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INTRODUCTION

Ten years after the global financial crisis, UNCTAD estimates that the ratio of global debt to gross domestic product (GDP) was a third higher at the beginning of 2018 than at the start of the crisis in 2007/2008, and roughly four times global GDP[1]. While rising indebtedness is a general and global phenomenon, it is the debt levels of developing countries that have highlighted future debt sustainability vulnerabilities.

In this paper, it is argued that it is only in the context of the conditions and mechanisms created by the global financial system that the increasing indebtedness of developing countries can be understood. While it is generally accepted that the provision of unprecedented levels of liquidity by advanced economies to counter weakness and instability in their economies following the global financial crisis of 2007–2008 sowed the seeds for the next crisis by making portfolio capital flows to developing countries more attractive; the global financial system that created the crisis remains in place and continues to exert its influence over debt sustainability in developing countries.

Monetary expansion, accompanied by private sector deleveraging, weak aggregate demand and volatile financial conditions, did little to help boost private capital formation. The bulk of the newly available credit remained unused or was channelled towards speculative markets. In particular, the lopsided policy response to inadequate demand in the advanced economies made asset markets in developed (and emerging) economies default destinations for international investors seeking higher yields. For some time, this trend encouraged credit expansion in developing countries, appreciated their currencies and propelled commodity prices above the levels justified by market fundamentals alone. These flows have led to increasing indebtedness of developing countries, most notably, emerging market economies, but also some of the poorest countries emerging successfully from the Heavily Indebted Poor Countries Debt Initiative and the Multilateral Debt Relief Initiative, designed to relieve them from unsustainable debt.

In recent years, developing countries have faced renewed financial stress in a context of increased (and, in many cases, premature) connectivity to international financial markets. It could be argued that the constraints imposed by a world with policy parameters shaped by unregulated international financial markets are particularly binding on developing countries. This point of departure acknowledges that developing countries' vulnerabilities are not due to their failure to organize themselves and to create policy space for themselves; they are largely influenced by global trends over which they have little control (Dymski, 2018).

The picture worldwide appears to be one of economic growth that continues to be reliant on debt. This situation is a result of four decades of financial globalization that have undone regulation designed to contain cross-border capital flows, with financial capital chasing existing assets that have little to do with productive investment or employment creation. The returns have increasingly flowed to fewer and fewer multinationals, rather than to households or to the State. Governments have become increasingly diminished in terms of capacity and control, while remaining responsible should debt sustainability become a problem.

While it is unrealistic to expect developing countries to meet their development needs – let alone achieve the Sustainable Development Goals – without recourse to external resources, unregulated capital inflows can lead to exchange rate appreciation, reducing the competitiveness of domestic industry and having

1. See Institute of International Finance (IIF), 2018, Global Debt Monitor Database, July (IFF estimates of global debt stock are based on household, non-financial sector, corporate financial and public sector debt for 72 countries and Tanzi A, 2018, Global debt topped US$247 trillion in the first quarter, IIF says, Bloomberg, 10 July.

The global financial system that created the crisis remains in place and continues to exert its influence over debt sustainability in developing countries.

a negative impact on export earnings. Flows contributing to high levels of indebtedness are associated with increased vulnerability and high precautionary reserve accumulation. These reserves represent forgone opportunities in terms of much-needed investment and social expenditure in developing countries.

The inflows to developing countries over the past decade also represent a rise in the accumulation of private, non-financial, corporate debt. The rise in corporate debt in developing countries in the context of liquidity seeking high yields presents a number of complexities for debt sustainability – the productivity of the inflows is questionable – and, given that such debt is contracted at market rates, its serviceability is unknown. When conditions in advanced countries change, developing countries are likely to experience sudden capital reversals.

In recent decades, some emerging economies, particularly those relying on primary exports or low-skill manufactures, have enjoyed export success. However, this success has, in many cases, come at the expense of economic diversification, a key to growth in the long term. Those economies whose export growth is commodity dependent are now beginning to experience severe price shocks, diminishing fiscal and foreign exchange earnings and slower growth; all of which continue to challenge their debt sustainability.

What developing countries require most is long-term access to foreign demand, and thus reliable export markets to support their emergent domestic growth, and investment to repay external debt.

At the international level, what developing countries require most to help with finance structural transformation is long-term access to foreign demand, and thus reliable export markets, to support their emergent domestic growth, and investment to repay external debt. The challenge for the Governments of increasingly vulnerable economies is finding room to manoeuvre to manage debt sustainably, while ensuring growth-inducing expenditure to enhance development. In this report, it is argued that, within the global financial system, developing countries have a limited number of choices, and that, in the absence of sweeping reform of the global financial system, regional and interregional monetary and financial cooperation and reliance on directed development banking may be a good place to start.

The report is divided into five sections. Section I provides the point of departure for understanding the debt sustainability challenges of developing countries. Section II examines the debt indicators for 145 developing and transitional countries on a regional basis. The data are limited in scope but provide a useful point of departure for forming a picture of debt at the regional level. More specific data for emerging markets as a subcategory of developing countries show increasing exposure of emerging markets to spillover debt from advanced countries. Financialization has not delivered on its promises of growth and, in the context of persistent downward pressure on aggregate demand, income and employment, together with systemic financial fragility and recurrent instability, a new development agenda must be found. Section III introduces elements of a balanced growth strategy and section IV contains discussion of the financial elements that would facilitate such a strategy. In the absence of international commitment to reform the global financial system, second best approaches to pre-empt and circumvent its influence on developing countries must be found. A number of such approaches, including the development of regional and interregional monetary and financial cooperation and an invigorated role for development banks in local development, are discussed in section IV. Section V consists of a brief conclusion.

SECTION I Global trends, financialization and debt sustainability*

Global debt stocks rose from US$69 trillion in 1995 to over US$140 trillion in 2007, and as much as US$247 trillion by early 2018. The indebtedness associated with this global rise in debt stocks between 1995 and 2007 affected all sectors, with the build-up concentrated in households and financial institutions (Kozul-Wright, 2019; United Nations, 2018).

The fragility accompanying the accumulation of trillions of dollars in debt has been compounded by an even larger volume of financial bets through derivatives, and other complex instruments that promised to diminish risk, and were buttressed by the idea that efficient financial markets do not make mistakes. Not only did the profitability of financial institutions rise sharply on the back of this lending activity, but non-financial firms also became increasingly dependent on financial activities for their revenue flows. Governments – whose own revenue flows were being squeezed by a combination of slow wage growth and tax cuts – also increased their lending.

In this new debt-led growth model, it is the financial markets and its associated financial leverage that drive the real economy, evident in changes in consumption and investment trends. Consumption behaviour has become tied to rising asset prices and access to credit, and, at the firm level, rising profits have been channelled towards short-term investments, including buying other companies and their own shares on a massive scale. The mushrooming of mostly short-term, cross-border capital flows from the early 1990s failed to generate the levels of capital formation associated with the 1970s.

Those who promote globalization claim that the spread of competitive markets, increased flows of foreign direct investment and advances in information and communication technology, have, since the collapse of the Union of Soviet Socialist Republics, resulted in a massive increase in global welfare.

