coherence, transparency and accountability of aid (UNCTAD, 2006). Multilateral aid represented 39 per cent of total ODA in 2011–2012 (OECD, 2014b). Also, aid provided on a multi-year basis is more predictable for the recipient; when it is unpredictable and volatile, the value of aid can fall by as much as 15–20 per cent.⁶

Besides the modality of ODA, the nature of some of its components also influences its effectiveness. Indeed, some of the flows included in the OECD-DAC definition provide only limited development aid. For instance, for many years some credit delivered at market interest rates could be registered as ODA even though it did not really reflect a donor effort, just because the reference interest rate of 10 per cent was excessively high. Other components of ODA do not imply a transfer of resources to developing countries, such as in-donor expenditures, including technical assistance, administrative costs, costs of educating foreign students and costs of hosting refugees (Charnoz and Severino, 2015). Moreover, debt relief is included as a significant element of ODA, even in cases where it has little or no impact in terms of net financial flows (see chart 6.1A). Some loans might even be counted twice as ODA: when they are delivered, and again when they are cancelled. According to ActionAid (2005), in 2003 only 39 per cent of ODA was “real aid”.⁷

OECD-DAC has responded to this criticism by distinguishing between total ODA and country programmable aid (CPA), also known as core aid. CPA excludes from bilateral ODA those activities that are inherently unpredictable (such as humanitarian aid and debt relief), that do not involve cross-border flows, and that are not part of agreements between governments (OECD, 2014a). It is estimated that between 2009 and 2013 CPA accounted for 57 per cent of gross bilateral ODA. However, total ODA remained the target in DAC countries’ commitments. Furthermore, in December 2014 the OECD-DAC

High-Level Meeting decided to revise the definition and measurement of ODA in order to “modernize” it (OECD, 2014c). The main change relates to the way in which concessional loans are reported as ODA.

Since the turn of the millennium, the international community has progressively focused on improving the way aid is delivered. This indicates a growing recognition that it is not only the volume of ODA that matters; the quality of ODA is also critical for maximizing its development impact.⁸ This has led to the development of a number of principles for improving aid effectiveness, including ownership of national development strategies, alignment of donors to those strategies, harmonization among donors, a focus on results, mutual accountability and transparency. It has also resulted in periodic assessments of the evolution of ODA. An assessment of development effectiveness made in 2010 indicated that there had been very slow progress in meeting most of the targets set in the Paris Declaration (UNCTAD, 2011a). The Busan Partnership agreement in 2011 resulted in the establishment of the Global Partnership for Effective Development Co-operation, which held its first High-Level Meeting in Mexico in 2014. The assessment of progress on aid effectiveness prepared for this meeting showed that the results were mixed (OECD and UNDP, 2014).

2. Development cooperation among developing countries

A potentially important new trend in global development assistance is the growing significance of developing-country donors. According to the United Nations (2014b), in 2011 the total value of South-South cooperation was estimated at between \$16.1 billion and \$19 billion, and its share in total development cooperation was 10 per cent in 2011, up from 6.7 per cent in 2006. However, this may well be an underestimate, especially as definitions of development assistance vary, and there are no systematic and comparable data across countries. For many developing countries, development cooperation is closely linked to trade

and investment relationships, and it is often hard to distinguish between public and private components (Zhou, 2010).

One study has suggested that South-South financial assistance represented around 15 per cent of DAC real aid in 2008, with the largest developing-country donors that year being Saudi Arabia, China, the Bolivarian Republic of Venezuela, the Republic of Korea, Turkey and India, though in other years Brazil has also been a significant donor (The Reality of Aid Management Committee, 2010). Since then, the amount of financial assistance has grown substantially, led by China. It should be noted that not all of this financial assistance would qualify as ODA in the sense used by DAC members. Financial assistance from non-DAC countries has taken the form of grants, concessional loans, non-concessional loans and debt relief. The mix of financial assistance varies from country to country, but loans are the predominant form.

Official Chinese sources explicitly distinguish between three categories of financial assistance: grants, interest-free loans and concessional loans. The first two are funded directly by the government exchequer, while the third is funded by the Exim Bank of China (see section E). A large proportion is tied aid, which requires that at least half the purchases made under the assistance programmes be for Chinese goods, and, in several cases, for Chinese labour as well. Nevertheless, since a substantial proportion of such Chinese assistance is directed towards infrastructure development, it can contribute significantly to transforming productive capacities over the medium and long term. Wolf et al. (2013) estimate that, during the period 2001–2011, Latin America received the largest amount of such

Chinese assistance (much of it for a multi-country programme oriented to natural resources), followed by Africa (a mix of natural resource and infrastructure programmes), South Asia (infrastructure and financial aid for budgetary support) and South-East Asia (mostly infrastructure).

Indian financial assistance takes the form of credit, concessional loans and grants. It has been used to finance infrastructure development (e.g. railway

A potentially important new trend in global development assistance is the growing significance of developing-country donors.

reconstruction in Angola), the purchase of agricultural machinery and equipment, development of information and communications technologies (ICTs), the setting up of processing companies (cashew nuts in the United Republic of Tanzania) and for health and humanitarian purposes. Most of it is provided by the India Export-Import Bank. The Republic of Korea and Saudi Arabia provide grants and concessional loans. Assistance by the former supports health, ICT, education and agriculture. Through the Petroamérica Project launched in 2005, the Bolivarian Republic of Venezuela has been providing oil under very favourable financial conditions to Latin American and Caribbean countries (*TDR* 2007). A number of West Asian countries provide assistance to productive sectors (e.g. transportation, telecommunications, energy and agriculture). Most of their funding comes from their finance ministries and a small portion from the Saudi Fund for Development, in addition to assistance provided through multilateral channels. Turkey's assistance takes the form of grants, export credits and loans to support the education and health sectors, and the development of water resources, infrastructure, agriculture and culture (Kragelund, 2008).

Brazil can be singled out as the country in which co-financing is the most prevalent form of assistance, delivered trilaterally with the involvement of its own government agency, a host government agency and a developed-country donor (Kragelund, 2008; UNCTAD, 2010); it has targeted in particular the agriculture, education, health and fisheries sectors, as well as reconstruction (Gottschalk et al., 2011). Also, its national development bank has provided an increasing number of loans, particularly for large infrastructure projects in Africa and Latin America.

3. Challenges of official cooperation

Proponents of increased aid agree that, while it is not a panacea or engine of growth, it can work as a catalyst for development, for example by supporting infrastructure development. Sceptics of aid, on the other hand, point to various downside risks, such as limited absorptive capacities of some recipient countries, Dutch-disease effects, crowding out of other sources of finance, reduction of fiscal efforts and corruption. However, some of these concerns

are often exaggerated (UNCTAD, 2006), and others can be resolved by proper aid management and macroeconomic policies, as well as through appropriate procedures for accountability and monitoring. The conditionalities associated with aid are clearly important in this respect, and can have either positive or negative effects depending upon their terms and how they are implemented.

Since the Monterrey Consensus of 2002, which emphasized the need for increasing ODA as a precondition for achieving the Millennium Development Goals, there have been some improvements in the management of aid flows. These include efforts to untie aid, reporting of ODA in national budgets of recipient countries and the use of country administrative systems in the management of aid-funded programmes and projects (United Nations, 2014b). For instance, in 2012, 79 per cent of DAC bilateral ODA was reported as untied, up from about 50 per cent at the start of the millennium (OECD and UNDP, 2014).⁹ However, “conditions attached to ODA remain too numerous and detailed in some cases, (and) procedures remain complex and insufficiently flexible”. Moreover, fragmentation of aid remains high, and is increasing, with emerging donors and actors, which poses significant coordination challenges (United Nations, 2014b: 8). Most of all, despite recent increases, this type of long-term development financing still remains well below both commitments and requirements.

An important area of official financing that has remained relatively neglected relates to the financing of programmes for global public goods. This is particularly evident in the areas of climate change mitigation and adaptation. Major global agreements on climate change have stressed the need for climate finance to be “new and additional”. Under the Copenhagen Accord, developed countries collectively committed to provide “fast start” finance of about \$30 billion for the period 2010–2012, with a balanced allocation between adaptation and mitigation. They also committed to the goal of jointly mobilizing \$100 billion a year by 2020 to address the needs of developing countries (UNFCCC, 2009). An assessment of fast-start finance between 2010 and 2012 found that \$35 million was mobilized in this period. However, 80 per cent of these resources were estimated to have also been counted as ODA (Nakhooda et al., 2013). Pledges made by donors to mobilize \$10.2 billion (UNFCCC, 2014) represent an

important step to operationalizing the United Nations Green Climate Fund, although they only amount to about 10 per cent of the committed target for 2020.

