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Improving all forms of cooperation and partnership for trade and development with a view to accomplishing the internationally agreed development goals

Note by the UNCTAD secretariat

Executive summary

This note reviews the prospects for improving all forms of international cooperation and partnership for trade and development with a view to accomplishing the Sustainable Development Goals and the post-2015 development agenda. It first takes stock of the challenging global economic climate and how developing countries and countries with economies in transition face serious threats to their economic stability, resilience and prospects for inclusive growth. The note then explores how macroeconomic policies can help build resilience and enhance development in both the short and long terms, better enabling countries to weather economic crises, ensure macroeconomic stability and use industrialization to enhance long-term resilience in ways that generate inclusive development. A central focus of the discussion is on how collaboration, particularly among countries of the South, can enhance these capacities and directly contribute to achieving the Sustainable Development Goals, particularly Goals 8, 9 and 17.

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Introduction

1. Given the increasingly volatile economic conditions that have characterized the global economy and the continuing failure of developed countries to fully emerge from the great recession, developing countries face serious threats to their economic stability and resilience. These threats could compromise long-term growth prospects as well, and seriously challenge the viability of the Sustainable Development Goals and the post-2015 development agenda.

2. The fourth session of the Multi-Year Expert Meeting on Promoting Economic Integration and Cooperation will be invited to consider these threats and challenges from the perspective of South–South cooperation and how collaboration and the identification of best practices can help build capacity to weather economic crises, ensure macroeconomic stability and enhance long-term resilience in ways that also generate inclusive growth and end poverty.

3. Macroeconomic policies can help build resilience in both the short and long terms. In the short term, countercyclical monetary and fiscal policies, as well as financial policies designed to blunt the destabilizing effects of capital flows, are essential tools for countering external shocks. In the long term, industrialization and diversification can serve to increase both macroeconomic stability and resilience, but require industrial policy and the building up of institutional capacities to fulfil the development promises of structural transformation. In this context, there are a wealth of lessons to be drawn from past experiences in developing countries, both successful and not. There are also many opportunities to collaborate in ways that substantially raise the likelihood of success.

4. While traditional North–South and multilateral cooperation have been fundamental for many developing countries since the end of World War II, South–South and triangular cooperation have been increasing in importance and potential. Experiences and opportunities exist with regard to both finance and trade, as well as the coordination of domestic policies for investment and the expansion of public infrastructure. All told, despite the challenging global economic circumstances developing countries face in the current era, there is tremendous potential to draw from best practices and build cooperation in order to support and even speed up inclusive and sustainable development.

5. Such issues are important components of the 2030 Agenda for Sustainable Development. While macroeconomic stability and resilience are an explicit part of target 13 (enhance global macroeconomic stability, including through policy coordination and policy coherence) of Sustainable Development Goal 17 (strengthen the means of implementation and revitalize the global partnership for sustainable development), the questions that may be addressed by the fourth session of the Multi-Year Expert Meeting contribute to the achievement of many of the Goals including, most directly, Goal 8 (promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all), Goal 9 (build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation) and the wider scope of Goal 17 by identifying promising opportunities for international collaboration.

I. The external economic environment

6. Many of the targets of the Sustainable Development Goals are affected by the state of the external economic environment. Robust growth of external demand and trade, as well as productive channelling of global financial flows, are essential tools for generating economic growth, decent work and pathways towards industrialization and innovation.

Moreover, the level and volatility of global prices and financial flows are key to successfully implementing the global partnership for sustainable development. This chapter takes stock of recent trends in the global economic environment from this perspective.

1. World growth is slowing down

7. Prior to the 2007–2008 financial crisis and soon thereafter, the pace of economic growth in developing countries was the main driver of global growth. Yet the strength of developing country growth has markedly weakened. In the post-crisis period, the growth rate of developing countries was about three times faster than that of developed countries; in 2015, despite a notable deceleration, the former group still grew twice as fast as the latter. However, more recent data suggests that a number of large developing economies will experience a considerable slowdown or recession in 2016.

8. The macroeconomic performance of developing countries remains strongly linked to global conditions, as evidenced by the economic fallout from declining commodity prices. Outcomes and prospects should also be analysed in conjunction with the past performances and expected outlooks of developed countries. More specifically, some of the difficulties currently experienced by developing countries reflect limits derived at from several years of sluggish growth in developed countries and financial and trade liberalization worldwide, with capital flows playing a significant role in dictating exchange rates and other macroeconomic prices. In addition, the economic stances in developed countries are not conducive to renewed growth in developing countries and could contribute to the further deterioration of economic prospects.