Expanding trade and advances in communications have certainly been important in connecting and shrinking the world over the past 30 years, indeed, in making parts of that world more prosperous. However, these were also features of the post-war era of regulated market capitalism and the accompanying pattern of partial globalization. What distinguishes the last three decades of economic change, at the global as well as the national levels, is the dominant role of financial markets, activities and innovation, or what has been termed “financialization”, in generating a “hyperglobalized” world economy (UNCTAD, 2017a).

While there is no simple definition of financialization, commentators point to rising cross-border capital flows, the explosion of bank assets and the increasing proportion of national income accruing to the financial sector. It is a process whereby financial markets, financial institutions and financial elites have gained influence over economic policy and outcomes. It involves a structural shift in the organization of economic activity, along with changes to economic and political behaviour, which together have altered the way in which income is produced, distributed and consumed.

* Section II of the present publication draws on Kozul-Wright, 2019, Development prospects in an era of financialization, in: Bateman M, Blankenburg S and Kozul-Wright R, eds., 2019, The Rise and Fall of Global Microcredit: Development, Debt and Disillusion, Routledge, London: 24–41.

Financialization is a process whereby financial markets, financial institutions and financial elites have gained influence over economic policy and outcomes.

Financial innovation has come to rival technological innovation as a focus for entrepreneurial energies, and the rights of the owners of financial assets have trumped those of other economic actors and have at times escaped social and even judicial accountability. Moreover, the validation of policies (and not just economic policies) seems to come from reference to market interests, measured by performance indicators devised, managed and endorsed by the financial institutions themselves, including stock prices, credit ratings, returns from real estate investments, quarterly earnings, the scale of mergers and acquisitions, etc.

Stiglitz (2016, p. 423) refers to the process by which the financial institutions use their dominance and power to get special treatment from regulators (including bailouts, direct injections, propping up the mortgage market, etc.) as rent-seeking behaviour. The rents extracted are paid out as dividends to shareholders and as bonuses to management, as earned income – rather than investment income – and are ascribed to individual performance. In economies where this has been most extreme, such as the United States of America, 95 per cent of income gains since 2009 have been captured by the top 1 per cent (ibid., 2015, p. 120). This is the world of "superstar" earnings of executives and senior managers where gains from financialized growth spurts and boom conditions have been captured on a scale that would have been impossible, or even conceivable, under more regulated financial structures barely a generation ago (Piketty, 2015).

Rent-seeking corporates intent on predatory extraction have successfully lobbied to influence key national and regional regulatory policy frameworks that affect developing countries.

Financialization has taken place in the context of three decades of "hyperglobalization" – the combined and continuous deregulation of financial, labour and product markets at global levels – that have given rise to structural shifts in the relations between States and large corporations, and a new breed of corporate rentierism (UNCTAD, 2017a). Rent-seeking corporates intent on predatory extraction have successfully lobbied to influence key national and regional regulatory policy frameworks that affect development outcomes – including intellectual property rights, investment policies, taxation issues and, of course, development financing.

Keynes famously anticipated "the euthanasia of the rentier", which he described as "the cumulative oppressive power of the capitalist to exploit the scarcity value of capital", a power which he viewed as functionless. Keynes optimistically assumed that a monetary policy of low long-term interest rates, in combination with a gradual socialization of investment, would create a large enough capital stock to make rental (fixed) income from capital non-viable. However, more recent discourse has identified a new generation of rentiers emerging from the financial sector, in which corporate "looting" is the game in town. The extraction of value and market manipulation of companies by senior management for their own gain has been described at least since the savings and loans crisis in the United States (see Akerlof and Roemer, 1993). There is mounting evidence that firms in developed economies, but also in some emerging economies, are diverting profits away from reinvestment and into dividend payments, share buy-backs and acquisitions in order to raise share prices and reward senior management (Lazonick, 2014; UNCTAD, 2016). Galbraith (2014, p. 160) argues that firms employing predatory strategies "can quickly come to dominate markets, using their apparent financial success to attract capital, boost market valuation, and expand through mergers and acquisitions".

Seen from this perspective, it is possible to describe contemporary financialization as a new mode of social regulation that strives to subject everyone – from pensioners in advanced economies to the 'deserving' poor in developing countries – to the private logic of financial risk management (Storm, 2018). Rather than describing a relatively benign situation where markets have moved closer towards deregulation on some kind of regulation continuum, financialization should be seen as a core obstacle, preventing the recovery of a degree of public policy coordination at the regional, national and international levels, to mobilize both public and private financial resources for structural transformation in developing countries in a stable and reliable manner (Kozul-Wright, 2019).

SECTION II Worsening debt vulnerability of developing countries

Analysis of debt indicators of developing countries is confounded by poor data availability, quality and country coverage of different debt components and debt financing instruments. Improvement of such data remains an urgent priority, not only to better assess the short- and long-term sustainability of developing country debt, but also to improve debt management strategies and facilitate sovereign debt restructurings. This said, the debt indicators currently available for developing countries support the narrative presented in section I in the following ways:

- Debt stocks have grown over 8 per cent per annum over the past decade and now represent more than 25 per cent of GDP for all developing countries. The growth of the indebtedness of sub-Saharan Africa is of concern.
- High accumulated reserves show the vulnerability of developing countries to outflows and represent forgone opportunities to undertake development investment.
- Debt stocks are multiples of export earnings and debt servicing absorbs almost 14 per cent of export earnings on average.
- Private non-financial corporate sector debt makes up an increasing share of debt.
- Growth of developing country regions remains highly variable and on a downward trend.

In aggregate terms, the debt owed by developing countries and countries in transition has grown by 8.5 per cent per annum since 2008–2017. Table 1 shows that debt stocks have grown across the board for developing countries and countries in transition across all regions. The annual growth of debt stocks in the East Asia and the Pacific region (13.5 per cent) and sub-Saharan Africa (9.4 per cent) has outstripped the average annual growth for all developing countries over this period. The former region notably includes China, a country whose share of total developing country debt stock increased from 11.5 per cent in 2009 to 21 per cent in 2017 (United Nations, 2018).

It is notable that the sub-Saharan region includes 30 of the 36 countries that have benefited from the Heavily Indebted Poor Countries Debt Initiative and the Multilateral Debt Relief Initiative. These initiatives have been successful to the extent that they have reduced debt stocks, made debt servicing as a percentage of GDP more manageable and allowed slightly stimulatory GDP expenditure (International Monetary Fund, 2016). While it was always expected that countries emerging from the abovementioned initiatives would grow their debt again – given the realities of their own development demands and low tax bases – the speed with which the debt has grown has outstripped expectations.

Developing countries have expanded and opened their domestic financial markets to non-resident investors, foreign commercial banks and financial institutions prematurely: they have allowed their citizens to invest abroad and, as mentioned, many developing country Governments are engaged in raising finance in developed country financial markets.

The rising indebtedness of developing countries has increased vulnerability and undermined growth prospects – capital inflows have led to exchange rate appreciation, which reduces competitiveness of the domestic industry (Kregel, 2018) and rising reserve accumulation means opportunity forgone in terms of much-needed investment and social expenditure (Elhiraika and Ndikumana, 2007).

