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Classification by country or commodity group

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

The major country groupings used in this *Report* follow the classification by the United Nations Statistical Office (UNSO). They are distinguished as:

- Developed or industrial(ized) countries: the countries members of the OECD (other than Mexico, the Republic of Korea and Turkey) plus the new EU member countries and Israel.
- Transition economies refers to South-East Europe and the Commonwealth of Independent States (CIS).
- Developing countries: all countries, territories or areas not specified above.

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

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

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

For statistical purposes, regional groupings and classifications by commodity group used in this *Report* follow generally those employed in the *UNCTAD Handbook of Statistics 2013* (United Nations publication, sales no. B.13.II.D.4) unless otherwise stated. The data for China do not include those for Hong Kong Special Administrative Region (Hong Kong SAR), Macao Special Administrative Region (Macao SAR) and Taiwan Province of China.

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 2013* refers to *Trade and Development Report, 2013* (United Nations publication, sales no. E.13.II.D.3).

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

The term “billion” signifies 1,000 million.

The term “tons” refers to metric tons.

Annual rates of growth and change refer to compound rates.

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

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

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

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

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

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

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

Abbreviations

AfDB	African Development Bank
AGP	Agreement on Government Procurement
BEPS	base erosion and profit shifting
BIS	Bank for International Settlements
BIT	bilateral investment treaty
CIS	Commonwealth of Independent States
CPI	consumer price index
DSM	dispute settlement mechanism
ECLAC	Economic Commission for Latin America and the Caribbean
EITI	Extractive Industries Transparency Initiative
EU	European Union
FATCA	Foreign Account Tax Compliance Act (of the United States)
FDI	foreign direct investment
FET	fair and equitable treatment
FTA	free trade agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GPM	Global Policy Model (of the United Nations)
GSP	Generalized System of Preferences
GTA	Global Trade Alert
IBRD	International Bank for Reconstruction and Development
ICSID	International Centre for Settlement of Investment Disputes
IFF	illicit financial flows
IIA	international investment agreement
ILO	International Labour Organization
IMF	International Monetary Fund
IP	intellectual property
IPR	intellectual property right

ISDS	investor-State dispute settlement
ITO	International Trade Organization
LDC	least developed country
MDG	Millennium Development Goal
MERCOSUR	Common Market of the South (Mercado Común del Sur)
MFN	most favoured nation
NAFTA	North American Free Trade Association (or Agreement)
NAMA	non-agricultural market access
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OFC	offshore financial centre
PPP	purchasing power parity
PWYP	Publish What You Pay
R&D	research and development
RTA	regional trade agreement
SCM	subsidies and countervailing measures
SDT	special and differential treatment
TARP	Troubled Assets Relief Program
TDR	Trade and Development Report
TJN	Tax Justice Network
TNC	transnational corporation
TRIMs	trade-related investment measures
TRIPS	trade-related aspects of intellectual property rights
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UN-DESA	United Nations Department of Economic and Social Affairs
URA	Uruguay Round Agreement
VAT	value added tax
WTO	World Trade Organization

OVERVIEW

Fifty years ago this year, and twenty years after a new multilateral framework for governing the post-war global economy was agreed at Bretton Woods, a confident South gathered in Geneva to advance its demands for a more inclusive world economic order. The first United Nations Conference on Trade and Development (UNCTAD) added a permanent institutional fixture to the multilateral landscape, with the responsibility "to formulate principles and policies on international trade and related problems of economic development". Moreover, and moving beyond the principles that framed the Bretton Woods institutions (and later the General Agreement on Tariffs and Trade (GATT)), it was agreed that "Economic development and social progress should be the common concern of the whole international community, and should, by increasing economic prosperity and well-being, help strengthen peaceful relations and cooperation among nations".

UNCTAD's 50th anniversary falls at a time when, once again, there are calls for changes in the way the global economy is ordered and managed. Few would doubt that, during the five intervening decades, new technologies have broken down traditional borders between nations and opened up new areas of economic opportunity, and that a less polarized political landscape has provided new possibilities for constructive international engagement. In addition, economic power has become more dispersed, mostly due to industrialization and rapid growth in East Asia, with corresponding changes in the workings of the international trading system. However the links between these technological, political and economic shifts and a more prosperous, peaceful and sustainable world are not automatic.

Indeed, growing global economic imbalances, heightened social and environmental fragilities and persistent financial instability, turning at times to outright crisis, should give pause for thought and further policy discussion. Hunger still remains a daily reality for hundreds of millions of people, particularly in rural communities, with children being the most vulnerable. At the same time, rapid urbanization in many parts of the developing world has coincided with premature deindustrialization and a degraded public sector, giving rise to poor working conditions and a growing sense of insecurity. Where these trends have collided with the ambitions of a youthful population, economic frustrations have spilled over into political unrest.