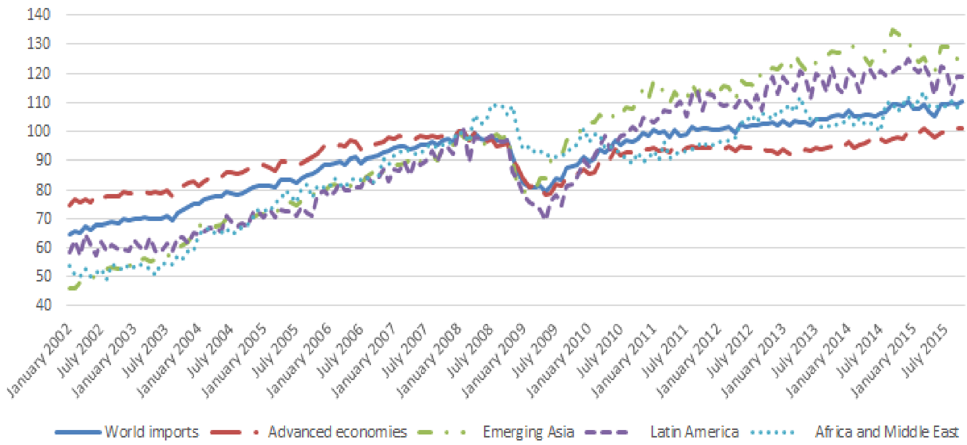
2. Trade continues to falter

9. In the recent past, trade has been cited as an engine of global growth, growing at double the pace of gross domestic product (GDP) in the past decade. External demand from advanced countries has been central to growth and export earnings for many developing countries, while the relatively high prices of commodities have also generated significant export revenues for a large number of countries. However, the relative strength of external demand from advanced countries was to a large extent based on credit creation and asset appreciation, a shaky foundation that ultimately fell apart with the financial crisis.[1]

10. In the post-great recession world, many advanced economies have experienced sluggish job recovery and little wage growth, and the external demand that raised growth in many developing countries has been severely weakened. In addition, spending by Government is generally still below pre-crisis trends, as austerity-type approaches to economic recovery remain the dominant policy choice. After the initial recovery period, the combination of lower private and public demand in advanced countries has been associated with declining or stagnant trade volumes across regions. In the past three years, world trade growth has slowed significantly, and is now at par with global GDP growth. Although imports seem to have gained some traction in advanced countries over the past 18 months, they have barely reached pre-crisis levels (see figure 1).

[1] UNCTAD, 2014, *Trade and Development Report, 2014* (New York and Geneva, Sales No. E.14.II.D.4, United Nations publication).

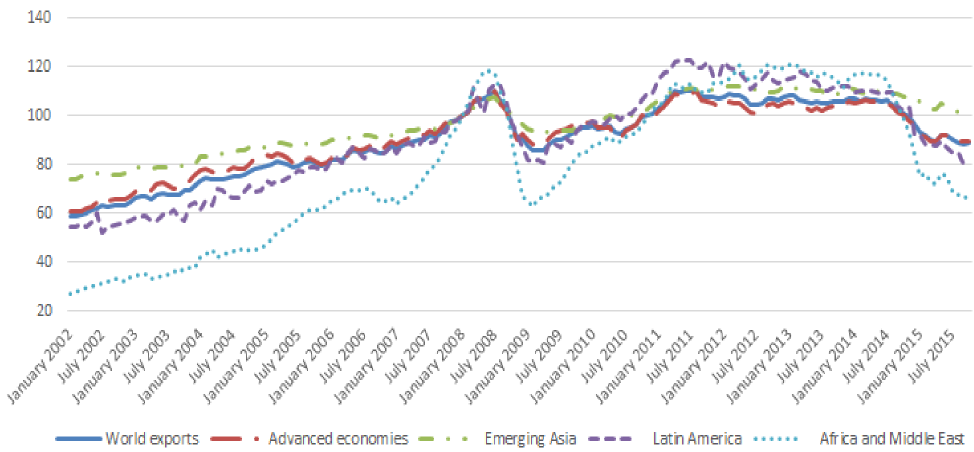
Figure 1
World trade dynamics, monthly indices, January 2002–October 2015:
World import volume by region



Source: Netherlands Bureau for Economic Policy Analysis, 2015, World trade monitor, available at http://www.cpb.nl/en/data (accessed 25 January 2016).
Note: 100 = January 2008.

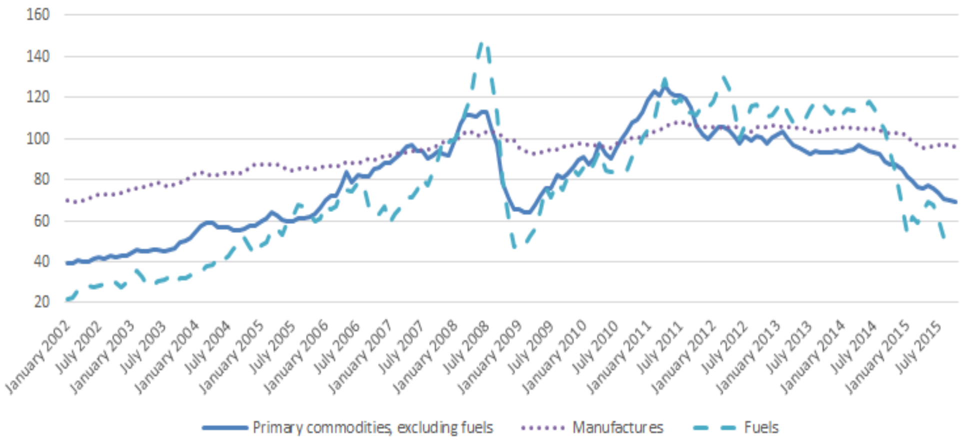
11. Declining external demand and stiff international competition are further apparent when the export unit values of different regions and product groups are considered (see figures 2 and 3). Export unit values for all developing countries remain well below pre-crisis peaks. Asia's relatively better performance stems from its large share of low-cost manufactures exports; the exports of other developing regions are heavily skewed towards raw materials and commodities. The most affected regions remain Africa and the Middle East, where export unit values fell to levels reached during the worst of the great recession. This highlights the continued vulnerability of many poor countries, especially the least developed countries, and threatens progress accomplished to date under the Millennium Development Goals, let alone achievement of the Sustainable Development Goals.