Since there appears to be no proper definition of what “new and additional” means, nor any internationally agreed definition of climate finance and how it is to be delivered, “much climate finance is currently sourced from existing aid commitments and flows through a decentralized system dominated by a large number of bilateral aid agencies and a series of multi-lateral funds” (Pickering et al., 2015:149). Therefore much of the climate finance has not been additional, and has also made the aid fragmentation problem more complex. Further, the aid provided thus far has been mainly directed to mitigation efforts, which disproportionately benefit middle-income developing countries. Financing for adaptation purposes, which is crucial for the poorest countries, remains inadequate (UN-DESA, 2015; Nakhooda et al., 2013). This makes a strong case for a greater focus on official financing by the richer countries – and other countries in a position to do so – for climate change mitigation and adaptation in the poorer countries.

In recognition of the relatively small amount of official financing that is currently available, there are ongoing discussions on the potential use of “blended finance”, in which ODA would be used to “leverage” private capital for long-term investment. For example, ODA could provide subsidies on loans and equity investments, or guarantees to private investors or for co-financing arrangements. This approach of using aid as a lever to attract private finance is already part of the external assistance programmes of several developing countries, including China, as noted above. It is also now being encouraged by other donors, and is strongly promoted by international organizations such as the World Bank and the OECD.¹⁰

In a sense, since development-oriented investment necessarily generates externalities and complementarities between the public and private sectors, and effective investment finance mixes public

and private initiatives, all development finance is blended; the greater issue is to address who is doing the blending, how and to what end. Such initiatives may have advantages in terms of increasing resource mobilization,¹¹ but also have some drawbacks, as highlighted in recent research.¹² In particular,

they risk allowing ODA flows to reinforce the inequalities that private markets generate in terms of geographical, sectoral and institutional coverage. Aid that is linked to expanding investment by the private sector is more likely to go to middle-income countries and bypass

the low-income countries. Furthermore, there is typically inadequate support for SMEs in developing countries. Many attempts to utilize ODA to support private investment do not adequately capture the diversity in the private sector; for example, they do not always take into account the difference between development-oriented spending to support small farmers with input purchases and investments in developing countries by transnational corporations (TNCs) that are simply seeking better returns. In addition, where the benefits accrue to TNCs from the donor countries, bypassing developing-country firms, there is the risk that, increasingly, aid will be tied to the delivery of goods and services of donor countries’ companies.

In view of these drawbacks, the international community should consider further exploring the functioning of these mechanisms and their potential development impact before making policy recommendations in this regard. There should be an ex ante evaluation to ensure that the additional investment funds will support companies that would not otherwise invest for the stated purposes and activities, and to ascertain that those companies do not have access to any other funds. The impacts

The opportunity cost of using ODA to leverage private finance may be too high.

on poverty reduction and development should be clearly demonstrable. Moreover, the opportunity cost of using ODA to attract private finance may be too high. Instead, it might be preferable to direct the ODA flows towards building the productive private sector of developing countries by supporting their domestic SMEs and smallholder farmers. It is also important to prevent such aid from becoming a mechanism

for transferring risks from the private to the public sector, with the latter paying in case of failure of a project but with potential profits mainly reverting

to the private sector. Finally, the funds leveraged in this manner should be based on the same principles of effectiveness as relate to ODA in general.

C. Public-private partnerships for development

A PPP is a contract between a government and a private company under which the private company finances, builds and operates some element of a service which was traditionally considered a government domain.¹³ In some forms of PPP, the private company even “owns” the underlying assets needed to provide the service for a period of time. The company is paid over a number of years, either through charges paid directly by users, or by payments from the public authority, or a combination of both. Since the private partner is not necessarily a foreign investor, and does not necessarily obtain financing from external sources, PPPs themselves do not only represent a vehicle for international financing. Indeed, as illustrated below, several large countries frequently have sizeable domestic firms that are able to implement large-scale investment in infrastructure and operate the PPPs.

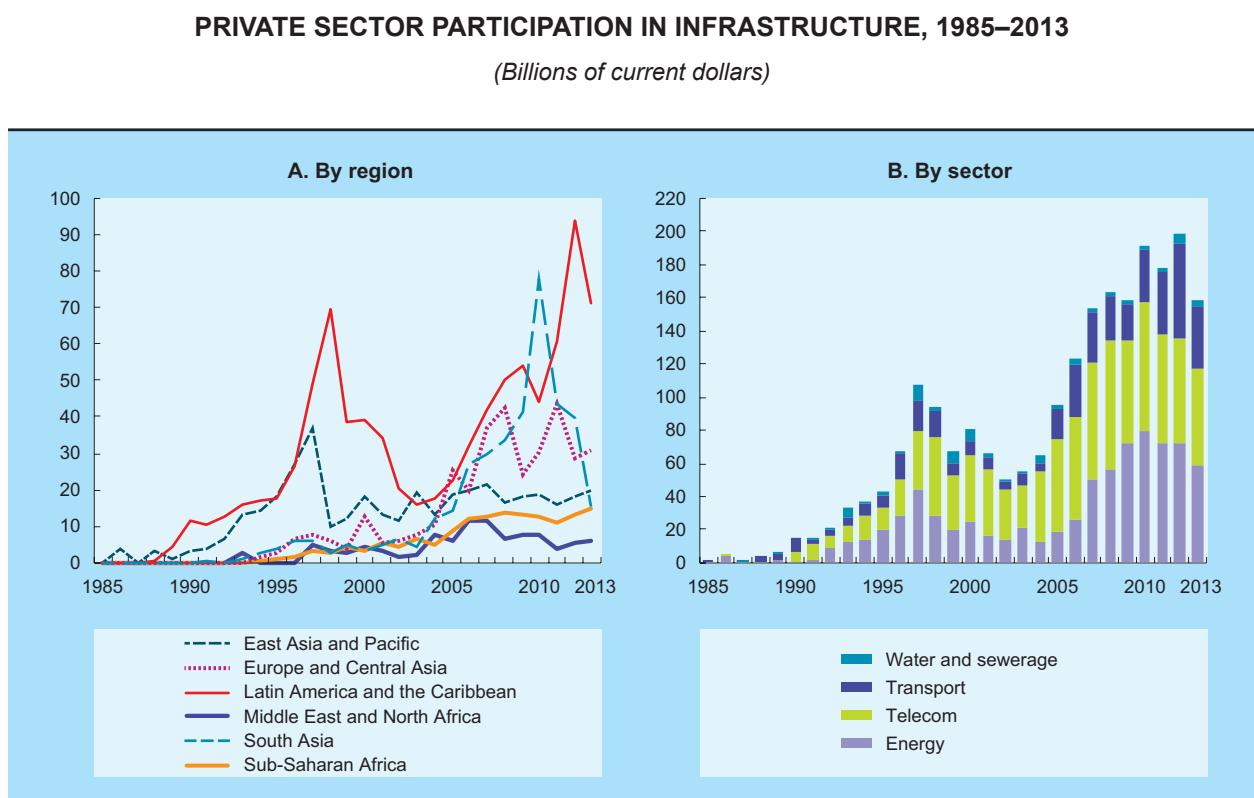
PPPs have been used widely in developed and developing countries over the past 20 years, and are currently seeing a revival of interest in the context of negotiations on finance for development and the Sustainable Development Goals. There are hopes that “harnessing” the private sector in this way can help multiply millions of dollars into billions, and billions into trillions.

PPPs may appear to be effective in terms of generating and implementing infrastructure projects when public budgets are constrained, and there are certainly some success stories in this regard. If properly managed, they can also improve the efficiency of the public service through the technical expertise provided by the private sector (ECLAC, 2015). However, there is also evidence of many pitfalls

and unexpected fiscal and other costs, and rarely, if ever, is their performance properly compared to other available mechanisms such as traditional public procurement and delivery systems. The evidence across decades and countries suggests that public sector finance will still have to do the heavy lifting. A cautious approach is needed if PPPs are to deliver the expected development benefits and to avoid, or minimize, the potential costs such partnerships can generate (IEG, 2014).