Back in 1964, the international community recognized that "If privilege, extremes of wealth and poverty, and social injustice persist, then the goal of development is lost". Yet, almost everywhere in recent years, the spread of market liberalism has coincided with highly unequal patterns of income and wealth distribution. A world where its 85 wealthiest citizens own more than its bottom three and a half billion was not the one envisaged 50 years ago.

There is no fast or ready-paved road to sustainable and inclusive development; but the past three decades have demonstrated that delivery is unlikely with a one-size-fits-all approach to economic policy that cedes more and more space to the profitable ambitions of global firms and market forces. Countries should ultimately rely on their own efforts to mobilize productive resources and, especially, to raise their levels of domestic investment (both public and private), human capital and technological know-how. However, for this, they need to have the widest possible room for manoeuvre to discover which policies work in their particular conditions, and not be subject to a *constant shrinking of their policy space by the very international institutions originally established to support more balanced and inclusive outcomes.*

Insisting on the importance of domestic institutions and policies does not mean adopting a closed or insular attitude to the many development challenges. On the contrary, access to external financial resources and technological know-how is still critical to unlocking the development potential of many poorer and vulnerable countries. Moreover, long-standing development issues − from sovereign debt problems to improved market access in a fairer international trading system, and from commodity price stabilization to financial markets that serve the real economy − can only be addressed through effective multilateral institutions supported by (and this is no small proviso) sufficient political will on the part of the leading economies. Added to these persistent challenges, today's interdependent world has thrown up a variety of new ones, such as health pandemics, food insecurity, and global warming, which require even bolder multilateral leadership and collective action.

Pursuing bold international collective action to correct the deep inequities of the world, along with determined and innovative domestic policy initiatives, was what motivated the participants at Bretton Woods 70 years ago and in Geneva 50 years ago. Henry Morgenthau, the United States Secretary of the Treasury, was on the mark when he insisted at Bretton Woods that "Prosperity like peace is indivisible. We cannot afford to have it scattered here or there among the fortunate or to enjoy it at the expense of others. Poverty, wherever it exists, is menacing to us all and undermines the well-being of each of us". As the international community frames an ambitious development agenda beyond 2015, the moment is right to propose another international "New Deal" that can realize the promise of "prosperity for all".

The world economy in 2014 still in the doldrums

The world economy has not yet escaped the growth doldrums in which it has been marooned for the past four years, and there is a growing danger that this state of affairs is becoming accepted as the "new normal". Policymakers everywhere, but particularly in the systemically important economies, need to assess current approaches and pay closer attention to signs of inclement economic weather ahead.

Growth in the world economy has been experiencing a modest improvement in 2014, although it is set to remain significantly below its pre-crisis highs. Its growth rate of 2.3 per cent in 2012 and 2013 is projected to increase moderately to between 2.5 and 3 per cent in 2014. This improvement is essentially due to growth in developed countries accelerating from 1.3 per cent in 2013 to around 1.8 per cent in 2014. Developing countries as a whole are likely to repeat their performance of the previous years, growing at between 4.5 and 5 per cent, while in the transition economies growth is forecast to further decelerate to around 1 per cent, from an already weak performance in 2013.

The moderate growth acceleration expected in developed countries should result from a slight pick-up in the European Union (EU), where a tentative easing of fiscal austerity and a more accommodating monetary policy stance, notably by the European Central Bank (ECB), has helped pull demand growth back to positive territory. In some countries (e.g. the United Kingdom), household demand is being supported by asset appreciation and the recovery of consumer and mortgage credit, and in others by some improvement in real wages (e.g. Germany). However, in a number of other large euro-zone economies (e.g. France, Italy and Spain) high levels of unemployment, stagnant or sluggish real wage growth, and persistent weakness in the banking sector continue to hinder the expansion of domestic credit and demand. In the United States, the economy is continuing its tentative recovery through a reliance on domestic private demand. The negative impact of fiscal austerity eased slightly in 2014, the unemployment rate has continued to fall, and asset price appreciations are encouraging the recovery of domestic borrowing and consumption. However, average real wages remain stagnant. Growth in Japan has also been relying on domestic demand, as private consumption and investment benefited from the expansionary monetary and fiscal policies of Abenomics. The effects of public spending for reconstruction following the 2011 earthquake, which helped propel the Japanese economy to higher growth in 2012−2013 have dissipated, while recent tax increases could hurt consumer spending, so that further stimulus packages may be needed to maintain positive growth and price targets.