TABLE 1

Debt indicators – total external debt stocks,[b] by region

	2014	2015	2016	2017	2008–2017 Annual growth rate	2016–2017 growth rate
	(Billions of United States dollars)				(Percentage)	
All developing countries[a] and countries in transition	**7 266.7**	**6 798.1**	**7 079.0**	**7 635.3**	**8.5**	**7.9**
Sub-Saharan Africa	415.0	432.0	463.9	518.8	9.4	11.8
Middle East and North Africa	189.9	199.1	224.7	255.8	6.2	13.9
South Asia	606.3	636.9	626.7	677.2	8.5	8.0
East Asia and Pacific	2 615.1	2 186.2	2 308.4	2 550.5	13.5	10.5
Latin America and the Caribbean	1 868.9	1 897.3	1 934.9	2 022.2	8.6	4.5
Europe and Central Asia	1 571.4	1 446.7	1 520.4	1 610.9	3.6	5.9
Least developed countries	233.3	247.9	266.9	293.4	7.3	9.9

Source: UNCTAD calculations based on World Bank Group, International Debt Statistics 2018 (online database).
[a] Developing countries as defined by the World Bank.
[b] Total debt stocks include long-term debt, short-term debt and use of International Monetary Fund credit.
[c] 2017 estimates.

Taken together, tables 1 and 2 show that countries in East Asia and the Pacific and in Latin America and the Caribbean hold the greatest aggregate debt of developing regions. However, when compared with GDP, debt in East Asia and the Pacific accounts for a relatively low 17.5 per cent of GDP, but for 34.5 per cent in Latin American and the Caribbean. East Asia and the Pacific (17.5 per cent), South Asia (20.6 per cent) and the Middle East and North Africa (22.4 per cent) are the only regions whose debt to GDP ratio is below the average for all developing countries of 25.7 per cent. The debt to GDP ratios for sub-Saharan Africa, Latin America and the Caribbean and Europe and Central Asia exceed 30 per cent.

The ratios in table 2 reveal that debt stocks are greater than export earnings in all regions (total debt/exports > 100 per cent) except East Asia and the Pacific (including China) and the Middle East and North Africa. While, on average, the debt servicing to exports is 13.6 per cent for all developing countries, it is 10 per cent or higher for low-income developing countries and sub-Saharan Africa, and above 20 per cent for Latin America and the Caribbean and for Europe and Central Asia.

For all regions, reserves are close to, or more than three times higher than, short-term debt stocks. High reserve levels are a consequence of several factors but can be seen as a precaution against hot flows out of a country leading to currency crises. The level of reserves reveals the perception of risk and the extent to which policies in a given country are dominated by short-term concerns about "firefighting" immediate liquidity constraints and by the diversion of much-needed development finance to hedge against such liquidity risks through the build-up of substantive international reserves (Blankenburg, 2018).

The level of reserves reveals the perceptions of risk and the extent to which policies in a given country are dominated by short-term concerns about "fire-fighting" immediate liquidity constraints.

There is some speculation as to whether developing countries are holding excessive reserves (see, for example, Elhiraika and Ndikumana, 2007; Park and Estrada, 2009; Dadush and Stancil, 2011) but, in all cases, they represent costs to the countries involved. These reserves could, at the very least, be invested more actively, but importantly, they could also be more effectively spent on investment and social needs.

TABLE 2

Debt ratios by region, 2017 (Percentage)

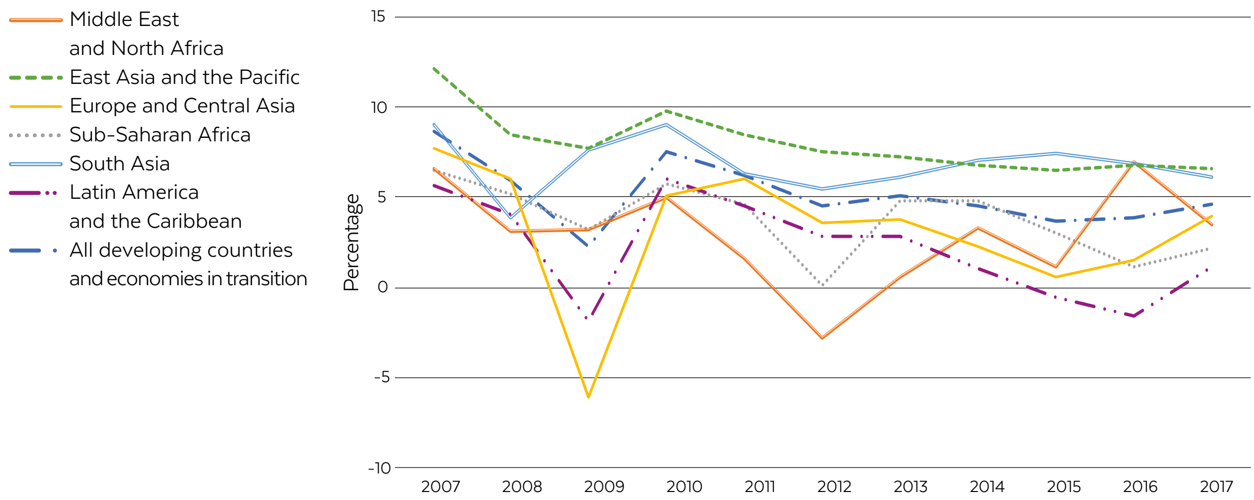
Debt indicators	**All**	**Sub-Saharan Africa**	**Middle East and North Africa**	**South Asia**	**East Asia and the Pacific**	**Latin America and the Caribbean**	**Europe and Central Asia**	**Low income countries**
Total debt/GDP	**25.7**	31.7	22.4	20.6	17.5	34.5	49.4	28.1
Total debt/exports	**109.9**	137.3	92.9	115.5	71.8	175.9	159.8	138.8
Debt service/GDP	**3.2**	2.5	1.9	2.9	1.7	5.0	7.5	2.0
Debt service/exports	**13.6**	10.8	8.0	16.2	7.0	25.5	24.2	10.0
Reserves/short-term debt	**339.9**	292.5	733.4	390.5	343.0	292.7	288.5	445.3

Source: UNCTAD calculations based on World Bank Group, International Debt Statistics 2018 (online database).

Figure 1 provides an aggregated view of growth for all developing countries and by region. The swings in the data from year to year suggest exposure to external shocks associated with export prices, cross-border capital flows and external debt service burdens, which are largely determined by policy decisions in advanced economies. There is little evidence that developing country reliance on financial and trade openness has generated the higher growth paths promised: instead, the data suggest gradual convergence to lower, rather than higher, growth rates for developing countries.