1. Scale, scope and use of PPPs

In 2013, PPP funding for infrastructure projects in developing countries amounted to about \$159 billion, having recovered after the economic and financial crisis in 2008–2009 but falling sharply from a peak in 2012.¹⁴ Even with the recent downturn, the use of PPPs has increased markedly since their introduction in the 1980s (chart 6.3A), recovering from setbacks following the Latin American and Asian crises, as well as Enron and other corporate scandals which affected even those countries that had previously been successful in attracting capital (World Bank, 2009). Their use in developed countries has also shown a broad overall increase, and again reflects sensitivity to external shocks and the broader economic cycle. However, in Europe, the value of PPPs was around 13 billion euros in 2012, the lowest in at least 10 years. These recent trends point to the challenges that lie ahead. Never has the cost of debt been lower and yet it is increasingly difficult to finance new infrastructure investment, especially

Chart 6.3

Source: UNCTAD secretariat calculations, based on World Bank, *Private Participation in Infrastructure Project Database* (as on July 2015).

Note: Country groups in chart A are those of the source. Investments refer to the year of implementation.

when equity commitment is a requirement (Helm, 2010).

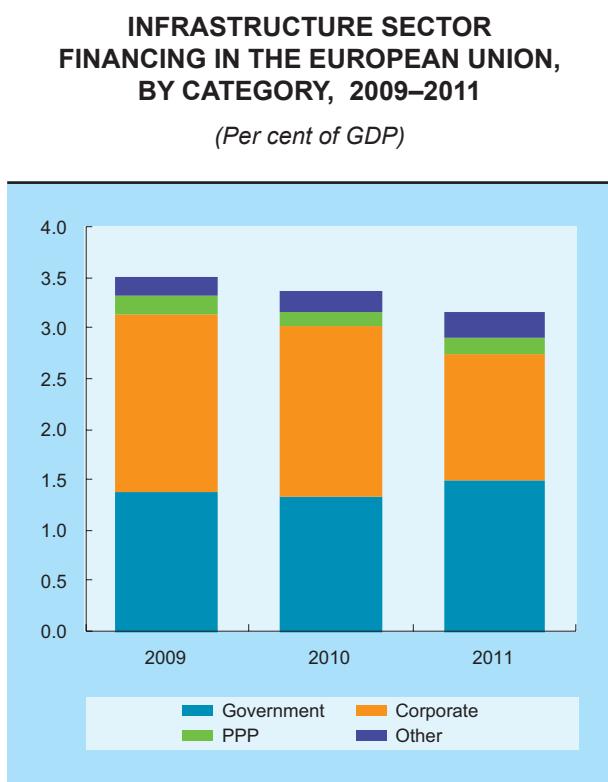
PPP investment has been concentrated in relatively few countries and sectors. Almost 60 per cent of the total private participation in projects recorded in developing countries was in China, Brazil, the Russian Federation, India, Mexico and Turkey (by order of magnitude). This is an indication that PPP investors are not dissimilar from other institutional investors, preferring large and dynamic markets to the more vulnerable economies where financing needs are greatest. Of the developing regions, Latin America has traditionally hosted the largest share of PPPs and still accounted for 45 per cent of the total in 2013. Only 10 per cent of the total went to Africa, although in sub-Saharan Africa investments have been steadily rising (primarily because of investments in telecoms).

Also, PPP investments have been concentrated in relatively few sectors, with telecoms accounting

for 37 per cent of the total, or \$58 billion, in 2013, and energy for 37 per cent of the total, or \$59 billion (chart 6.3B). Water and sanitation are among the most needed infrastructure services to relieve human suffering, and yet they are the least likely to be financed through this method, having received a mere \$3.5 billion in 2013 (see also UNCTAD, 2013). Indeed, most commercial interest has been directed to ICTs and energy-related activities, while socially challenging sectors attracted almost no private activity (AICD, 2010). PPPs also appear more likely to emerge in brownfield projects (changing ownership of assets that already exist) than in completely new greenfield projects or risky transformative activities such as those related to climate change (WEF, 2014).

Unsurprisingly, therefore, the growth in the use of PPPs has not relieved State responsibilities for investment in infrastructure development, and the public sector's contribution continues to be essential, especially at times of uncertainty. Estimates of

Chart 6.4



Source: European Investment Bank, 2012.

the share of public investment in infrastructure vary from anywhere between 75 per cent and 90 per cent (Estache, 2010; Briceño-Garmendia et al., 2008; Hall, 2015). Even in the European Union, PPPs, on average, contribute a very small share to total infrastructure investment, with some countries deciding not to use PPPs at all (chart 6.4). In developing countries, governments financed around 70 per cent of infrastructure investment during the period 2000–2005, rising to 90 per cent for the lowest income countries.¹⁵ To a large extent, this reflects the very nature of infrastructure. As the World Bank (2009:78) has noted, “many governments see the private sector as a solution. However, private financing, while offering additional resources, does not change the fundamentals of infrastructure provision: customers or taxpayers (domestic or foreign) must ultimately pay for the investments, and cost-covering tariffs (and well-targeted subsidies) remain the centre-piece of all sustainable infrastructure provision, public or private.”

As a result, even with PPPs, public finance remains critical. Of the total investment in developing

countries broadly described by the World Bank as PPPs, public debt and equity accounted for 67 per cent and private debt and equity accounted for the remaining (Mandri-Perrott, 2014). Moreover, these data relate only to the phase before projects are operational, after which contingent liabilities and other charges generally add considerably to the total public costs.

Historically, private participation in infrastructure has been dominated by large TNCs domiciled in OECD countries (OECD/NEPAD, 2005), especially for large-sized projects. Data from the World Bank PPI Database for the period 2010–2014 suggest that foreign actors are still a significant presence in many developing countries, accounting for around 58 per cent of PPP investments in Mexico and 35 per cent in China (calculated as the share of investments with either full or partial foreign sponsorship). One implication of this for developing countries is that it adds some of the risks associated with private external financing discussed in previous chapters, in addition to the other aspects of infrastructure provision. Projects may be financed through international lending, involving foreign currency exposure for both debt repayments and dividends, while the returns (profits, if there are any) are in the weaker, local currency. Sudden exchange rate shocks can dramatically affect profitability, as was experienced in Latin America and South-East Asia during the 1990s, which “helps to explain the diminished enthusiasm for such projects on the part of the international investment community” (OECD/NEPAD, 2005: 171).¹⁶ Therefore, in some countries, the currency risks of PPP projects are borne by the host government. However, during the period 2010–2014, for four of the six developing and transition economies that account for the largest share of PPPs, the PPI database suggests that domestic firms are more significant than foreign ones. In India, 81 per cent of projects had domestic sponsorship only, in China the share was around 60 per cent, in Turkey it was 55 per cent and in Brazil 39 per cent (compared with 14 per cent attributed to foreign firms acting alone).¹⁷ In particular, domestic sponsorship appears to be linked with smaller sized projects, but it is too early to tell whether this is a permanent change in financing sources or a cyclical one related to the post-crisis environment. In any case, if funds are borrowed internationally, foreign-exchange concerns remain the same regardless of the nationality of project partners.

Some of the larger companies involved in PPPs are quasi-public monopolies in their home countries; others share cultural or linguistic links with the host location.¹⁸ This concentration means that governments negotiating the terms of private participation in PPPs do not necessarily deal with a number of competing atomistic suppliers. For example, there tend to be no more than two or three bidders in transport tenders (Estache and Serebrisky, 2004), and competition can be further limited by multi-stage bidding processes, whereby a company is selected in the first round without having to specify contract details until the second round from which competitors have been removed. Furthermore, a government may be dealing with a corporate entity with market power comparable to or even greater than its own (OECD/NEPAD, 2005). Not only can this create imbalance when the terms of contracts are agreed upon, it can also affect conflict resolution if things go wrong, as the partner companies may be large and powerful enough to “take on the regulators” in case of conflict (Shaoul, 2009).¹⁹

2. Assessing the contributions and costs of PPPs

One of the most common reasons for governments to choose PPPs over their own direct investment and procurement is that they are expected to bring additional finance, beyond what governments can provide. However the results are at best ambiguous. Some observers have argued that additionality is more likely to occur in developing countries than in developed ones (Winch et al., 2012), especially if capital is raised from outside the country. But after reviewing the World Bank’s decade-long experience of supporting PPPs in transition, developing and least developed countries, the Independent Evaluation Group (IEG) concluded that “contrary to intuition, PPPs generally do not provide additional resources to the public sector” (IEG, 2014: 6). If PPPs were more efficient than the public sector and could offset their higher financing costs, they could provide additionality in the sense of creating savings. However, the results in terms of improved efficiency have been mixed.

Moreover, the experience in developed countries is that the benefits of additionality can only be

realized under very specific conditions. In reality, some may be a form of “pseudo-additionality facilitated by accounting rules” (Winch et al., 2012: 15), whereby PPPs become a means of avoiding administrative (as opposed to macroeconomic or real) constraints, such as fiscal responsibility requirements. Implementing projects with off-budget finance from the private sector is one way to avoid such constraints. However, insofar as there are other fiscal costs emerging over time that have to be included in the budget, such as subsidies or other incentives that must be provided at a later date, even this accounting “advantage” may be – and typically is – short-lived.