Figure 2
World trade dynamics, monthly indices, January 2002–October 2015:
Export unit value by region



Source: Netherlands Bureau for Economic Policy Analysis, 2015.
Note: 100 = January 2008.

Figure 3
World trade dynamics, monthly indices, January 2002–October 2015: Manufactures export unit value and commodity prices



Source: Netherlands Bureau for Economic Policy Analysis, 2015.
Note: 100 = January 2008.

12. During the years leading up to the financial crisis and directly after, a large number of developing countries, particularly in Africa and Latin America, relied extensively on the continuing expectation of high or even increasing commodity prices. Many directed resources to their primary sectors, expecting to increase productive capacity and export revenues. However, the reversal of the rising trend in commodity prices beginning in 2011 – widely considered to mark the end of the upward phase of the latest commodity super cycle – threatens both short-term macroeconomic stability and the viability of commodity-dependent development strategies. In addition, the significant role of financial speculation in the determination of commodity prices portends continuing volatility, regardless of the state of commodity market fundamentals.[2] In both the short and long terms, macroeconomic stability and resilience significantly depend on an economy's productive structure. Narrow productive structures, such as those based on extractive sectors or primary commodities, increase the depth and length of a recession and expose countries to large swings in exchange rates and other key macroeconomic indicators.

3. Exchange rate and capital flow dynamics

13. Volatile finance can generate misleading price signals in markets other than for commodities. Capital flows can drive exchange rates as much as the policies of an economy's central bank, such as interest and exchange rate policies, as illustrated by the association between exchange rates and capital flows (see figure 4). Since the early 2000s, private capital inflows into developing countries and countries with economies in transition have accelerated substantially. As a proportion of gross national income, external inflows to these countries increased from 2.8 per cent in 2002 to 5 per cent in 2013, after having reached two record highs of 6.6 per cent in 2007 and 6.2 per cent in 2010. Worries about a sudden or substantial departure of inflows began with the economic slowdown and became more pronounced with the increased volatility in recent months.

[2] D Bicchetti and N Maystre, 2013, The synchronized and long-lasting structural change on commodity markets: Evidence from high-frequency data, *Algorithmic Finance*, 2:233–239; UNCTAD, 2011, *Price Formation in Financialized Commodity Markets: The Role of Information* (New York and Geneva, United Nations publication).

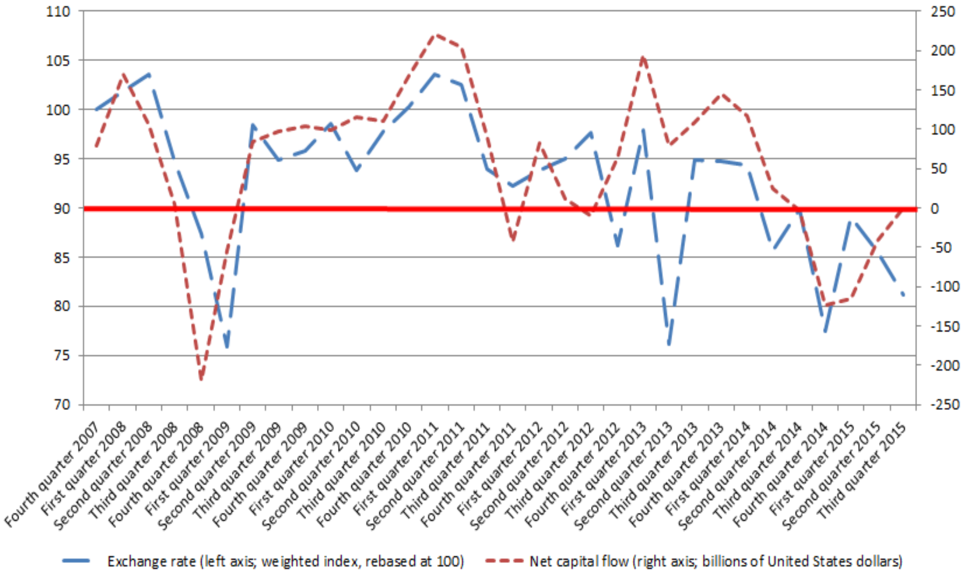
14. Such flows owe as much to policy decisions in advanced economies as to improved fundamentals in recipient countries. Prior to the financial crisis, borrowing and asset appreciations drove consumption booms and private investment bubbles in some major economies and net exports in others. After the inevitable collapse that followed, developed country policies of quantitative easing, coupled with fiscal austerity, have largely continued pre-crisis patterns of generating excess liquidity in the private sector.

15. Developing countries are currently experiencing their fourth dip in capital flows since the financial crisis (see figure 4)[3] and the recent interest rate hike in the United States of America, combined with a worsened economic outlook, including lower commodity prices and slow global economic recovery, are likely to sustain such flows. Capital outflows exert downward pressure on exchange rates, making it more difficult for countries to earn the foreign exchange they need to service external obligations and finance imports.

16. In many developing countries, the availability of cheap capital over the course of the 2000s encouraged both the private and public sectors to take on more debt, which rose in these countries by $8.1 trillion between 2000 and 2007 (not including financial sector debt). This build-up was from a relatively low base, however, and signs of financial fragility were masked by strong growth performances and debt relief for poorer developing countries. Yet between 2007 and 2014, the debt rose further, by $23 trillion. The average aggregate debt to GDP ratio reached over 120 per cent and in a number of economies was considerably higher.[4]

Figure 4

Aggregate net capital flow and weighted exchange rate index, selected emerging markets, fourth quarter 2007–third quarter 2015



Source: UNCTAD secretariat calculations based on data from Thomson Reuters Eikon and national central banks.