FIGURE 1

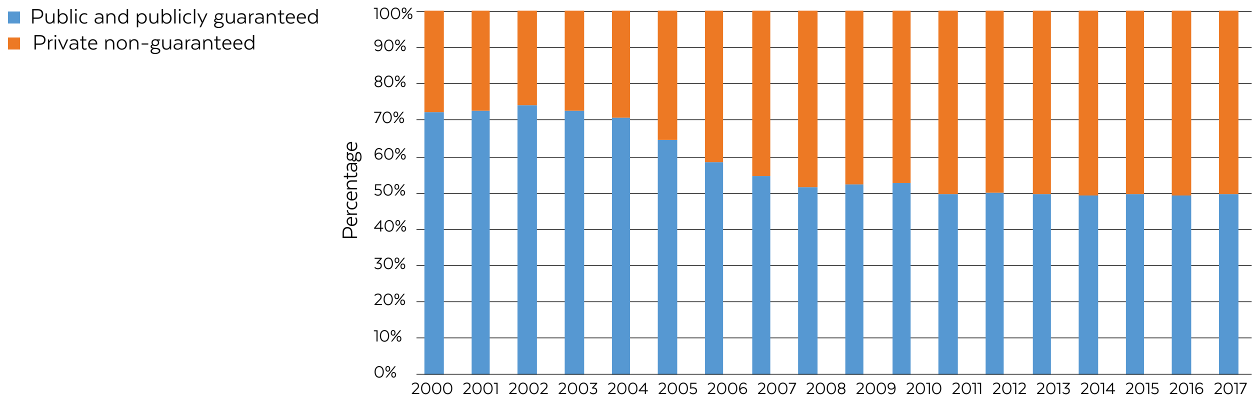
Growth rates of developing countries



Source: UNCTAD secretariat calculations for country aggregates, based on GDP at constant 2010 dollars;

FIGURE 2

Shift from public to private long-term debt[a]



Source: UNCTAD secretariat calculations, based on World Bank international debt statistics data.

[a] Long-term external debt composition: all developing countries and economies in transition.

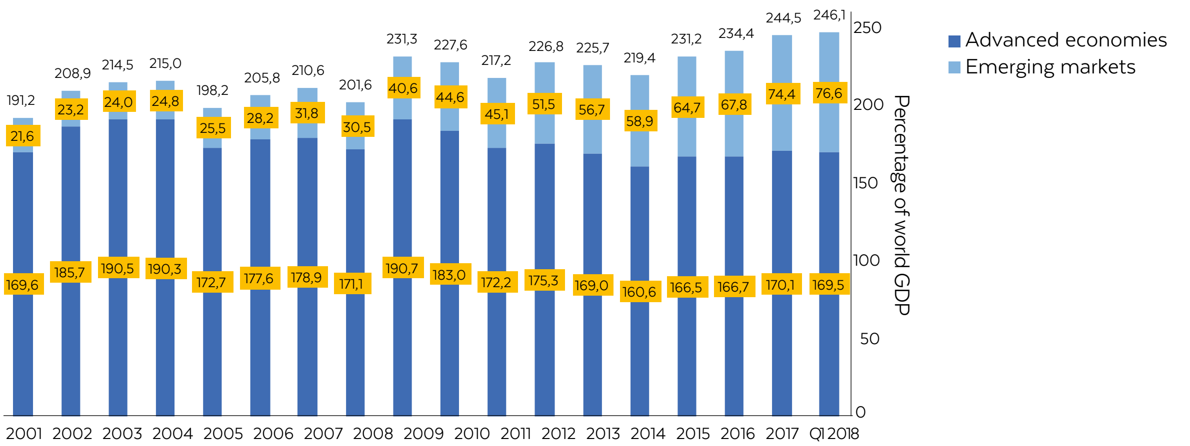
With financial globalization, economists have stressed the importance of "push factors" – mainly changes to global liquidity and risk – as the main determinants of surges and reversals in capital flows, giving "pull factors", i.e. country-specific factors and demand, only a secondary role. Global factors act as "gatekeepers", whereas "pull factors" – in particular, the foreign exchange regime – explain different degrees of exposure to changes in global conditions and the final magnitude of the surge in particular countries (Fernández-Arias, 1996; Cerutti et al., 2015).

As global debt stocks of developing countries have risen, the composition of long-term debt has changed. Data for long-term debt – defined as debt that has an original or extended maturity of more than one year and that is owed to non-residents by residents of an economy and repayable in foreign currency, goods or services – is typically divided into public (and publicly guaranteed) debt and private debt. Figure 2 shows that public debt clearly outstripped private sector debt at the turn of the century, but the private debt share has gradually increased, meaning that, by 2008, the two types of debt were at roughly the same level and have been ever since. Private sector debt of all developing countries, including China, amounted to 53.4 per cent of total debt stocks in 2017; with China excluded, that figure stands at 50 per cent.

In figure 3, private non-financial corporate debt is displayed as a growing share of world GDP since 2000. In particular, non-financial corporate debt in emerging markets rose to above 40 per cent of world GDP in 2009 and has grown steadily ever since (see figure 4). By the first quarter of 2018, private non-financial debt in emerging markets had grown to 80 per cent of global GDP. This emphasizes the extent to which emerging market have absorbed liquidity and grown their debt relative to advanced countries, whose non-financial debt has declined to some extent since 2009, when it peaked at 190 per cent of world GDP, to nearly 170 per cent of world GDP by the first quarter of 2018.

FIGURE 3

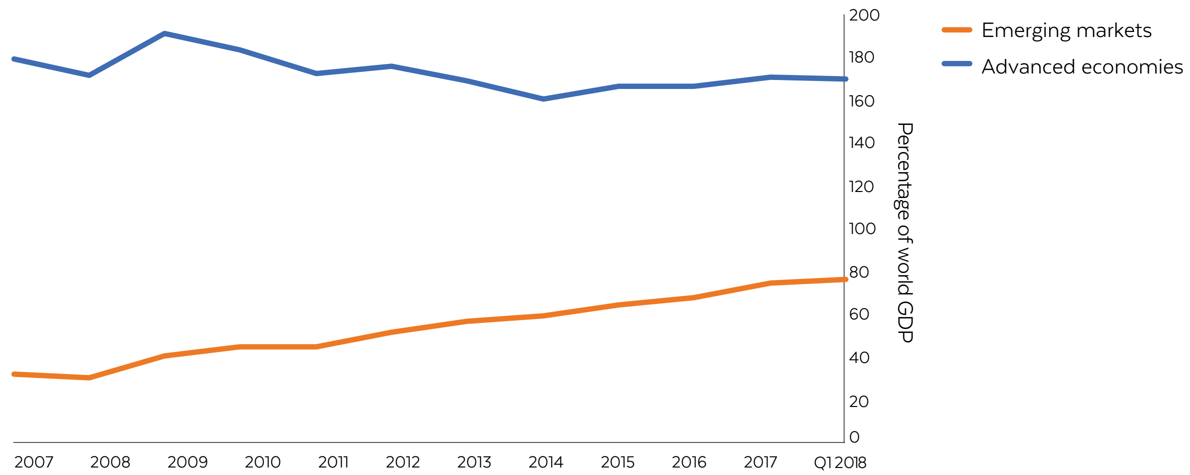
Non-financial corporate debt[a] has been rising…



Source: UNCTAD calculations, based on Bank for International Settlements data.
[a] Global debt level calculated based on credit to non-financial sector from all sectors and credit to general Government at market value.