Another argument in favour of PPPs relates to their greater efficiency and ability to deliver better value for money. According to measures of business performance during the construction phase, most of the PPPs supported by the World Bank were successful in the sense of being completed on time or within budget, with 62 per cent of those reviewed by the IEG rated satisfactory or better. However, broader measures that indicate longer term sustainability over the lifetime of a project are not estimated. Out of 128 projects studied, only 10 recorded results of service quality, 8 recorded results in terms of efficiency, and 1 reported fiscal results. Improved access to services for the poor could be confirmed in only about 10 per cent of cases (IEG, 2014). Owing to the scarcity of data, it is difficult to draw conclusions about the impact of PPPs on end-users.

It has been noted that PPPs are generally more costly than traditional procurement or provision of services through the public sector if only because governments can borrow more cheaply than the private sector.²⁰ An OECD survey of the 18 countries with sufficient information to report on the percentage of PPPs’ contribution to public infrastructure found that, “there is little information to assess empirically whether PPPs outperform TIP [traditional infrastructure procurement] projects over the lifetime of the project. This contrasts strongly with the purported motivation of going the PPP route, namely the maximization of whole-of-life value for money” (Burger and Hawkesworth, 2013: 69).

There are also relatively little data on the development impact of PPPs. Their performance over time tends to be greatly affected by the fact that more than half of all PPP contracts have been renegotiated, on average every two years (IEG, 2014). New terms

have typically favoured the concessionaire, with tariffs rising, fees falling or obligations being postponed, thus again adding potentially to the burden on the government partner to ensure that an adequate service is provided (in quality, price and coverage). This is not limited only to World Bank-supported projects; the OECD survey of member countries using PPPs found that when contract renegotiations took place at the request of the private partner, there was a high probability that the government lost value for money compared with the originally negotiated contract (Burger and Hawkesworth, 2013).

All this has meant that the scale of obligations and liabilities that governments have incurred through the use of PPPs has been surprisingly high, and thus merits greater attention. Liabilities may be explicit or implicit, contractual or non-contractual. Some are evident from the outset. For example, in China, foreign investors usually request a guaranteed fixed or minimum return; in the Republic of Korea, the offer of a guaranteed minimum revenue played a significant role in attracting private capital, but also caused moral hazard problems (Winch et al., 2012). Other liabilities may emerge over time, which is potentially a big problem for governments, given that projects have a life span of 30 years or more.

For the 128 PPPs in its sample, the World Bank concluded that it was not possible to show how much risk was being borne by the private or public partners because “downstream contingent liabilities are rarely quantified at the project level” (IEG, 2014: 40). This is partly due to a lack of standardized financial reporting, which makes it difficult for both investors and governments to judge the risks involved in PPP projects. China has sharply reduced the use of PPPs because they were found to be creating liabilities that were difficult to manage at local levels; following a peak of up to 6 per cent of government expenditure and 0.8 per cent of gross domestic product (GDP) during the period 1995–1997, they have fallen swiftly (Ahmad et al., 2014). Brazil introduced exposure limits for state and local governments and some states have already reached the limit, prompting calls for federal assistance.

This could be an issue not only for countries that are new to PPPs, but also for those countries with

PPPs already in place. An OECD survey found that most countries rely on medium-term affordability when making a decision about whether to use PPPs or traditional infrastructure procurement. However, the longer term view can be very different, and governments need to budget the full capital costs up front (Burger and Hawkesworth, 2013). Even if the cost of a project is expected to be fully covered by user charges, rather than through government revenues, planners need to be aware of the fiscal implications in the future if, for some reason, payment by users does not work out, for example if demand is lower than anticipated, or if consumers are unwilling or unable to pay. Once future government commitments are reported over the lifetime of a project, this can significantly increase the actual fiscal cost. In the United Kingdom, for example, concerns about the scale of the unitary payments the Government is required to pay each year (around £9 billion per annum for the next few decades) prompted the United Kingdom Treasury to review all PPPs and issue new guidelines.

The scale of obligations and liabilities that governments have incurred through the use of PPPs has often been much larger than anticipated.

Government liabilities can arise in various ways, whether from formal commitments through contracts or informally, stemming from the simple fact that governments are the providers of last resort. When things go wrong, the fiscal costs can be high, as exemplified by infrastructure-related experiences in Mexico. In the early 1990s, Mexico initiated an ambitious road-building programme involving more than 50 PPPs (concessions) to build and manage 5,500 km of toll roads. The concessions were highly leveraged, with loans provided at floating rates by local banks, which were owned by sub-national governments and were under pressure to support the project through lending. User tolls were expected to provide the revenues that would not only repay the debt, but also provide the private partners’ profits. However, costs proved to be higher and traffic volumes lower than anticipated, interest rates rose over time, and the banking system absorbed the increased liabilities. The system had already been struggling when a macroeconomic shock made matters worse. The Federal Government stepped in, even though there were no explicit guarantees compelling it to do so. It restructured the entire road programme, bailing out concessionaires, taking over 25 of them, and assuming close to \$8 billion in debt (Ehrhardt and Irwin, 2004).

In several countries, unsatisfactory outcomes of PPP projects meant that some schemes were given up early. Specifically with regard to water, more than 180 cities and communities in 35 countries have taken back control of their water services in the last 15 years (Water Justice, 2014). Such “re-municipalizations” have occurred for three main reasons: widespread problems affecting water privatization, seemingly independent of the country or regulatory regime; the equal or greater efficiency of public water services and lower prices that can be achieved when dividends or profits do not need to be paid to private operators; and the comparative advantage of the public sector in providing for human welfare and realizing social and environmental objectives (Lobina and Hall, 2013).

3. Policy implications

PPPs may remain a useful source of long-term financing for development, given the paucity of other external resources, particularly if real and perceived fiscal constraints persist, which prevent governments from directly undertaking public procurement for long-term development needs. However, it is important for governments to fully understand the various consequences and ramifications of such mechanisms, and be mindful of the potential costs and benefits over the entire life of a project so as not to experience unpleasant fiscal shocks subsequently.

To begin with, this requires efforts to improve transparency and accountability in PPPs, including standardizing the process for covering and reporting on public transactions, and, in particular, adopting accrual accounting systems that consider long-term investments and liabilities. Even when there are no explicit guarantees by governments, it is likely they will have to assume a significant share of liabilities. A particular concern is that many countries still do not have the basic accounting systems needed. Ironically, those countries that may have the highest hopes for PPPs may be the ones with the least capacity to manage them properly.

It is also necessary to improve the decision-making processes with respect to PPPs. As a mechanism for ensuring long-term investments with social goals, PPPs may not be appropriate in all circumstances. Therefore, a proper assessment needs to be conducted before they are selected in preference to other means of providing public goods and services. This also involves better pre-project planning, careful comparison with other means such as procurement, improved transparency with respect to contractual terms – including renegotiations and options for exit or breaking of contracts – as well as identifying and quantifying the fiscal implications. It further requires that governments disclose documents and information relating to PPPs and their contracts to encourage honest and transparent processes that are also socially accountable. It may also be useful to create a forum for the sharing of experiences and expertise, and build networks of developing countries for this purpose.

D. Can sovereign wealth funds make a difference?

Many national governments or regional authorities that have been accumulating large amounts of foreign assets in recent years have established sovereign wealth funds (SWFs) as a more profitable way to use such assets instead of further increasing their international reserves. The total value of these public assets currently stands at more than \$7 trillion. This has raised hopes in some quarters that

SWFs could complement the existing sources of development finance, particularly since more than 40 of the 52 SWFs established since 2000 are based in developing countries and 32 of them hold more than \$10 billion in assets. Their total assets were estimated to be nearly \$6 trillion in March 2015 (SWF Institute, 2015), 87 per cent of which were funds from SWFs in only seven developing countries

(China, Kuwait, Qatar, the Republic of Korea, Saudi Arabia, Singapore and the United Arab Emirates).

Apart from the funds held for macroeconomic stabilization purposes only (which therefore hold swiftly deployable, highly liquid instruments such as government bonds or cash), many SWFs are mandated to build up capital reserves for future generations, and can therefore consider deploying their remaining funds for equity and “alternative investments” that are illiquid and long term. Some are even explicitly expected to support national or regional development through investments in infrastructure. SWFs typically have more freedom in their choice of asset classes compared with more risk-averse funds operated by central banks, pension funds and other funds. Hints of portfolio choices can be gleaned from examples of recent decisions by various SWFs: the Norwegian Government’s SWF recently made a climate-change-related pledge to exit global equities in coal, Singapore’s Temasek has investments in national and regional infrastructure, and the Fund for Productive Industrial Revolution in the Plurinational State of Bolivia has investments in medical, cement and food industries, among others.