Notes: 100 = fourth quarter 2007. Partial estimates of net capital flow are given for the third quarter of 2015. The countries included are Brazil, China, India, Indonesia, Malaysia, Mexico, the Russian Federation, South Africa, Thailand, Turkey and Ukraine.

3 Also see UNCTAD, 2015, When the tide goes out: Capital flows and financial shocks in emerging markets, Policy Brief No. 40.

4 McKinsey Global Institute, 2015, Debt and (not much) deleveraging, available at http://www.mckinsey.com/insights/economic_studies/debt_and_not_much_deleveraging (accessed 25 January 2016).

17. Developing countries suffer from an inherent vulnerability in the global payments system. Since most of their respective currencies are not considered international reserve currencies, in the event of a crisis, significant capital outflows and exchange rate volatility, they face high currency mismatches on their private and public balance sheets, as they cannot use domestic currencies to service external obligations. Also, as detailed earlier, developing countries and the least developed countries in particular strongly depend on export earnings and accumulated reserves to overcome balance of payments constraints and the volatility of international financial markets. In addition to external vulnerabilities, domestic vulnerabilities may arise when assets have been collateralized, typically real estate and stocks or even commodities. To stem falling domestic prices, public intervention is required to rescue systemically important sectors.

18. Taken together, the slowdown in global growth and trade and the extreme volatility of the global economy pose serious challenges to accomplishing the Sustainable Development Goals, and require counterbalancing measures at national, regional and global levels in both the short and long terms.

II. Macroeconomic policy for short-term resilience

19. As shown in chapter I, developing countries are currently facing substantial risks associated with a fragile world economy. These risks may take the form of trade, financial or other shocks and cause a crisis. It is thus important for countries to build short-term resilience, in order to cope with such shocks and their effects; this importance is reflected in target 13 of Sustainable Development Goal 17. Lessons may be learned from countries that, in the past, successfully fought shocks by deploying a number of countercyclical and other economic policy tools, mitigating adverse impacts on economic growth, employment and the most vulnerable.

20. In the wake of the financial crisis, a number of developing countries responded by promoting monetary and fiscal expansion. On the monetary front, many Asian countries moved quickly to adopt expansionary monetary policies. Indonesia, Malaysia, the Philippines, the Republic of Korea, Thailand and Turkey cut their policy rates, in some cases from already low levels; China and India cut policy rates and lowered reserve requirements. The Republic of Korea cut its rate significantly, although it was facing sharp currency depreciation towards the end of 2008. Latin American countries such as Brazil, Chile, Mexico and Peru initially tightened monetary policies, but soon changed tack and, as Asian countries had done, adopted monetary expansion.[5]

21. On the fiscal front, Asia again took the lead. China introduced an especially large expansionary fiscal package, equivalent to more than 13 per cent of GDP. Other countries such as Malaysia, the Republic of Korea, Singapore and Thailand also adopted expansionary fiscal packages. Unlike in developed countries, where emphasis was on tax cuts, they focused on direct spending, especially on infrastructure projects. In Latin America, fiscal stimulus comprised tax reductions and the acceleration of public investments. Brazil included tax rebates, higher public investment and a large housing programme in its stimulus package. Chile and Peru increased public expenditure, drawing on resources they had accumulated to date in stabilization funds. Those countries facing smaller fiscal space opted to change their expenditure compositions to activities with stronger impacts on production and employment. In addition, countries strengthened their social programmes through measures that included increases in minimum wages and pensions with the purpose of protecting not only the most vulnerable, but also employment

[5] UNCTAD, 2009, *Trade and Development Report, 2009* (New York and Geneva, Sales No. E.09.II.D.16, United Nations publication)

and aggregate demand. Such programmes were adopted by larger economies, such as Argentina and Colombia, as well as smaller economies, including Costa Rica, El Salvador, Guatemala and Honduras.

22. Other developing regions and countries adopted expansionary policies as well. In Africa, a number of countries adopted fiscal stimulus packages, including Egypt, Kenya, Mauritius, Morocco, South Africa, Tunisia, Uganda and the United Republic of Tanzania. Monetary easing in the form of reduced policy rates was pursued in Botswana, Mauritius and South Africa.[6] Other developing countries, including oil-producing economies such as Kazakhstan and the Russian Federation, adopted fiscal stimulus packages or used available resources to rescue financial sectors that had been strongly affected by the financial crisis.[7]

23. Finally, foreign reserves and financial policies also constituted vital policy tools in country responses to the crisis. Foreign reserves were important in influencing expectations, and used to finance balance of payments shortages and prevent a free fall in country exchange rates. The latter could have had serious effects on the balance sheets of both financial and non-financial companies, in addition to causing sharp inflation increases and thus eroding the real value of household earnings, especially of the poorest. Financial policies, in turn, were used to further prevent a credit crunch and support aggregate demand. For example, in Brazil, State-owned banks sharply increased the availability of credit to offset the contraction of loans by private banks.

24. Most countries that successfully withstood the crisis using a range of countercyclical (along with other) policy tools had learned from previous crises. Between then and the latest crisis, they slowly acquired tools and conditions to increase resilience to new shocks. For instance, they accumulated foreign reserves, reduced their public debts and adopted less rigid exchange rate regimes. In particular, they put in place countercyclical fiscal mechanisms, which today are seen as key to mitigating crisis effects. Some Governments that were heavily dependent on commodity revenues built stabilization funds to deal with volatile behaviour. The oil reserve fund in Angola, cotton support fund in Burkina Faso, copper compensation fund in Chile and excess crude account in Nigeria are examples of funds that have been created to smooth the expenditures of Governments over time. Unfortunately, few export commodity-dependent countries have such funds in place. This makes external assistance to dealing with shocks indispensable (see chapter IV).