FIGURE 4

…and accruing to emerging market economies[b]

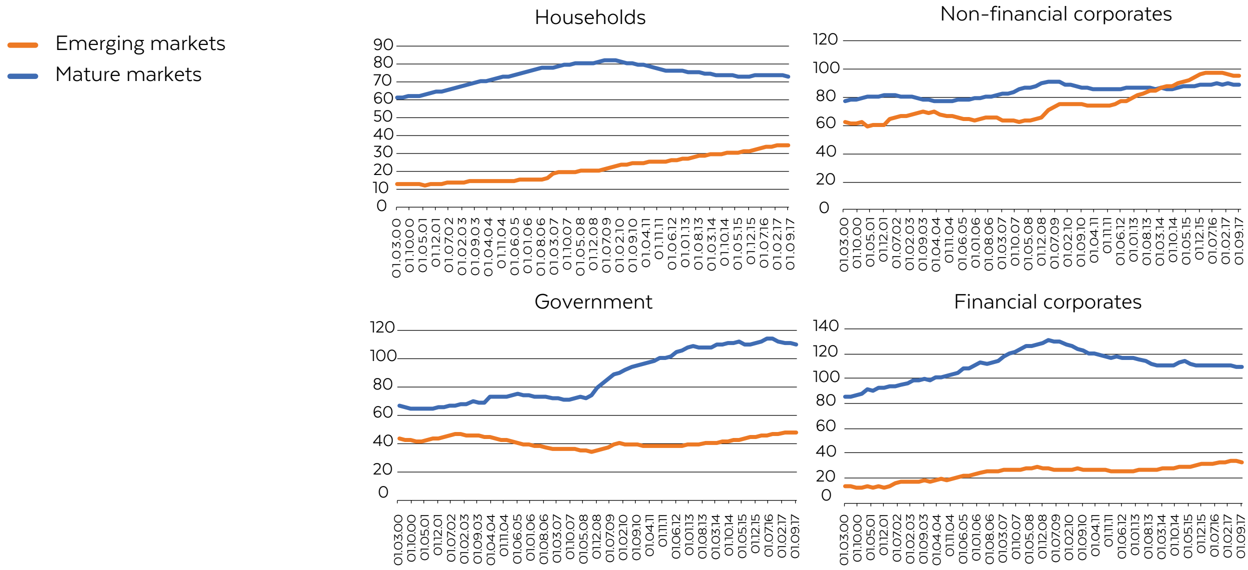


Source: UNCTAD calculations, based on Bank for International Settlements data.
[b] Credit to non-financial sector from all sectors at market value.

A sectoral breakdown of the data for advanced (or mature) economies and emerging economies in figure 5 provides additional information. For emerging economies, all sectors of the economy – households, the non-financial private sector, the government sector and the financial sector – show an increase in the ratios of debt stocks to GDP over the past 17 years.

FIGURE 5

Debt by sector: Advanced and emerging market economies



(Percentage of GDP*)

Source: Bank for International Settlements data and Global Debt Monitor, 2018.
* Sectoral aggregates debt, using GDP-weighted averages.

The data in figure 5 support the narrative of the vulnerability of emerging markets to the conditions in advanced economies and the associated spillover. The data show increasing indebtedness of all sectors of the population, and the "business of debt" that permeates all the activities of households and firms. Falling wages for workers, and the loss of development-banking capacity to support enterprise, both associated with increasing financialization, have made increased debt a necessity for an ever-larger share of economic units. This is especially apparent in sectors where there are significant development needs and relatively few functional social support structures, such as households in emerging markets, compared to mature markets.

Taking the global financial crisis as a marker – and examining the data from the end of 2007 to the end of 2016 – it is perhaps not surprising that the debt ratios of households and the non-financial corporate sectors in emerging markets both rose substantially over the decade, by 69.6 per cent and 54.6 per cent, respectively.

The rise in corporate debt in emerging markets in the context of liquidity seeking high yield presents a number of complexities for debt sustainability: the productivity of the inflows is questionable and, given that such debt is contracted at market rates, its serviceability is unknown. When conditions in advanced countries change, emerging markets economies are likely to experience sudden capital reversals (Schanz, 2018).

By contrast, the household debt ratio in mature economies declined marginally (by 8 per cent) and increased only modestly for the non-financial corporate sector (by just under 5 per cent). More recently, this situation has changed for the worse, with the Federal Reserve Bank expressing concern at the fact that the credit standards of non-financial corporates have deteriorated as their share of borrowing has grown, indicating potential fragility going forward (Wall Street Journal, 2018).

The data for the government and financial sectors in mature markets shown in figure 5 also reflect what is known about the global financial crisis. Financial sector debt was at its highest at the onset of the financial crisis in 2007, and declined steadily as the government sector took on an increasing debt burden. By the end of the decade, the government debt ratio had risen by more than 56 per cent for mature economies (associated with bank bailouts and quantitative easing), while the debt of the financial sector in mature markets is some 10 per cent lower as a share of GDP than it was at the start of the crisis. By contrast, government and financial sector debt in emerging countries grew by a relatively more modest 31 per cent and 24 per cent, respectively.

These data suggest that financialization has not delivered on the promises of financial openness, deregulation and "market discipline" that its proponents would have people believe. The implementation of a balanced growth strategy is necessary if developing countries are to grow, be able to sustain useful levels of debt, meet their peoples' basic social needs, and become more resilient and less vulnerable to the vagaries of the monetary and financial manoeuvrings of financial players and corporate rentiers in advanced countries.

Financialization has not delivered on the promises of financial openness, deregulation and "market discipline" that its proponents would have people believe.

SECTION III Global economic environment, balanced growth and debt sustainability

A more balanced growth strategy in developing countries inevitably implies using a wide range of policy instruments to manage internal and external integration. Policy space is, therefore, critical. UNCTAD has been concerned for some time about how policy choices, often promoted as the irresistible consequence of globalization, have been reducing that space. To counter this trend, the developmental State has a key role in guaranteeing and employing the policy space needed to manage integration in a way that is sustainable and inclusive (Kozul-Wright, 2019).

The slow growth that has accompanied financialization reflects persistent downward pressure on aggregate demand, income and employment, combined with systemic financial fragility and recurrent instability. Raising aggregate demand is, from this perspective, a policy priority for the short term and the long term, with investment demand playing a key bridging role, combined with the reform of a financial system that has become obsessed with short-term, rent-seeking behaviour.

Policy prescriptions can be grouped along three fronts:

- First, boosting effective demand: If maintained for a sufficiently long period and calibrated towards expenditures with the greatest impact, expansionary fiscal policy can have a substantial and self-sustained effect on rising consumer and investment demand. In the process, government revenues will rise and the pace of public spending could be eased as private spending resumes. Credit expansion should also be channelled towards sustaining real investment.

- Second, boosting labour incomes: labour incomes need to be boosted so that households can sustain a higher level of consumption without adding to household debt. This will include raising the minimum wage to correct for real declines over the past decades, aligning average wage rises with productivity growth and expanding training and higher education programmes.
- Third, financial reform and reregulation: the need for reform to ensure that financial markets better serve the real economy by realigning incentives, clamping down on toxic financial products, curtailing the power of bloated financial institutions and reregulating areas that have been left to the markets, and strengthening the enforcement and supervisory role of regulators.