In practice, few SWFs take advantage of this freedom to invest in ways that would support developing countries’ long-term investment needs. Rather, their investment decisions mirror those of private

market players, favouring some countries (e.g. China, the United Kingdom and the United States) and what they deem to be low-risk and short-term market sectors (Inderst and Steward, 2014; IPE and Stirling, 2013). And while more than half of all SWFs invest some resources in infrastructure (typically in energy, transport and telecommunications), these investments are again mostly in developed countries (Inderst and Steward, 2014).

SWFs’ decision-making processes are not well known, as fewer than half disclose details of their activities (Bauer, 2015). Some funds are constrained by their legal structures. For example, several funds, such as the Botswana Pula fund, are not allowed to invest domestically, but others have mandates that allow investing both domestically and in infrastructure. Technical assistance may help boost project management capabilities in developing countries, thus responding to criticism that some SWFs are unwilling to invest in those countries because there are too few large-scale projects to attract them. Some mechanisms for risk mitigation may help, such as pre-project appraisals or contingent guarantees. However, since the declared aim of SWFs is typically to save for their country so that future generations may benefit from today’s (possibly windfall) successes, this necessarily requires an emphasis on low-risk investments that yield positive returns, whether in social or financial terms.

E. Development banks: Their evolution and potential for supporting development

1. Distinctive features of development banks

Multilateral development banks have played and can continue to play a crucial role as providers of long-term financing that is not delivered by private lenders.²¹ Typically, transformative development requires, among other things, large-scale projects of long maturity, which involve risks that private banks

are unwilling to assume, especially when their own liabilities are short term in nature. In addition, many large-scale projects generate positive externalities, and therefore social returns that are bigger than private returns. Development banks (both national and multilateral) are specifically designed to compensate for these shortcomings of private capital flows and markets. They have a clear mandate to support development-oriented projects that typically require long-term finance and a funding base whose liabilities

are predominantly long term and thus aligned with their mandate. Their capital is, for the most part, owned by highly rated sovereigns, which permits the banks to borrow long term in financial markets at relatively low costs.²² In addition to their provision of long-term finance, development banks act as “market makers” by creating and providing financing instruments that better spread risks, both between creditors and borrowers and over time, including through co-financing with private investors.

Development banks can also help to overcome some of the informational deficiencies facing the private sector by assisting in the screening, evaluation and monitoring of projects. Unlike private banks, development banks tend to have in-house technical and managerial expertise which allows them to participate in decisions involving choice of technology, scale and location. This reinforces their ability to leverage resources, as they can attract other lenders that do not have the same technical capabilities to assess a project’s viability and potential. Development banks, therefore, have unique features that give them a strong comparative advantage over private financial institutions, including the tools to mitigate specific risks that the private sector is unwilling to take on, and the ability to exploit the complementarities between them and their private partners effectively (Buiter and Fries, 2002).

These banks are generally mandated to provide credit on terms that render industrial and infrastructural investment viable. They provide working capital and finance for long-term investments, sometimes in the form of equity. To safeguard their investments, they often closely monitor the activities of the firms to which they lend, sometimes nominating directors to the boards of those firms.

National development banks have long predicated multinational banks. In Germany, for example, in the nineteenth and twentieth centuries German *Grossbanken* or universal banks became heavily involved in maturity transformation. Since such activities sometimes resulted in these banks experiencing illiquidity situations, they required constant and reliable access to last-resort lending by the Reichsbank, or central bank. It has been argued that

this represented “a clear case of planned institution building”, to finance the necessary long-term investments. The universal banks were private, limited liability, joint stock banks, but they were also instruments of the State, acting on its behalf

in return for large-scale liquidity support (De Cecco 2005: 355). Following the German experience, together with the experience of the main-bank system in Japan that financed export-led industrial expansion with support from and direction by the Bank of Japan and the Japanese Government, many developing countries have chosen to establish stand-alone

development finance institutions expressly geared to specific financing objectives (Chandrasekhar, 2014).

More than half of the development finance institutions in the developing world are relatively small, with assets of less than \$10 billion. However, about 5 per cent are mega-banks with assets greater than \$100 billion, including institutions like the China Development Bank (CDB) and the National Bank for Economic and Social Development (BNDES) of Brazil (Chandrasekhar, 2014).

Clearly, international or multilateral development banks can play even more significant roles if they also assist in reducing developing countries’ foreign-exchange gaps, and if they provide loans at even lower interest rates because of their greater ability to access global capital markets. As noted above, these financing gaps arise because of the public nature of some investment projects, the limited financing capacity of national (and sub-national) governments to undertake large projects, and the private sector’s unwillingness to undertake long-term, large-scale projects which they perceive as too risky. Since public investment, by nature, typically does not generate direct financial returns on investment, but only indirect and long-term returns in terms of higher growth, from which debt service can eventually be paid, this can be, and typically is, a major obstacle to commercial financing.

One area in which financing gaps remain huge is infrastructure, with an estimated current gap greater than \$1 trillion (Bhattacharya and Romani, 2013). As was evident in section C, even innovative

Development banks have a clear mandate to support development-oriented projects that typically require long-term finance and a funding base whose liabilities are predominantly long term.

mechanisms to meet this gap through PPPs have thus far been inadequate, and furthermore, they have tended to involve very substantial fiscal costs. It has been estimated that in order to meet the growth and development needs of developing countries, infrastructure spending would have to increase from 3 per cent to 6–8 per cent of developing-country GDP. However, private sector infrastructure investment is not only relatively small, but also very concentrated in the energy, transport and ICT sectors (Estache, 2010). The lack of private sector involvement is particularly marked for regional infrastructure projects due to the complexity of the regulatory framework for cross-border projects and the political risks involved. Multilateral development banks, especially regional ones, can play a leading role in providing finance for regional infrastructure development, since they can tackle collective action and coordination problems due to their international or regional nature, accumulated knowledge and access to different financing and implementation instruments.

International development banks can provide low-income countries with loans for development projects at subsidized interest rates. In 2013, their concessional lending amounted to almost \$20 billion, which represented 30.4 per cent of their total loan portfolios.²³ In addition, both national and multilateral development banks can play countercyclical roles, providing project finance to fill in gaps when private lenders reduce credit during recessions and crises (Ocampo et al., 2007). They may also be able to sustain or even increase lending during economic shocks, such as sharp changes in commodity prices or natural disasters. This in turn can help a country sustain its level of income and economic activity, as well as its capacity to import after such a shock. This was evident during the global financial crisis, for example, when lending by both the CDB and BNDES was sufficiently large to offset some of the likely declines in investment during the crisis (Ferraz, 2012). Some regional banks such as the European Investment Bank (EIB) have the explicit mandate to provide countercyclical lending,²⁴ which demonstrates that international/regional development banks, along with their national counterparts, can directly help support income and employment as part of their policy goals.

In recent years, some national development banks have become increasingly significant international players, providing external financing as part of their international operations.

2. The changing landscape of development banks

Over more than half a century, the World Bank and various regional development banks such as the Asian Development Bank (ADB), the African Development Bank (AfDB), the Inter-American Development Bank (IADB), EIB and the Islamic Development Bank (IDB), have played a vital role in financing long-term projects around the world. They have helped to fill some financing gaps, especially in large-scale infrastructure projects, and, more recently, in social and environmental projects. Despite their presence, however, given the relatively modest size of their loans, they have been able to only slightly reduce these gaps.²⁵

Other subregional development banks have also partially covered these financing needs. In the Latin American and the Caribbean region, these include the Central American Bank for Economic Integration, the Caribbean Development Bank and the Andean Development Corporation (Corporación Andina de Fomento, or CAF). The latter, now known as the Development Bank of Latin America, was created with a mandate to promote sustainable development and regional integration among its

founding member countries, the Plurinational State of Bolivia, Colombia, Ecuador, Peru and the Bolivarian Republic of Venezuela. Membership has been gradually expanded since the bank's creation to include most Latin American and Caribbean countries, as well as Portugal and Spain. The bank supports the strengthening of its members' national productive sectors,

particularly the development of value-added products and services, as well as job creation and the promotion of access to social services, including education, health, water and sanitation. In 2013, loan approvals by the CAF surpassed \$12 billion, which was a similar amount to the total loans of the IADB.²⁶ Although the CAF is owned mostly by developing countries, the bank has a fairly large capital base, which, together with the excellent record of repayment on its loans, has contributed to its investment grade status from the international rating agencies – a rating that is higher than that of most Latin American countries. The

bank's clear and focused mandate, lean management structure, rigorous economic evaluation of projects, rapid approval process and loans granted without conditionality help to explain its success and consistently high credit rating (Griffith-Jones et al., 2008).