The main developing regions are likely to more or less replicate their growth performance of 2012−2013. Asia is projected to remain the most dynamic region, growing at around 5.5 per cent. Among the major countries in this region, China continues to lead with an estimated growth rate of close to 7.5 per cent in 2014, based on domestic demand, with some tentative signs of an increasing role for private and public consumption. Growth in India is accelerating to an estimated 5.5 per cent as a result of higher private consumption and net exports; investment, on the other hand, remains flat. Most countries in South-East Asia should keep growing at around or above 5 per cent, driven by private consumption and fixed investment, with little or no contribution from net exports. Economic performance is more varied in West Asia, where several countries have been directly or indirectly affected by armed conflicts. Turkey has been exposed to financial instability and may not be able to sustain a growth rate that is heavily dependent on domestic credit expansion.

Growth in Africa also shows wide contrasts. It remains weak in North Africa due to ongoing political uncertainty and disruptions in oil production. It has also remained subdued in South Africa, at around 2 per cent, owing to a weakening of domestic demand and to strikes in the mining sector. By contrast, several large sub-Saharan economies have posted high growth rates, leading to projected growth for the subregion of almost 6 per cent in 2014. In several cases, historically high commodity prices have been supporting this growth that has persisted for more than a decade.

After a strong rebound in 2010, economic growth in Latin America and the Caribbean has slowed down to an estimated 2 per cent in 2014. This weak performance mainly reflects slow growth in the three main economies, Argentina, Brazil and Mexico, where domestic demand (their main driver of growth after the global crisis) has lost momentum. External financial shocks in mid-2013 and early 2014 also affected those economies, leading to macroeconomic policy tightening. Further financial instability might result from legal obstacles to the normal servicing of Argentina's sovereign debt. However, Argentina's solvency and sound macroeconomic fundamentals in most countries in the region should prevent this shock from developing into a regional financial crisis. Several countries exporting hydrocarbons or minerals have experienced significantly higher growth rates, pushed by strong domestic demand.

The European transition economies are likely to experience a further slowdown of growth this year, with stagnant consumption and investment demand in the Russian Federation exacerbated by financial instability and renewed capital outflows. On the other hand, the Central Asian transition economies, most of which are oil or mineral exporters, seem set to maintain fairly robust growth rates as a result of historically high terms of trade.

Trade winds not picking up

Six years after the onset of the global financial crisis, international trade remains lacklustre. Merchandise trade grew at close to 2 per cent in volume in 2012−2013 and the first few months of 2014, which is below the growth of global output. Trade in services increased somewhat faster, at around 5 per cent in 2013, without significantly changing the overall picture. This lack of dynamism contrasts sharply with the two decades preceding the crisis, when global trade in goods and services expanded more than twice as fast as global output (at annual averages of 6.8 per cent and 3 per cent respectively). During that period, the share of exports and imports of goods and services in GDP (at constant prices) virtually doubled, from around 13 per cent to 27 per cent in developed countries, and from 20 per cent to close to 40 per cent in developing countries.

Given the insufficiency of global demand, it is highly unlikely that international trade alone will be able to kick-start economic growth. Facilitating trade flows by modernizing customs procedures will be helpful in making the trading system more efficient over the longer term, but it will not address the main constraints on trade today. International trade has not slowed down or remained quasi-stagnant because of higher trade barriers or supply-side difficulties; its slow growth is the result of weak global demand. In this context, a lopsided emphasis on the cost of trade, prompting efforts to spur exports through wage reductions and an "internal devaluation", would be self-defeating and counterproductive, especially if such a strategy is pursued by several trade partners simultaneously. The way to expand trade at a global level is through a robust domestic-demand-led output recovery at the national level.

Although there is an overall lack of dynamism in trade at present, in some countries and regions imports have been growing (in volume) at relatively high rates: between 8 and 9 per cent in 2013. This has been the case in sub-Saharan Africa and West Asia that continue to benefit from high commodity prices by historical standards, and in China, which remains a strong market for several primary commodities.

That said, with a few but important exceptions, most commodity prices have been declining persistently since their peaks in 2011, although their downward trend seems to have been slowing down in 2013−2014. The main exceptions to this trend are oil, the price of which has remained remarkably stable at high levels since 2011, and tropical beverages (coffee and cocoa) and some minerals (most notably nickel), which experienced sharp price increases in 2014 due to supply shortages. Despite an overall declining trend, commodity prices in the first half of 2014 remained, on average, close to 50 per cent higher than during the period 2003−2008.