A balanced growth strategy requires policies that boost effective demand and labour incomes, and which reform and re-regulate finance.

Recognizing that the main obstacle to sustained growth presently lies on the demand side should not lead to a disregard of the need to expand and modernize production associated with supply side "structural" policies. Some policies aimed at enhancing demand are structural in nature, for instance: strengthening social security systems; creating minimum income schemes; introducing more progressive taxation rules; improving labour rights; and establishing wage negotiations procedures. In addition, these policies encourage real investment because they provide firms with a long-term expectation of expanding demand, without which they would not have the incentive to invest. Conversely, some supply side policies aimed at expanding the profitability of firms and, consequently, their investment (for example, wage compression) have negative impacts on demand and, therefore, on investment decisions. Ignoring the linkages between supply and demand policies may, therefore, lead to self-defeating outcomes.

Raising aggregate demand requires that spending programmes in support of development be properly financed using multiple sources. The availability of sufficient appropriate financing instruments and capacity is a potential constraint. However, a more fundamental issue is that of putting that capacity into the hands of agents wishing to undertake long-term investment projects that generate large positive externalities and therefore encourage rising productivity and incomes and induce further investments.

In order to avoid the risk of government spending creating sovereign debt pressures, debt financing should be limited in the medium term to the level of expenditure for public investment. Borrowing in a foreign currency, in turn, should be limited to meeting a country's actual foreign exchange needs (for capital goods, materials, technology, etc.) or for necessary foreign exchange reserves. Caution is the key word.

While bank credit is another major instrument to finance investment, private banks are seldom willing to undertake the risks associated with large-scale projects of long maturation.

By contrast, development banks are, by design, appropriate institutions to provide long-term finance and to address market failures. They have a clear mandate to support developmentally oriented projects, a funding base whose liabilities are predominately long term and equity, which is for the most part owned by highly rated sovereigns. For this reason, development banks are able to borrow long term in the international financial markets at relatively low costs (Kozul-Wright, 2019).

As is clear from the discussion above, debt sustainability of developing countries is hardly in the hands of the affected sovereigns. In an environment of fragility and spillovers, things can turn ugly against the backdrop of falling commodity prices and weakening growth in developed economies. If monetary policy decisions in advanced economies suddenly drive up borrowing costs, debt burdens that seemed reasonable under favourable conditions can quickly become unsustainable debt in emerging markets and other developing countries. The procyclical nature of capital flows – cheap during a boom and expensive during downturns – is not the only drawback. Once a crisis looms, currency devaluations to improve export prospects simultaneously increase the value of foreign currency denominated debt. For commodity exporters, the need to meet rising debt servicing requirements also generates pressures to continue to produce, potentially worsening excess supply constraints and downward pressures on commodity prices (Akyüz, 2016).

In this environment, debt sustainability is largely about the perceived fragility of developing countries and their ability to withstand external shocks. Scaling up of development finance efforts is, therefore, closely linked to the need to reduce, as much as possible, the exposure of developing countries to external shocks, cross-border capital flows and external debt service burdens.

SECTION IV Development finance and addressing the challenges posed by debt sustainability*

An alternative agenda for improving conditions and policy space for developing countries to better manage demand – and, in turn, debt sustainability – must roll back some of the destructive outcomes of global financialization and corporate rentierism.

The urgency of the problem is apparent when considering the financing gap for development financing. Estimates for financial shortfalls to deliver the Sustainable Development Goals for basic infrastructure, food security, climate change mitigation, health and education suggest an average annual shortfall of US$2.5 trillion, given current investment levels (UNCTAD, 2014a).

It is crucial to strengthen domestic public policy spaces and capacities in developing countries to raise domestic public funds and ensure that both domestic and foreign private capital are reliably channelled into developmental investment projects whose short-to-medium term private profitability is uncertain (Blankenburg, 2019). The quest is not for just any private capital, but "patient" capital. One of the concerning features of recent surges in private non-financial corporate flows to emerging market countries is that it does not, by and large, service productive investment needs (UNCTAD, 2015).

In the absence of an international monetary and financial system supportive of developing countries' attempts to mobilize development finance, developing countries will have to prioritize South–South financial and economic cooperation and ensure that local, national and regional policy initiatives are connected and coordinated to limit the counterproductive influence of global financialization. While

* Section V of the present publication draws on Blankenburg, 2019, Delivering development finance in 'the time of cholera': a 'bottom-up' agenda for pro-development financial resource mobilization, in: Bateman M, Blankenburg S and Kozul-Wright R, eds., 2019, The Rise and Fall of Global Microcredit: Development, Debt and Disillusion, Routledge, London: 255–277.

this may be a second best (bottom-up) option to sweeping pro-development reform of the international financial system, its strengths lie not only in beginning to scale up productive development finance, but also in eventually forcing international economic governance reform back onto the multilateral agenda (Blankenburg, 2019).

Ocampo et al. (2007) provide a reminder that a viable development financing agenda requires two essential components: effective domestic resource mobilization and a system of international trade inclined towards development. In the following sections, these are discussed in turn and then a third and a fourth alternative – regional payments and clearing systems and multilateral development banks – are examined.

A. "Leveraging" private finance for development: the domestic "profit-investment" nexus

A viable development financing agenda requires effective domestic resource mobilization and a system of international trade inclined towards development.

While there is no disagreement over the fact that private capital should be mobilized to co-finance development, the question is how best this is to be achieved. "Blended" development finance has emerged as part of the donor discourse fairly recently and became an integral part of the Addis Ababa Action Agenda of the Third International Conference on Financing for Development (para. 48). Blended finance refers to the use of international public finance, including official development assistance, to "leverage" (primarily) private finance for developmental projects. There are many variants including, private sector instruments – such as public loan guarantees, public–private partnerships, investment grants, technical assistance, equity investment and first-loss-for-public-sector-entities policies. All are meant to promote fair risk- and cost-sharing. However, it is not clear what "fair" means in this context, nor whose considerations dominate. The literature increasingly shows that the effectiveness and the actual developmental impact of such financing tools are contested.

A recent Organization for Economic Cooperation and Development survey of blended finance instruments found that these had mobilized an estimated US$81.1 billion of private capital between 2012 and 2015, a far cry from the estimated annual financing gap for the Sustainable Development Goals. Government guarantees, that essentially shift the bulk of risk from private to public entities, represented almost half of the [private sector instruments] used (Benn et al 2017). In the absence of an agreed public framework for the appropriate design of "blended" financing instruments for development – including, for instance, mechanisms that would reliably tie private capital into high-risk transformational investment projects for the long term, as well as more systematic evaluations of their actual developmental impacts – there is little to give comfort that blended finance will deliver even some of its promises. This is even more the case where these subsidies go to large corporations, given a long history of such corporations having benefited from public subsidies in advanced economies without obvious benefits to taxpayers (UNCTAD, 2017a).