In Africa, the AfDB is an important source of external long-term finance. Africa also has a large number of subregional banks, including: the East African Development Bank, the West African Development Bank, the Central African States Development Bank, the Eastern and Southern African Trade and Development Bank, commonly known as the Preferential Trade Area Bank (or PTA Bank) and the Development Bank of Southern Africa (wholly owned by South Africa but serving the Southern African Development Community, with a focus on large infrastructure projects). However, these banks have limited capacity to provide finance for large development-oriented projects on a scale that meets the needs of their respective subregions.²⁷ This may be explained by their small capital base, and by the fact that most of their shareholders are the borrowing countries themselves, which have limited financial resources to expand these banks' capital bases substantially. In Asia, the ADB plays a major role in financing long-term projects, including in infrastructure, as there is a lack of subregional banks.

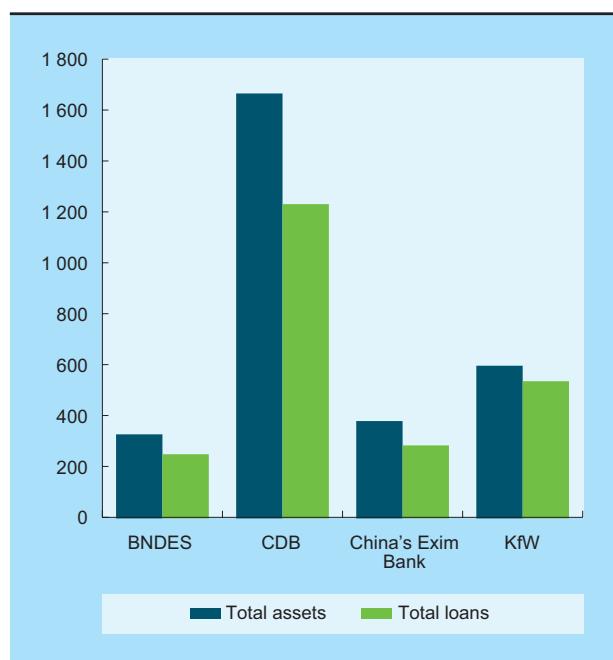
In recent years, some national development banks have become increasingly significant international players, providing external financing as part of their international operations. The most active international lenders have been China Development Bank (CDB), the Export and Import Bank of China (China Exim Bank), Brazil's BNDES and the German Development Bank, *Kreditanstalt Für Wiederaufbau* (KfW). The international operations of these major development banks account for a significant proportion of their total assets and loans, which can be quite large (chart 6.5).

The CDB and China Exim Bank are two of the three "policy" banks that China created in 1994 to support specific development goals set by the Chinese Government. The CDB is a primary provider of long-term finance for infrastructure projects, such as railways, roads and telecommunications, and for large-scale investments in basic and heavy industries, such as petrochemicals. China Exim Bank's mandate is to support China's exports and imports of mechanical and electronic products, equipment and high-tech

Chart 6.5

TOTAL ASSETS AND LOANS, SELECTED NATIONAL DEVELOPMENT BANKS, 2014

(Billions of dollars)



Source: Banks' annual reports.

products, as well as overseas investments of Chinese companies. The bank also acts as the financing arm of China's international cooperation programmes by providing concessional lending abroad (Poon, 2014; China Exim Bank, 2014).

Since the early 2000s, both of these Chinese banks have been active providers of international finance to developing countries. Their loans have supported China's "going out" strategy as part of its new role as an emerging superpower on the global stage. Recent initiatives include their planned contributions to the new "Silk Road" strategy that involves large infrastructure investments across Asia, along with continuing financing in Africa, Asia and Latin America through South-South cooperation agreements.

In 2014, the CDB's foreign currency loans totalled \$267 billion, accounting for about 22 per cent of its entire loan portfolio. They generally support infrastructure development in different developing countries, while facilitating China's access to raw

materials at lower transportation costs.²⁸ The bank also provides financing through other mechanisms, such as the China-Africa Development Fund (CAD Fund), to which the bank was the sole provider of capital funds in its phases I and II. In 2014, the CAD Fund committed \$3.1 billion of investments in 80 projects in a range of areas, including regional aviation, ports, electricity, pharmaceuticals and vehicle assembly (CDB, 2014).

Together with the CDB, China Exim Bank has strongly supported China's strategic partnership with other developing countries. It has made preferential loan commitments to different countries and regions, including Africa, Asia and the Pacific, Central and Eastern Europe and the Caribbean (China Exim Bank, 2014). In 2014, its actual export seller's credit disbursements reached \$287.8 billion, of which 15.2 per cent was spent on overseas construction contracts and 7.9 per cent on overseas investment projects. Recently, the bank has provided support to "the development of high-speed railway, expressway and regional aviation networks (the 'Three Networks') in Africa" through loans (part of these concessional) and other assistance mechanisms (China Exim Bank, 2014: 9).

In addition to these Chinese national development banks that have an international reach, another prominent national development bank is Brazil's BNDES, which has been providing financing for development, both nationally and abroad, in recent years. Created in 1952 with an initial focus on financing domestic infrastructure development as part of the country's strategy of modernization and industrialization, it subsequently broadened its focus to foster Brazil's capital goods industry and other industrial sectors. Since the 1990s, it has also been providing financing to exporting sectors. In the 2000s, the bank expanded its international operations, reflecting the willingness of Brazil's Government to play a greater role on the international stage. This new strategy has included supporting regional economic integration and therefore investment promotion in neighbouring countries, as well as strengthening Brazil's economic links with fast-growing developing regions, particularly Africa. The bank's loans have also bolstered the internationalization of large Brazilian corporations.

In 2014, 14 per cent of the bank's total loan portfolio was in foreign currency. Since BNDES figures among the largest national development banks in the world, with a total loan portfolio of \$245 billion

in 2014 (chart 6.5), its provision of foreign loans is significant, especially for smaller countries that lack funding for large-scale development projects. In South America, for instance, the bank has played a very important development-supporting role by lending to small countries such as Ecuador as well as larger ones such as Argentina, to finance economic infrastructure. In Africa, it has extended loans to large national construction companies investing in infrastructure and other projects.

An example of a national development bank from a developed country is KfW. It has been playing an increasingly important role internationally as the lending arm of Germany's development cooperation programmes. It promotes development programmes in all developing regions. At the end of 2014, its loan portfolio totalled \$536 billion (chart 6.5), and 10 per cent of its business promotion activities were related to development programmes around the world. Its mandate is to improve living conditions in Germany, Europe and around the world sustainably, such as by promoting climate-friendly economic development, including in developing countries. Its projects include power supply lines in India, a solar thermal power plant in Chile and sustainable housing construction in Africa (KfW, 2014). Parts of these financing programmes are linked to the bank's participation in a variety of climate protection initiatives, such as the Initiative for Climate and Environmental Protection and the International Climate Initiative. It has also created a Climate Insurance Fund aimed at supporting local insurance and reinsurance companies, and it is expected to contribute to the new United Nations Green Climate Fund (GCF) for climate protection and adaptation. In addition, the German Government channels funds through this bank for the provision of grants and highly concessional loans to LDCs (KfW, 2014).

3. *The potential financing role of South-led multilateral banks*

A system of development banks that provides international financing to support growth and development should include South-led multilateral banks, alongside multilateral, regional and subregional banks and national banks with international operations. Recent initiatives to design and set up such

banks are aimed at addressing the shortage of long-term capital for investment in crucial infrastructural areas and capital-intensive industries essential for development. These initiatives include the newly created New Development Bank (NDB) set up by the group of countries known as the BRICS (Brazil, the Russian Federation, India, China and South Africa), the Asian Infrastructure Investment Bank (AIIB) and the Bank of the South. The decisions to create these institutions are partly motivated by the disillusionment of developing countries with the governance structures, patterns of lending and the conditionalities associated with lending by the Bretton Woods institutions and by some of the leading regional development banks.