While recent developments in commodity prices have differed by commodity group and for particular commodities, a common feature in the physical markets is that supply-side factors have played a major role. This is reflected, for instance, in the lower prices of minerals, as investments made during the period of rapidly rising prices eventually translated into increased supplies. By contrast, changes in physical demand had only a minor impact on the evolution of commodity prices in 2013 and early 2014. In general, demand for commodities has continued to grow in line with the moderate economic growth of the world economy.

Short-term developments in commodity prices continued to be influenced by the substantial financialization of commodity markets during 2013 and the first half of 2014. However, regulatory changes in commodity futures trading have encouraged a shuffling of participants from banks towards other financial operators such as commodity trading companies, which often operate in a less transparent and less regulated environment than more traditional financial institutions.

From a longer term perspective, the conclusion of the analysis of *TDR 2013* that commodity prices are set to remain at relatively high levels in historical terms in the coming years, with some short-term corrections, remains valid. This does not suggest that producing countries should be complacent; rather they should try as far as possible to use the rents generated in these markets to finance structural transformation, particularly with a view to production and export diversification.

A "new normal"?

The apparent stabilization of relatively low growth rates across different groups of countries in the world economy may give the impression that it has reached a "new normal". However, to assess the sustainability of the present situation, it is necessary to examine not only the rates of GDP growth, but also its drivers.

After a brief experiment in 2009 and the first half of 2010 with expansionary fiscal measures in response to the immediate threat of a global financial meltdown, the policy mix used in the developed economies comprised, to varying degrees, a combination of fiscal austerity, wage containment and monetary expansion in the hope that increased investor confidence, labour market flexibility, greater competitiveness and the expected rehabilitation of banks' balance sheets would orchestrate a rapid and sustained recovery. However, with fiscal and labour market policies dampening domestic demand, liquidity expansion by monetary authorities was channelled mostly to financial, rather than productive, investments. This in turn led to significant increases in asset prices, despite anaemic economic growth, and to large capital outflows, much of them to emerging markets. Consequently, this policy mix only indirectly (and with a significant delay) supported a demand recovery in those countries where asset appreciation generated a sufficiently strong wealth effect and encouraged renewed consumer borrowing. As such, the new normal has some obvious parallels with the conditions that led to the global financial crisis.

In the case of emerging economies, the extent to which the expansion of domestic demand was being supported by genuine income expansion or by unsustainable asset bubbles and excessive consumer borrowing (with likely significant variations across countries) is still unclear. However, the potential vulnerability of developing and emerging economies in the new normal is heightened by persistent weaknesses in the international financial architecture. Under these circumstances, capital flows can have significant, and not always welcome, effects on the real economy and on the ability of policymakers to respond to unforeseen shocks.

Some developing countries also remain exposed to negative shocks originating from international trade, particularly in countries that rely mainly on exports of only a few primary commodities or on low-skill, labour-intensive manufactures. Diversification of their productive and export activities is a pending task for many transition and developing economies. The UNCTAD Merchandise Trade Specialization Index confirms that, despite the rapid rate of growth of trade in many developing economies over the period 1995−2012, the degree of specialization in their export structures has not varied significantly.

There is, in fact, nothing particularly "new" about the current financial cycle affecting developing and transition economies. These economies are now experiencing their fourth such cycle since the mid-1970s; and, much as before, because the present cycle is mainly driven by developed countries' economic conditions and monetary policy decisions, the resulting international capital movements do not necessarily coincide with the needs of developing countries. On the contrary, if recent history is any guide, they could have serious disruptive macroeconomic and financial effects. In order to create and maintain domestic macroeconomic and financial conditions that support growth and structural transformation, governments should have at their disposal suitable policy instruments for managing capital flows, and for preventing or coping with the recurrent shocks these can provoke. Multilateral rules in the IMF's Articles of Agreement and in the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO) do allow governments to manage their capital accounts, including a resort to capital controls. However, the emphasis has been on their use only for prudential reasons or crisis management. Instead, capital management measures should be seen as a normal instrument in policymakers' toolkit, rather than as an exceptional and temporary device to be employed only in critical times.

Some new bilateral and plurilateral trade and investment agreements that have been signed, or are being negotiated, introduce even more stringent commitments with respect to financial liberalization than those contained in multilateral agreements, which might further reduce policy space in this context. Therefore, governments that aim to maintain macroeconomic stability and wish to re-regulate their financial systems should carefully consider the risks in taking on such commitments.