25. The availability of crisis management tools was not uniform during the financial crisis, but varied across countries, in some cases quite considerably. While a number of countries that suffered from previous crises reduced their exposure to shocks and built response capacity, many others, especially low-income countries, did not have the fiscal and/or financial resources to smooth consumption and support recovery. This was because, at the start of the crisis, their national debts were high as a proportion of GDP and levels of reserves in months of imports were low and they had large current account deficits.

26. Related to these indicators, their fiscal space – a measure of their capacity to respond – was very limited. In addition, many had economic structures that were not conducive to sustainable stabilization and rapid recovery. Export bases were very narrow, with the main export product accounting for over 50 per cent of total exports. In many cases, social protection mechanisms that could be activated to protect the most vulnerable did not exist. Moreover, most such countries were under International Monetary Fund programmes, whose principal features include very low inflation targets, a stress on budget balance, a lack of pro-growth expenditure and an absence of flexibility to deal with shocks, further

[6] L Kasekende, Z Brixova and L Ndikumana, 2010, Africa's Countercyclical Policy Responses to the Crisis, *Journal of Globalization and Development*, 1(1):1–20.

[7] UNCTAD, 2009; UNCTAD, 2011, *Trade and Development Report, 2011* (New York and Geneva, Sales No. E.11.II.D.3, United Nations publication).

constraining their ability to pursue expansionary macroeconomic policies.[8] However, it is important to note that this ability is not a given, but may be influenced by the actions of Government, for example by augmenting revenues in the short term or increasing inflation or budget deficit targets.[9] Furthermore, it is possible to find innovative ways out of a crisis. That is, while stimulus policies may be made possible through fiscal space, they are not limited by it. Even if countries have limited fiscal space, they still have some room for stimulus through the use of alternative policy instruments.[10] Monetary policy tools are one example. Loosening of monetary policy is currently possible in a number of developing countries, where inflationary pressures may be subdued due to the current context of very low world inflation. Thus, where fiscal space is limited, space must be sought elsewhere, for example by easing monetary policy in line with higher (but still moderate) inflation targets, or encouraging bank lending that generates productive investment and decent employment.

27. As noted earlier, stimulus on the monetary front may include lower policy rates and reserve requirements, while financial policies may include using public banks to direct credit to productive sectors, small and medium-sized enterprises and the poor. A further policy tool, which did not feature prominently during the latest crisis but was nonetheless deployed during previous crisis episodes, is capital controls on outflows. For example, this tool was used by Malaysia during the East Asian financial crisis that began in 1997, and contributed to a fast economic recovery. It is a tool particularly suitable for countries with low levels of international reserves. Importantly, it creates space for expansionary monetary policy and prevents excessive currency devaluation. This suggests that policy space for action is not merely about the availability of tools that operate independently of each other but rather how much flexibility a Government has for macroeconomic policy management, which involves the simultaneous use of a range of policy tools for maximum effect. This is vital to enabling a Government to fight downturns and crises, in order to maintain the country’s level of economic activity, income and employment and, ultimately, protect productive structures for the next phase of economic expansion and support the poor and most vulnerable.

III. Industrial policy for long-term resilience

28. The central importance of industrialization for sustainable development is reflected in Sustainable Development Goal 9, which calls for promoting inclusive and sustainable industrialization in addition to building resilient infrastructure and fostering innovation. However, externally generated economic shocks and crises not only threaten short-term macroeconomic stability, but may also compromise prospects for long-term industrialization and growth, as development is fundamentally path dependent. The building up of productive capacities and institutions may be seriously compromised or redirected as a result of macroeconomic shocks and ongoing fragility, as when cutting investments in public infrastructure to service external debt lowers the profitability of private investment or when volatile exchange rates driven by volatile capital flows lower export competitiveness and hamper industrialization. Fortunately, this cause and effect works both ways; industrialization and diversification into higher productivity activities can

[8] R Gottschalk, 2015, The effectiveness of International Monetary Fund/World Bank-funded poverty reduction strategy papers, in: Y Bangura, ed., *Developmental Pathways to Poverty Reduction* (London, Palgrave Macmillan). (This chapter discusses the lack of flexibility in International Monetary Fund Poverty Reduction and Growth Facility programmes.)

[9] UNCTAD, 2014.

[10] R Gottschalk and L Bolton, 2009, Macroeconomic policy, stimuli, aid and budgeting: What options?, *Institute of Development Studies Bulletin*, 40(5):78–88.

lower an economy's vulnerability to external shocks, strengthening the developmental case for industrial policy.