An essential task of domestic resource mobilization in developing countries is to establish a robust domestic "profit–investment" nexus that promotes a dynamic interaction between private profit expectations, actual investment, realized profits and consequent growing retained earnings (UNCTAD, 2016, chapter V): High expected profits incentivize firms to invest and, if realized in the markets, simultaneously increase their capacity to finance future investment out of retained earnings… if policies aimed at lowering the private costs of private investment (through the subsidies implied in blended finance structures), lead to a fall in aggregate demand (for example, through downward pressure on wages, or public finances being depleted by these costly subsidies), this will put a damper on private profit expectations, and therefore private investment, however low the private costs associated with a particular investment project may be. Advanced economies are testimony to a decade of low and negative interest rate policies that have resulted in high (financial or speculative) profits but falling (real) investment (Blankenburg, 2019).

From the perspective of financial resource mobilization, a domestic banking system that can manage the targeted provision of credit money to the private sector – as well as to the public sector for large-scale public investment in core infrastructural projects that yield potentially high social returns in the long term (even if short-term private profitability is highly risky) – is essential to promote a domestic "profit–investment" nexus.

A fit-for-purpose financing for development agenda involves well-planned public investment in essential infrastructure to create productive links with domestic private investment projects - a "profit-investment" nexus.

Rather than relying passively on offering irresistible deals to large corporations in the hope that primarily foreign corporate savings will – somehow – be invested productively in long-term developmental projects, a fit-for-purpose financing for development agenda must take on board the need to actively support the emergence of a virtuous "profit–investment" nexus in developing economies. Well-planned public investment in essential infrastructure to create productive links with domestic private investment projects and through the creation of temporary learning rents for dynamic domestic firms (see for example, Khan, 2013) may well do more to lower uncertainty and crowd-in investment than attempts to attract foreign investors.

While foreign corporate capital may need to be mobilized, the essential task of developmental "financial risk management" is to ensure that this capital can be reliably tied into long-term developmental projects, for example, through "blended" financing instruments that include enforceable contractual obligations for multinational enterprises to reinvest (at least a substantial share of) their profits in these projects over long periods. Hence, tax-related illicit financial outflows, such as tax evasion and profit shifting, need to be closely monitored. At present, for example, Africa loses US$50 billion per year to illicit financial outflows, the bulk of which are attributable to profit shifting and abusive tax practices by multinational enterprises African Union/Economic Commission for Africa, 2014). At the same time, total foreign direct investment into Africa has amounted to only marginally higher figures of US$60–US$70 billion over recent years.[2]

2. See http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=96740 and UNCTAD World Investment Report 2017: Investment and the Digital Economy. Regional fact sheet: Africa. Available at https://unctad.org/Sections/dite_dir/docs/WIR2017/wir17_fs_Africa_en.pdf.

B. An international trade system that inclines to towards development

Ideally, a development-friendly international monetary system should ensure that high-productivity surplus economies systematically "recycle" their surpluses to lower-productivity countries by adopting expansionary policies at home to stimulate domestic demand for imports from lower productivity deficit economies, by investing into these economies and by lending to them on reasonable, or even concessional, terms.

In many ways, this was the ideal pursued by the negotiators of the London Agreement between Germany and its creditors in 1953 (UNCTAD, 2015, p. 134). While the London Agreement was a debt relief arrangement, the notion that there could be a coordination of the surplus and deficit countries was implicit in the original conceptions of the Bretton Woods institutions (Kregel, 2018, p.

89). The wider implication is that such a system would have to sustain significant macroeconomic imbalances that allow domestic development strategies to progress and, at a minimum, to generate the export earnings needed to meet external debt obligations.

As with the domestic “profit-investment” nexus, a development-friendly global “trade–money” nexus – and, more broadly, “surplus recycling mechanism” – does not emerge spontaneously. Rather than the long-term public management of private risk that, as has been argued, is essential to promoting the emergence of a domestic “profit–investment” nexus in developing countries, public “risk management” of a global “trade–money” nexus requires direct policy coordination and political cooperation between nation States.

In a hyperglobalized “market” economy with floating exchange rates and open capital accounts, there is no mechanism to ensure a development-friendly global “trade–money” nexus emerges. Rather, if there is no adjustment in the rest of the world to allow a borrower country an increasing deficit, the adjustment can only take place through reductions in the level of income in the borrower country, and ultimately, the world economy. In the absence of a coordination of policies between deficit and surplus countries, the system promotes instability (Blankenburg, 2019).

C. Regional payment systems and clearing unions: Harnessing the power of credit creation

Since the creation of the Bretton Woods system, there have been critics of what has been described as an internal contradiction: the use of a national currency – the United States dollar – as the basis of international settlement. Instead, it has been argued that the use of special drawing rights would be a better alternative or, failing this, an International Monetary Fund that operated on a regional basis – as then it would better represent the interests of developing countries and have more sensitively designed policies (Kregel, 2018, p. 59). The key aim here would be to strengthen macroeconomic stability in the region, create monetary buffers to exogenous shocks and provide access to countercyclical liquidity and the promotion of intraregional trade outside the dollar hegemony.

The kinds of arrangements and policies that would achieve this stability range from regional swap arrangements to bridge immediate liquidity constraints and reserve funds with a wider remit to mitigate medium-term balance of payment problems, to regional payment systems and clearing unions. The latter would need to build on agreements, usually between members’ central banks, to extend credit to each other’s central banks through the regular offsetting of accumulated (trade-related) debts and credits between member States, rather than reserve-pooling. Such arrangements essentially serve the purpose of providing some respite from exposure to destabilizing global – capital flow and trade – shocks largely emanating from policy decisions in advanced economies.

In principle, regional payment systems that use some form of internal clearing mechanism can serve differing purposes, depending on their design. They can simply be limited to reducing the transaction costs of domestic enterprises by allowing such firms, in the participating countries, to settle their transactions with counterparts in their domestic currencies, thereby promoting bilateral or regional trade. A recent example is the Local Currency Payment System (or Sistema de Pagos en Monedas Locales, SML) between Brazil and Argentina in 2008. More ambitiously, regional payment systems can shield participating countries from a drain on their foreign reserves in times of crisis, by providing temporary liquidity within the clearance period, extending credit lines beyond the clearance period, and allowing for final settlement in national currencies rather than the [United States] dollar. The Asian Clearing Union (1974), while making the choice of currency for final settlements optional, is an example. Finally, regional clearing unions can also leverage the power of credit creation to systematically coordinate adjustment between deficit and surplus economies within a region through the automatic extension of credit, thereby shielding the entire developing region from the fickle short-term rentierist capital inflows from outside the region.

In practice, regional payment systems and clearing unions have a long history of facilitating financial resource mobilization for catching-up development, if only temporarily. Since the 1960s and 1970s, regional payment unions were promoted for developing countries by UNCTAD (Kregel, 2018) and sprang up, in various forms, including the Central American Clearing House (1961), the Latin American Integration Association or Payment[s] and Reciprocal Credits System (LAIA) (1965), the CARICOM (Caribbean Community) Multilateral Clearing Facility (1977), the West African Clearing House (1975), the monetary arrangement under the Economic Community of the Great Lakes Countries (1978), the Central African Clearing House (1979), the Clearing House of the Common Market for Eastern and Southern Africa (COMESA) (1981), the Regional Cooperation for Development and Union for Multilateral Payment Arrangements (the Islamic Republic of Iran, Pakistan and Turkey, 1967) and the Asian Clearing Union (1974). Many of these arrangements went into decline in the 1980s and the 1990s, in part because participating central banks met with payment difficulties in the wake of major debt crises, and in part because financial deregulation in advanced economies promised the lure of cheap(er) credit to be obtained in international financial markets.