The NDB was established at the BRICS Fortaleza Summit of July 2014, with the specific mandate for “mobilizing resources for infrastructure and sustainable development projects in BRICS and other emerging and developing economies” (BRICS, 2014, paragraph 11). This focus is clearly justified in the light of the large unmet needs in these areas, as highlighted above. It has been established with an initial authorized capital of \$100 billion (and a subscribed capital of \$50 billion). According to the declaration of the VII BRICS Summit in July 2015 in Ufa (Russian Federation), the NDB is expected to start approving its first investment projects at the beginning of 2016 (BRICS, 2015a). The quality of its loans to infrastructure and other projects should be an important priority so as to maximize the development impacts of such projects and minimize risks of default. Moreover, the ability to make profits will help the bank expand its capital base, and therefore increase its lending in the future.

In terms of geographical coverage, it would be important for the NDB to have a balanced portfolio of loans that include both middle- and low-income countries, since this mix would generate benefits of geographical diversification and make the bank more creditworthy. In order to lend to low-income countries, there is a case to be made for including a subsidy element, making loans to this group of countries concessional. The creation of a trust fund, funded by developed countries, could support such loans (Griffith-Jones, 2014).

The Asian Infrastructure Investment Bank was established in October 2014 in Beijing, with 33 founding members from within the Asian region and 17 (including several developed countries) from outside the region; an additional seven prospective members have yet to sign on.²⁹ Most of the bank’s authorized capital stock of \$100 billion will be contributed by China. In order to reflect the regional character of the AIIB, its regional members will be the majority shareholders, holding approximately 75 per cent of shares. The bank’s creation is a response to the recognition of the importance of infrastructure to the development of Asia, and the need for significant additional long-term financing for building infrastructure in the region. While the ADB estimates Asia’s infrastructure financing needs to be around \$720 billion per annum over the period 2010–2020, its own annual loan approval amounts to only \$13 billion (Junio, 2014). The AIIB aims to finance both national and regional infrastructure projects. The latter should aim to support trade and further development of the region’s production networks. The main funding mechanism will be through the issuing of bonds, both in regional and global markets.

A system of development banks that provides international financing to support growth and development should include South-led multilateral banks.

In Latin America, the Bank of the South (Banco del Sur) is a subregional entity whose founding member countries are all from South America: Argentina, the Plurinational State of Bolivia, Brazil, Ecuador, Paraguay, Uruguay and the Bolivarian Republic of Venezuela. Established in 2009 with a promised initial capital of \$20 billion, it aims to promote economic development and regional integration in the South American subregion.

None of these three banks is in operation yet, but they are promising signs of a renewed interest both in development banks and in the need to finance infrastructure creation for social and economic development. They also add to an environment of healthy competition with other development banks; for example, partly as a response to these developments, the World Bank has decided to step up its presence in the area of infrastructure development by setting up a Global Infrastructure Facility (GIF), which it defines as “a global open platform that will facilitate the preparation and structuring of complex infrastructure PPPs to mobilise private

sector and institutional investor capital.³⁰ This is an ambitious step, given the World Bank's relatively limited spending on infrastructure development so far – about \$24 billion in 2014, up from \$16.7 billion in 2013³¹ – and its mixed record on social and environmental standards. Nevertheless, it points to the possible catalytic role these new institutions may play in changing both the conditions and the approach of existing multilateral financing institutions. Further, they could become a driving force for collaboration in a network of development banks, creating synergies and complementarities among them.

In this network, the new South-led banks could work closely with national development banks, particularly from the BRICS countries, such as Brazil's BNDES, the Development Bank of Southern Africa and China's CDB, as was proposed at the VII BRICS Summit in July 2015 (see BRICS, 2015b). While multilateral banks may have greater expertise in the engineering and financing aspects of loans, national development banks have greater local knowledge, thereby helping reduce asymmetries of information at the national level.

These new South-led banks are expected not only to supplement the amount of financing for

long-term investments that are on offer globally, but also to better serve the interests of economic development, along with greater concern for sustainability and inclusiveness, than multilateral banks that are dominated by developed countries. This would depend on several factors. One is the degree to which the emergence of these banks is able to significantly alter the global financial architecture, and perhaps, therefore, the behaviour of the institutions that currently dominate it. Another relates to whether they would differ in their lending practices from the established institutions – not just increasing the quantity of financing for long-term development, but also changing its quality to focus more on inclusive and sustainable economic transformation. Thus, while greater diversity in the international financial and monetary landscape is certainly welcome, and the additional resources that these new institutions provide can have a significant positive impact in terms of generating more long-term financing for development, it does not necessarily follow that there will be major changes in the terms and conditions of such financing. For this to happen, governments and civil society in developing countries will need to place greater emphasis on monitoring the funding patterns, terms and conditions in the lending activities of the new development banks.

F. Conclusions

In a world economy inundated with liquidity, the main obstacle to financing development is not the lack of financing capacity. Rather, the question is how to move resources from highly leveraged institutions with short-term financial horizons to economic agents wishing to finance long-term investment projects that generate large positive externalities and therefore encourage additional investment. This report stresses that this cannot be ensured simply through the workings of market mechanisms, either nationally or internationally. This is because private financial institutions are naturally driven by a profit motive, whereby during a boom, they tend to produce too much credit and debt, while during a bust, credit ceases and a debt deflation sets in.

As a consequence, and left to itself, private finance finds it difficult to incorporate social or development benefits in its calculations. Where there are externalities, as with public goods, private finance is insufficient for social needs. In addition, private finance has tended to be geographically concentrated in high and middle-income countries and in sectors in which profitability is more assured, rather than in risky projects or projects with long gestation periods that may be more necessary for industrialization and development. Within countries, private finance tends to provide less financing to SMEs, to sectors that are characterized by different forms of risk such as agriculture, to projects with bulky upfront investment requirements such as economic infrastructure and to

necessary social investments in health, sanitation and education, among others. Yet sufficient spending in all of these areas is clearly essential for a sustained and inclusive development process.

Therefore, ensuring financing for development requires specialized agents and mechanisms designed specifically for this purpose, in which the role played by the public sector is crucial. This chapter has reviewed the most important potential sources of international finance that, having some degree of public involvement, may be used for development finance. Related mechanisms may result directly from public spending, as with ODA and other forms of cooperation, may involve changing the terms of profitability and the incentives available to private investors to consider externalities, as with PPPs, or may emerge from public institutions, such as development banks set up for this purpose, which are effectively underwritten by the government.

ODA remains the only existing mechanism whose central aim is to redistribute income at the global level. Despite its potential, the amount of ODA has remained far short of both needs and expectation. In the past few years, there has been progress regarding both the amount of assistance provided and efforts to improve its effectiveness. In addition, South-South cooperation has been significantly increasing. However, most ODA still reflects flows from developed countries to developing countries, and closing the gap between the current level of such ODA (0.29 per cent of GNI of developed countries) and the committed level of 0.7 per cent remains of the utmost importance for sustaining development strategies, particularly in LDCs. In this context, there is an increasing focus in the debate on financing for development on the potential use of ODA to catalyse additional resource mobilization, both public and private. However, the use of public aid for leveraging private finance should be considered with caution, to avoid the risk of privatizing benefits and socializing losses. The opportunity cost of using ODA for this purpose may be too high.

This chapter has also shown that, despite their recent popularity, experience with PPPs has been mixed and rather limited in terms of generating additional private investment in desired areas.

As with other blended finance instruments, PPPs may “lower investment specific risks and incentivize additional private sector finance across key development sectors” (Addis Ababa Action Agenda of the Third International Conference on Financing for Development in

2015). However, the scale of obligations and liabilities that governments have incurred through the use of PPPs has often been much larger than anticipated and, therefore, the fiscal costs have often been so high as to suggest that governments could have more effectively and efficiently engaged in public investment in these areas directly. Therefore, there is a need to improve pre-project planning processes, increase transparency and accountability and identify fiscal implications for the duration of such projects.