29. A key feature of most successful development paths is diversification out of agriculture and the production of traditional goods. Labour and capital progressively shift into manufacturing, services and modern economic activities, favouring increases in productivity and the expansion of income. Advanced economies also produce a vast spectrum of goods and services and generally do not depend on any specific industry. Diversification is also crucially related to economic resilience, that is, the capacity of an economy to successfully recover from shocks that throw it substantially off its growth path and cause an economic downturn. Economic resilience may exist because an economy can simply bounce back (for example due to favourable shifts in demand for its products) or as a result of an economy undergoing changes in its industry or occupational structure (with productive factors moving towards more productive sectors) or less radical economic changes (for example, existing firms adopt better technologies or organizational forms or produce new products). In a sufficiently diversified economy all of these reactions are more likely to take place effectively, as follows:[11]

(a) With a vaster production and export base, it is more likely that negative economic shocks will be compensated for by favourable price variations affecting other industries operating in the country

(b) A wider production base would also facilitate the relocation of jobs and capital away from the industries most affected from a shock

(c) Diversified economies are generally populated by dynamic firms able to adapt quickly to the changing conditions of the market by adopting new technologies or organizational forms

30. Recent empirical research confirms that countries with more diversified production structures tend to be more resilient and to display a lower volatility in output, consumption and investment.[12] Papageorgiou and Spatafora (2012) studied the link between diversification and volatility in the context of large diversification spurts and identified a total of 61 spurts in the last 50 years, including the well-known examples of Chile, Malaysia and Thailand in the 1970s and 1980s. As shown in the study, such spurts were associated with a 17 per cent average reduction in the volatility of output growth in developing countries.[13] Geographic diversification also helps reduce volatility. Countries whose exports are geographically concentrated are more likely to import volatility from their trading partners and be exposed to external shocks. Conversely, if fluctuations in different countries or regions are not highly correlated, geographically diversifying an economy's external linkages reduces exposure to external shocks.[14]

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[11] E Hill, T St. Clair, H Wial, H Wolman, P Atkins, P Blumenthal, S Ficenec and A Friedhoff, 2011, Economic shocks and regional economic resilience, Macarthur Foundation Network on Building Resilient Regions Working Paper No. 2011-03.

[12] See for example AM Mobarak, 2005, Democracy, volatility and economic development, *The Review of Economics and Statistics*, 87:348–361; and W Moore and C Walkes, 2010, Does industrial concentration impact on the relationship between policies and volatility?, *International Review of Applied Economics*, 24:179–202.

[13] C Papageorgiou and N Spatafora, 2012, Economic diversification in low-income countries: Stylized facts and macroeconomic implications, International Monetary Fund Staff Discussion Note SDN/12/13.

[14] A Farshbaf, 2012, Does geographical diversification in international trade reduce business cycle volatility?, available at http://www-scf.usc.edu/~farshbaf/job_market_paper_arian_farshbaf.htm (accessed 25 January 2016).

31. In the current context, characterized by increasing trade and productive integration across the world, the fundamental policy challenge faced by developing economies is to ensure that participation in global trade and production networks is one of several complementary components of a development strategy that focuses on a rapid pace of capital formation, economic diversification, technological upgrading and high-quality employment generation. Significantly, in the first-tier East Asian newly industrializing economies, this included import substitution industrialization (in conjunction with export orientation) in an effort to move from the assembly of imported components to their domestic production.[15]

32. Active policy responses are now under consideration in many developing countries as industrial policies are once more on their agendas.[16] While simple imitation is ruled out by country-specific constraints and challenges, a number of broad policy lessons may be drawn from successful industrializers.

33. First, a broader pro-growth macroeconomic stance is essential. This requires adopting a full range of macroeconomic instruments to both stimulate investment and counteract any damaging effects on social welfare and capital formation from economic shocks and volatility. For example, in China, the second half of the reform era (from the early 1990s onwards) was characterized by high levels of investment in infrastructure and industrial upgrading. This led to a path of “capital-deepening, investment-led industrialization, carried out mainly by State-owned enterprises in a number of basic industries and by transnational corporations in higher technology industries. Combined with a ready supply of low-cost labour, these investments propelled a strong export drive. Around 1998–2002, China’s State leadership adopted a policy shift under the new policy line known as ‘constructing a harmonious society’, which widened the previous narrow focus on market reform and growth to pay more attention to social and environmental outcomes, in particular growing inequality and worsening social polarization”.[17]

34. Second, given the strong links between investment and diversification, and the importance of financing investment from retained earnings, States need to raise enterprise profits to levels above those that would likely emerge from the workings of the market, and ensure that such profits are used to support an agenda of diversification and productive transformation. The acceleration of growth in East Asia since the start of the 1980s has been underpinned by a Government–business relationship in which Governments have created conditions for higher business profits than would otherwise have been possible under normal market conditions and firms have delivered by investing a large part of their profits instead of distributing them as dividends.[18]

35. Third, while most fiscal and other instruments may be applied deliberately to specific industries at specific times, investment should be especially promoted in industries with the greatest potential for upgrading skills, reaping economies of scale and raising productivity growth, thereby increasing the rates of return on investment. The selection of the relevant sectors and industries for industrial policy support varies from country to country according to areas of strength and potential for dynamic comparative advantages.

[15] UNCTAD, 1994, *Trade and Development Report, 1994* (New York and Geneva, Sales No. E.94.II.D.26, United Nations publication); UNCTAD, 1997, *Trade and Development Report, 1997* (New York and Geneva, Sales No. E.97.II.D.8, United Nations publication).

[16] See for example JM Salazar-Xirinachs, I Nübler and R Kozul-Wright, eds., 2014, *Transforming Economies: Making Industrial Policy Work for Growth, Jobs and Development* (Geneva, International Labour Organization); and UNCTAD, 2015, *Technology and Innovation Report 2015* (New York and Geneva, Sales No. E.15.II.D.3, United Nations publication).

[17] JM Salazar-Xirinachs, I Nübler and R Kozul-Wright, eds., 2014.

[18] UNCTAD, 2004, *Trade and Development Report, 2004* (New York and Geneva, Sales No. E.04.II.D.29, United Nations publication).