Regional payment systems and clearing unions can function to strengthen regional macroeconomic stability, create monetary buffers to exogenous shocks and provide access to countercyclical liquidity and the promotion of intraregional trade.

A core policy tool to achieving regional monetary integration is the use of a non-tradable regional unit of account that promotes intraregional trade by allowing accumulated credits within the regional clearing mechanism to be offset against debits only through imports from or foreign direct investment in member States, at fixed intraregional exchange rates with the regional unit of account (Kregel, 2015; 2018; see also Keynes, 1973, for the original blueprint of a global clearing union). This has also been termed a “surplus recycling” mechanism. A key constraint to achieving this mechanism is the degree of intraregional trade. For example, a number obvious regional groupings, such as Brazil, the Russian Federation India, China and South Africa (BRICS), the Southern Common Market (MERCOSUR, including Argentina, the Plurinational State of Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Suriname, Uruguay and the Bolivarian Republic of Venezuela) and the Association of Southeast Asian Nations (ASEAN, including Brunei, Cambodia, Indonesia, the Lao People’s Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore and Thailand) could very well benefit from clearing, but the relatively low share of intragroup trade in potential member States’ global trading balances poses perhaps the most obvious difficulty for the immediate effectiveness of clearing to promote regional development (Kregel, 2018, pp. 80–87). However, the purpose of fully fledged regional clearing unions is precisely to increase intraregional trade, such that trade patterns change. For regional clearing unions to function properly in the interest of freeing up their own financial resources and policy space to pursue national development strategies, there also has to be the political will and insight, among developing country Governments, to put regional before national developmental interests, in the understanding that reverse priorities will, ultimately, undermine isolated national development strategies in a hyperglobalized world economy that puts corporate rentierism before development (Blankenburg, 2019).

D. South–South multilateral and national development banking

New South-South multilateral development banks can be supportive of smaller and low-income developing countries that lack the clout, productivity potential and domestic market scope to access subsidized loans.

The recent emergence of multilateral development banks in the global South – the New Development Bank of the BRICS countries (Brazil, the Russian Federation, India, China and South Africa), the Asian Infrastructure Investment Bank and the Bank of the South – including Argentina, the Plurinational State of Bolivia, Brazil, Ecuador, Paraguay, Uruguay and the Bolivarian Republic of Venezuela – can be seen as a direct response to the failure of the current global economic system to mobilize development finance in the financial markets or through comprehensive multilateral engagement. These South–South multilateral development banks have considerable potential to scale up development financing, in particular in the crucial area of large physical (but also environmental and social) infrastructure projects of cross-national and cross-regional scope. They can do so by making use of their own funding sources – such as the large amount of foreign reserves held by China and other emerging economies, and that are partly placed in sovereign wealth funds and currently invested in low-yield assets from developed countries – and by leveraging both private as well as other public finance to channel this into long-term (infrastructural) development projects. In this latter regard, they have a key role as potentially powerful brokers between diverging short-term private profit interests, national developmental interests and wider transformational investment into a developmental infrastructure for the global South. Their main "asset" is not only having their own funding, but their knowledge of and consequent ability to assess specific risks to private and other public investors reliably as well as to provide adequate financing instruments to circumvent or mitigate these risks (Blankenburg, 2019).

The new South–South multilateral development banks that have been in operation only for a couple of years face the formidable challenge of having to establish themselves in international capital markets and, thus, to demonstrate their capacity for high standards and safeguards in project selection and lending, while also meeting the imperative for large, rapid and effective loan disbursements that 'crowd in' private and other public investment (Kozul-Wright and Poon, 2015). Multilateral development banks also face a radical call from the Group of 20 Eminent Persons Group on Global Financial Governance (2018) to shift their basic business model from direct lending towards risk mitigation with a view to mobilizing private capital. In its report, the Eminent Persons Group postulates that, once the multilateral development banks have created a large-scale asset class, crowding in of commercial banks loans and green bond issuing will be encouraged (ibid., p. 42). A key mechanism by which this can be achieved in the view of the Eminent Persons Group is to securitize existing multilateral development bank assets (loans) into tranches that appeal to different categories of investors, thereby allowing for a rerating of these assets (at considerable cost in fees and interest paid to the financial sector). Like the exercise of blended finance, this proposal is likely to generate greater financial fragility and lack of transparency. South–South multilateral development banks should resist this call and stick to basic development banking practices. Instead, the new South–South multilateral development banks can be supportive of smaller and low-income developing countries that lack the clout, productivity potential and domestic market scope to access subsidized loans for the long-term financing of their development. Larger developing countries as well as industrializing and, later on, war-ridden European economies, have benefited enormously from the operations of their own national development banks. In Germany, universal banks were crucial in helping to mobilize long-term finance for industrialization projects. While these were private banks, they worked closely with the German central bank (the then-Reichsbank) to obtain liquidity support when needed, and thus acted as an instrument of the State (UNCTAD, 2015).

Successful examples of national development banks which became central players in State-led development strategies across developing countries in the 1960s and the 1970s include Brazil, Turkey and China and the East Asian tiger economies. They were essential in facilitating rapid capital accumulation and productivity growth in the crucial initial phases of late industrialization, helping to promote a viable "profit–investment" nexus, and remained important to ensure that initial successes were sustained through well-planned technological upgrading later on. While subsequently they went into decline in tandem with the implementation of the Washington Consensus of the 1980s and 1990s, new development banks have emerged again in many developing countries since (Gottshalk, 2016).

For many years, the dominance of financial markets and financialization has pushed to the side-lines the understanding that the architecture and character of a country's financial system matters for its long-term growth and development. An important task for the new South–South multilateral development banks is to promote viable national financial developmental architectures and to facilitate cooperation between these, at regional levels and beyond (Blankenburg, 2019).

SECTION V Conclusion

At present, regional and interregional monetary and financial cooperation between developing countries is the most realistic way forward with regard to stemming the corrosive influence of corporate profiteering and financialization on development financing and, hence, debt sustainability. Unless a new path is found for developing countries, debt sustainability will remain a burden that weighs on balanced growth and development. While this is far from a perfect solution and one that requires cooperation at the regional level, the proposals set out in the present paper have a history and a wealth of accumulated national, local and regional experience, in both developing and developed countries. Their potential lies not in simply trying to replicate specific features of past successful financial architectures to raise development finance, but in creating a dense and flexible network of local, national and regional State-led financial institutions in developing countries that can deliver credit and finance for development -under public control- that offers an alternative agenda to address the challenges of debt sustainability.

A dense and flexible network of local, national and regional State-led financial institutions in developing countries can deliver credit and finance for development -under public control- to address debt sustainability.

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