Finally, multilateral and regional development banks that are dedicated to the special challenges inherent in infrastructure could play a greater role, delivering technical assistance as well as finance. Indeed, existing and new development banks have a primary role as providers of long-term financing, vis-à-vis private financial institutions. Since they have a clear mandate to support developmentally oriented projects and a funding base whose liabilities are predominantly long term, as well as in-house technical expertise that allows them to participate in decisions involving choices related to technology,

scale and location, they have unique features that give them a strong comparative advantage over private financial institutions. International development banks can, in addition, play an important countercyclical role through their provision of crisis financing to individual countries, in response to an economic shock (e.g. commodity-price related) or a natural disaster,

... therefore, ensuring finance for development requires specialized agents and mechanisms designed specifically for this purpose, in which the role played by the public sector is crucial.

which can help sustain levels of income and economic activity and the capacity to import during downswings. ■

Notes

- 1 A target of official flows equivalent to 0.75 per cent of each developed country's GNP was initially adopted at the second conference of UNCTAD in New Delhi in 1968. This proposal was accepted by most, but not all, developed countries. After further negotiations, this initiative was approved by the United Nations General Assembly of October 1970, although the target was lowered to 0.7 per cent of GNP. This commitment was endorsed by the members of OECD-DAC, which defined ODA as "those external financial flows which are provided by official agencies, have the promotion of economic development and welfare of developing countries as its main objective, and are concessional in character."
- 2 Only five members exceeded the target of 0.7 per cent of GNI: Denmark, Luxembourg, Norway, Sweden and the United Kingdom (OECD, 2015).
- 3 Developmental ODA includes social infrastructure and services, economic infrastructure and services and production sectors, which in 2013 represented about 63 per cent of total registered ODA.
- 4 For empirical evidence on the relationship between aid and growth, see *TDR 2008* and UNCTAD, 2006. For more recent reviews on the literature relating to this, see Alonso, 2012; Edwards, 2014; Glennie and Sumner, 2014; Morrissey, 2015; Qian, 2014; and Quibria, 2014.
- 5 Such costs increase by 15–30 per cent, on average, and by as much as 40 per cent or more for food aid (DIIS, 2009).
- 6 On aid predictability, see OECD at: <http://www.oecd.org/dac/aid-architecture/> (accessed 21 July 2015).
- 7 The remaining 61 per cent was "phantom aid" – aid which was not targeted for poverty reduction, or was double-counted as debt relief, overpriced and ineffective technical assistance, tied to the purchase of goods and services from the donor country, poorly coordinated and with high transaction costs, too unpredictable to be useful to the recipient, spent on immigration-related costs in the donor country or spent on excessive administration costs.
- 8 Evidence of this can be found in the high-level forums on aid effectiveness held in Rome (2003), Paris (2005), Accra (2008) and Busan (2011).
- 9 Even with the recorded increases in formal, untied aid, some part of it may still be "de facto" tied. This may be due to donor regulations, lack of local capacity, difficulties for local and regional contractors to compete internationally, unequal access to information, potential risk aversion on the part of donors and pressure for speedy implementation (UNCTAD, 2011b).
- 10 Similarly, the Addis Ababa Action Agenda of the Third International Conference on Financing for Development (13–16 July 2015) stresses in its paragraph 54: "An important use of international public finance, including ODA, is to catalyse additional resource mobilization from other sources, public and private. It can support improved tax collection and help strengthen domestic enabling environments and build essential public services. It can also be used to unlock additional finance through blended or pooled financing and risk mitigation, notably for infrastructure and other investments that support private sector development."
- 11 However, "evaluating blended projects is not easy and it can be difficult to demonstrate key success factors, such as additionality, transparency and accountability and to provide evidence of development impact" (UNCTAD, *World Investment Report 2014*: 169).
- 12 See for instance, Griffiths et al. (2014), UK Aid Network (2015), Concord (2014), ActionAid (2014), Bretton Woods Project (2012), Eurodad (2012), ActionAid, Eurodad and Oxfam (2015), Eurodad (2013), Kwakkenbos and Romero (2013).
- 13 Definitions of PPPs vary considerably, reflecting different institutional arrangements and conceptual understandings, but they nonetheless share many similarities. In their simplest form, PPPs "refer to arrangements where the private sector supplies infrastructure assets and services that traditionally have been provided by the government" (IMF, 2006:1). Such a definition can encompass existing assets and the acquisition of new ones, and user-pays services, or free-to-user systems where governments pay a unitary charge to the provider. Other definitions focus on risk and how it is intended to be allocated between the public and private partners. For example, one

- definition states that PPPs are “an agreement between the government and one or more private partners (which may include the operators and financers) according to which the private partners deliver the service in such a manner that the service delivery objectives of the government are aligned with the profit objectives of the private partners and where the effectiveness of the alignment depends on a sufficient transfer of risk to the private partners” (OECD, 2008: 17). In practice, much of the current debate concerns the perceived imbalance of risk between public and private partners; in particular that the public sector carries too much risk, especially in the long-term operational phases of a project as opposed to the first couple of years during which construction takes place.
- 14 Most of the data used in this section are drawn from the Private Participation in Infrastructure (PPI) Database, produced jointly by the Infrastructure Policy Unit of the World Bank’s Sustainable Development Network and the Public-Private Infrastructure Advisory Facility (PPIAF), which is a multi-donor trust fund. The database records contractual arrangements related to infrastructure projects in low- and middle-income countries (as classified by the World Bank), in which private partners assume some degree of operating risk through ownership, finance or operational activities. It focuses on sectors with a degree of monopolistic or oligopolistic characteristics, including energy, telecommunications, transport and water. Such “private participation” should not be equated with private investment in infrastructure. First, it does not necessarily correspond to real investment, as it also includes management and lease contracts, concession projects and divestitures; second, recorded investment refers to what was committed (not necessarily made) for the whole project; and third, when project companies are owned by both public and private parties, the database presents the investment by both parties, not by private investors alone.
- 15 See World Bank (2009). Notable exceptions were middle-income countries, and the ICT and telecoms sector, where private sector finance was more forthcoming.
- 16 For example, the French company, Suez, pulled out of a water concession in Argentina after the peso fell steeply in 2002 and the authorities did not agree to increase charges to offset the devaluation. Largely as a result of the devaluation, there were 28 proceedings against Argentina under the International Convention for Settlement of Investment Disputes (ICSID) by early 2004 (OECD/NEPAD, 2005).
- 17 The other two countries are Mexico and the Russian Federation.
- 18 Of the top five developing countries hosting PPPs, Spain and the United States together account for almost 30 per cent of projects with uniquely foreign sponsorship, potentially reflecting language or proximity factors.
- 19 On the challenges that this may pose to competition policies, see <http://unctad.org/en/Pages/DITC/CompetitionLaw/ResearchPartnership/Contact4114.aspx>.
- 20 A review by the United Kingdom’s National Audit Office (2015) found that private finance deals were charged an interest rate that was double that of all government borrowing. This trend has been consistent over time: in 2010 *Infrastructure UK* estimates that the cost of capital for public funding was 3.9 per cent, compared with costs of up to 6.9 per cent for firms operating in regulated markets (e.g. privatized water or electricity utilities) and 10.9 per cent for firms in unregulated markets (e.g. concessions for user-pay services).
- 21 This has been reaffirmed in the Addis Ababa Action Agenda, which states in its paragraph 75: “Development banks can play a particularly important role in alleviating constraints on financing development, including quality infrastructure investment.”
- 22 Regional development banks with excellent records of credit recovery can have even better ratings than the States that own them.
- 23 This refers to the total multilateral lending by the World Bank, the African Development Bank (AfDB), the Asian Development Bank (ADB), the Inter-American Development Bank (IADB) and the European Bank for Reconstruction and Development (EBRD).
- 24 Since the global crisis, the EIB has played a strong countercyclical role to help sustain income and investment levels across Europe and protect the region’s infrastructure and productive capacity from the effects of the deep economic downturn. The Bank’s provision of finance is enlarged by its leveraging and by combining resources from other sources of financing (e.g. the European Union budget and the private sector), which implies a large multiplier effect (<http://www.eib.org/about/index.htm>, accessed 9 March 2015).
- 25 In 2014, gross disbursements by EIB (\$78 billion) and the World Bank (\$44 billion) were by far the most significant, compared to IDB and ADB (about \$10 billion) and AfDB (almost \$5 billion), as noted in the banks’ annual reports.
- 26 See CAF Factsheet 2014 at: www.caf.com.
- 27 The total assets of the Development Bank of Southern Africa amounted to \$6 billion as of end-March 2014. Those of the West African Development Bank, PTA Bank, Central African States Development Bank and East African Development Bank were \$3 billion, \$2.5 billion, \$0.5 billion and \$0.2 billion, respectively, as of December 2013, as noted in the banks’ annual reports.

- 28 For example, some foreign projects the CDB currently supports include the Las Bambas Copper Mine in Peru, to which it has committed \$3.5 billion (and disbursed \$2.6 billion by the end of 2014), a coal-fired power plant in Bali, Indonesia, to which it has committed \$473 million (and disbursed \$367 million), and the upgrading of the Mansa-Luwingu Road in Zambia, to which it has committed \$175 million (and disbursed \$65 million) (CDB, 2014).
- 29 See <http://www.aiibank.org/>.
- 30 See <http://www.worldbank.org/en/programs/global-infrastructure-facility>.
- 31 See <http://www.worldbank.org/en/news/press-release/2014/07/18/world-bank-group-infrastructure-spending-increases-to-24-billion>.

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