In South America, for example, Brazil – a country with an already large industrial base – prioritizes sectors such as capital goods, electronics and pharmaceuticals; Uruguay – in recognition of the limitations imposed by its small domestic market – promotes biotechnology, information and communications technologies and cultural industries.

36. Finally, it is important to note that effectively implementing such a diversification strategy depends on the creation of an appropriate structure of public and private institutions and, not least, the development of a strong and competent bureaucracy. Successful economies of the past have practiced what has been called adaptive efficiency, developing institutions that provide a stable economic environment for existing activities to flourish while at the same time allowing room for, and providing support to, new lines of activity and the promotion of technological upgrading.

IV. Prospects for cooperation

37. Confronting the challenges to economic resilience and sustainable development posed by recurrent crises and secular stagnation requires increasing the effectiveness and transparency of the institutions involved in global economic governance. For instance, implementing expansionary macroeconomic policies or financial regulatory reforms is most effective when coordinated among countries. Institutional structures should be more inclusive and participatory, ultimately addressing the long-term causes of boom and bust cycles and minimizing the impacts on developing countries. In addition, there is great potential for productive collaboration and partnership on a smaller scale, as evidenced by the history of North–South cooperation and emerging models of South–South cooperation and triangular partnerships. These issues are captured by the broad base of targets under Sustainable Development Goal 17, which centres on revitalizing the global partnership for sustainable development.

38. As highlighted at previous sessions of the Multi-Year Expert Meeting, with regard to South–South cooperation, economic cooperation in the areas of finance, trade, investment and technology among developing countries can address existing biases and gaps in the international economic system. South–South cooperation builds on mutual understanding and provides a strong push for more inclusive partnerships among countries with certain structural or regional similarities in socioeconomic conditions. Cooperation helps build institutional capacity and emboldens participant countries both politically and technically to face external shocks and address deficiencies in global and regional institutions that influence the development agenda and global demand.

39. As noted earlier, many developing countries have attempted to avoid boom and bust cycles and increase short-term resilience by building high levels of international reserves as an insurance policy against possible future external shocks. However, the accumulation of large foreign reserves by each individual country may carry an opportunity cost, especially if such reserves are borrowed. The recent decline in reserves among many developing countries raises concerns regarding such costs. A more coordinated approach towards external insurance mechanisms against macroeconomic imbalances may help reduce the need to accumulate large foreign reserves to counter the effects of global boom and bust cycles.

40. Some aspects of the potential for monetary coordination are already evident. For example, in October 2008, the United States Federal Reserve System provided swap lines to four emerging countries, namely, Brazil, Mexico, the Republic of Korea and Singapore. Swap lines and repurchase agreements were also extended to countries in Central and Eastern Europe by the European Central Bank, the central bank of Sweden and the central bank of Switzerland. In 2010, the Chiang Mai Initiative was multilateralized and

a surveillance unit – Association of Southeast Asian Nations (ASEAN) Plus Three Macroeconomic Research Office – was created to monitor signs of emerging risks and provide policy analysis for its member States. Member States were entitled to borrow a multiple of their contributions, with the most vulnerable countries qualifying for the highest multiple. In 2014, the size of the agreement doubled from the original $120 billion to $240 billion. However, these swap lines have never been used, possibly because accessing substantial liquidity requires the adoption of an International Monetary Fund programme, involving the types of conditionalities that contributed to dissatisfaction with such programmes after the financial crisis in Asia.

41. Other notable examples of regional approaches to such issues are the Latin American Reserve Fund and Arab Monetary Fund, which provide balance of payments support by tailoring their lending conditions to each beneficiary's situation. The People's Bank of China has signed 32 bilateral swap agreements to facilitate trade and investment with both developed and developing countries. These agreements, as well as initiatives such as the Chiang Mai Initiative, may provide a stronger short-term safety net for developing countries and reduce the need to accumulate large foreign reserves. Part of these resources could then be invested in long-term projects in infrastructure and diversification of the economic structure.

42. In terms of trade, regional markets may expand the extent of a market and open up opportunities for developing countries to provide demand for each other's outputs through enhanced trade and investment links. The identification of key constraints to regional integration is crucial to fostering regional trade in order to boost productive capacities. The conditions under which trade might become an engine of growth in a process of regional integration suggest that it is necessary to go beyond trade liberalization and facilitation and that trade policy should be integrated in a framework aimed at the development of productive capacities at national and regional levels.[19] When there is deficient global demand and a less favourable trade environment, export-led growth strategies face constrained prospects. Under such circumstances, adjusting to the changing dynamics of the world economy necessarily involves greater reliance on regional and domestic markets. Regional integration at various levels, however, faces diverse challenges, and solutions may involve a range of policies and institutional options.

43. The possibility of rapidly changing to a more regional demand-oriented growth strategy depends on how closely the sectoral structure of domestic production is linked to demand generated at the respective country levels. This linkage may be particularly weak in countries that export a large proportion of primary commodities. Regional integration among countries is more difficult to achieve if their productive capacities are less developed and economies less diversified. This is because countries in a region that relies predominantly on the production of commodities will not be in a position to provide for each other's increasing needs for manufactured and capital goods. Hence, a potential for regional integration is positively associated with policies designed to build long-term macroeconomic stability.

44. In keeping with a holistic vision of development, regional trade may also be promoted through the coordination of investment in strategic areas such as regional transport and other ancillary infrastructure. The issue of regional infrastructure is especially pertinent in the 32 landlocked developing countries (16 in Africa, 12 in Asia, two in Europe and two in Latin America) that share one common feature, namely, the lack of direct territorial access to the sea, often coupled with remoteness from major markets.

[19] See for example UNCTAD, 2013, *Economic Development in Africa Report 2013* (Geneva, Sales No. E.13.II.D.2, United Nations publication).

45. If left only to market forces, a country engaging in international trade tends to have little recourse but to specialize along the lines of historically generated factor endowments (comparative advantages). The development of regional production systems, on the other hand, is based on policies that go beyond trade liberalization in order to transform previously existing production patterns. Formal cooperation tends to focus on technical issues (such as trade barriers and standards) but, as production and trade systems become more integrated among neighbouring countries, the need for coordination and collaboration grows. Access to larger markets, as a means of achieving economies of scale and diversifying production, has been an enduring rationale for regional arrangements among developing countries. Although a regional strategy might require relinquishing some sovereignty in national policymaking, members can also anticipate the expansion of policy space in areas in which larger markets and shared resources promote investment and structural transformation. The creation of regional institutions that can facilitate development-oriented regional integration is required as productive integration progresses.

46. Among the successful examples of an emphasis on the development of regional infrastructure as a precondition for deeper regional productive integration is the Spatial Development Initiatives programme launched by South Africa, notably the Maputo Development Corridor. Another example is the Greater Mekong Subregion project, coordinated by the Asian Development Bank, which began in 1992. There are also successful examples of regional projects in Latin America. One of the most comprehensive is the Initiative for the Integration of the Regional Infrastructure of South America, launched in 2000 and focusing on transport, communications and energy infrastructure to foster improved regional integration for 12 South American countries. The ASEAN High-Level Task Force on ASEAN Connectivity, established in 2009, constructed a plan for regional connectivity designed to ensure the synchronization of sectoral plans within the framework of ASEAN and its subregions. This plan included innovative infrastructure financing mechanisms that could be an example for other groupings of developing countries.

47. In addition to augmenting the quantity and quality of trade, regionally based institutions can also support productive linkages to the global economy by setting guidelines for multilateral and bilateral trade agreements, ensuring that they enable market access for developing countries while protecting policy space to support strategic industries.[20] Regional cooperation may become what a former Executive Secretary of the United Nations Economic Commission for Europe once wrote of national planning: a means of reaching consolidation because it creates an institutional structure to articulate aspirations.[21] Regional institutions and commitments can increase the scope for investment region-wide, preventing race to the bottom pressures and beggar thy neighbour policies that position each nation individually in competition vis-à-vis extraregional markets. Finally, triangular cooperation can promote the sharing of knowledge and experiences in areas that require greater financial commitment due to the lack of institutional capacity or because they involve highly technical cooperation that similarly demands substantial funding commitments.

48. Beyond such regional arrangements, the emergence of new growth poles in the South may be leveraged in support of more widespread development gains through South–South integration and cooperation that targets the least developed countries in particular. In fact, following a hiatus of two decades, new institutional arrangements have emerged among developing countries to discuss mutual needs and challenges and to extend

[20] See UNCTAD, 2014.

[21] G Myrdal, 1968, *Asian Drama: An Inquiry into the Poverty of Nations* (New York, Twentieth Century Fund).

cooperation and support. In contrast with traditional North–South cooperation, South–South initiatives involve countries with shared development challenges and suggest more equal relationships between donor and recipient countries. However, growing divergence between emerging countries and the least developed countries suggest that capacity-building in support of developmental States should become an important component of South–South cooperation, as it has distinct advantages over traditional forms of development cooperation. This, in turn, will require a more robust monitoring and assessment of the scale and impact of South–South cooperation, in terms of its own metrics and ambitions.

49. Many of the new threats to inclusive growth and development may also be approached through stronger South–South links. For example, with regard to food security, scaling up agricultural extension and support services, improving water management and strengthening research and development may benefit from shared circumstances among developing countries. Other areas in which South–South cooperation may open up new possibilities include climate adaptation and improved responses to natural disasters.

V. Issues to explore further

50. The analysis in this note generates a number of important questions that the fourth session of the Multi-Year Expert Meeting may wish to consider, with the aim of building both short and long-term resilience to achieve the challenge of the Sustainable Development Goals of building more diversified and inclusive economies. These questions include the following:

(a) What policy lessons may be learned from previous crisis episodes in order to build short-term macroeconomic resilience?

(b) To what extent might countries be able to find innovative ways to counter the domestic effects of external crises in ways that not only maintain macroeconomic resilience but also preserve human capabilities and productive capacities?

(c) What are the most significant lessons learned from successful (and unsuccessful) experiences of development and diversification strategies adopted by developing countries in the past?

(d) How can strategic trade and financial integration with the world economy (especially at the South–South level) be used to foster the processes of industrialization and diversification in developing economies?

(e) Disparities in productive capacities are sometimes seen as deterrents to regional integration. Are there examples of regional cooperation that has seized on such differences to the advantage of productive integration?

(f) What is the scope for structured South–South cooperation and collaboration in crafting policies and building institutions for effective crisis management and long-term resilience building?

(g) How can traditional North–South cooperation, as well triangular cooperation between the North and South, complement such efforts?

(h) A key constraint on building resilience is the lack of policy space. How best can existing policy space be utilized and how can new forms of South–South cooperation effectively expand that policy space?

(i) What role can UNCTAD play in advancing South–South dialogue on these matters with a view to advancing the Sustainable Development Goals?