The case for coordinated expansion

UNCTAD, using its Global Policy Model, has assessed an alternative, "balanced-growth" scenario, which could offer a way of escaping from the current global economic doldrums. The two scenarios used in the model have the value not of forecasting, but of demonstrating the direction of change that could be expected from a general shift in policy orientation. The balanced-growth scenario introduces the following elements: incomes policies to support growth of demand on a sustainable basis; growth-enhancing fiscal policies; industrial policies to promote private investment and structural transformation; regulation of systemically important financial institutions and capital controls to stabilize global financial markets; and development-oriented trade agreements. This is contrasted with a "baseline" scenario, which broadly continues with business-as-usual policies.

The simulations for the baseline scenario show that structural imbalances will keep on growing, even with continued moderate growth, with countries becoming increasingly vulnerable to shocks and financial instability. The longer such imbalances remain unresolved, the harsher the consequences will be, in the face of another serious crisis. The balanced-growth scenario, on the other hand, shows considerable improvements in growth rates, and, most importantly, a gradual resolution of global imbalances. The average growth of the world economy is significantly faster than it is under the baseline scenario. The faster growth rates for all regions are the result not only of individual stimuli, but also of strong synergic effects from the coordination of pro-growth policy stances among the countries. Finally, the results confirm greater growth convergence in the balanced-growth scenario, as well as improved financial stability.

While the results of such exercises need to be viewed with a familiar degree of caution and care, their underlying message is that, in an increasingly interconnected global economy, policies have to be consistent for the world as a whole. Taking into account real and financial feedbacks, it should be clear that a sustained and stable demand-led growth path has to start domestically, rather than having each country individually pushing for competitive reductions of costs and imports in order to generate a net-export-led recovery − a process to which, admittedly, surplus countries have much more to contribute.

The absence of effective institutions and mechanisms for international policy coordination can push policymakers into adopting strategies that may appear to be expedient in the short term, but which are effectively self-defeating in the medium term. It is therefore essential to continue with efforts to devise a more effective set of globally inclusive institutions to regulate markets, help correct unsustainable imbalances when they emerge, and better pursue the aims of global development and convergence.

Challenges towards a new development agenda

If macroeconomic policy is tacking uncomfortably close to the "business-as-usual" strategy of the pre-crisis years, the discussions now under way on a post-2015 development agenda are tending to break with the past. The push for a more universal, transformative and sustainable approach to development will play a key role in the setting of new goals and targets for policymakers, at both the national and international levels. The 17 goals and sundry targets agreed to at the United Nations Open Working Group on Sustainable Development already signal a level of ambition well beyond the Millennium Development Goals.

The international community faces three principle challenges in fashioning this new approach. The first is aligning any new goals and targets to a policy paradigm that can help raise productivity and per capita incomes everywhere, generate enough decent jobs on a scale to meet a rapidly growing and urbanizing global labour force, establish a stable international financial system that boosts productive investment, and deliver reliable public services that leave no one behind, particularly in the most vulnerable communities. The dominant economic paradigm of market liberalism has disappointed in most of these respects. In this context, as Pope Francis has recently suggested, we can no longer simply put our trust in "the sacralized workings of the prevailing system". Undoubtedly, fresh thinking is needed.

The second challenge to consider in formulating a new development agenda is the massive rise in inequality, which has accompanied the spread of market liberalism. This is important because, in addition to its moral implications, growing inequality can seriously damage social well-being, threaten economic progress and stability, and undermine political cohesion. Previous *Trade and Development Reports* (*TDR*s) have insisted on the need to look beyond some of the headline-grabbing numbers surrounding the top one per cent, and examine what has been happening to functional income dynamics, in particular, the divergence between wage and productivity growth and the growth of rentier incomes. Heightened capital mobility has not only reduced the bargaining power of labour, further amplifying the adverse distributive impact of unregulated financial activity; it has also made it harder to tax some incomes directly, thus increasing the State's reliance on more regressive taxes and on bond markets. This can, in turn, have a very corrosive impact on the legitimacy and effectiveness of the political process.

The third challenge is ensuring that effective policy instruments are available to countries to enable them to achieve the agreed goals and advance the development agenda. Restoring a development model that favours the real economy over financial interests, puts sustainability ahead of short-term gains and truly seeks to achieve prosperity for all will almost certainly require adding more instruments to the policy toolkit than is currently contemplated by economic orthodoxy.

The enduring case for policy space

Any widening and strengthening of the ambition of national development strategies will need to be accompanied by institutional changes. Markets require a framework of rules, restraints and norms to operate effectively. As such, the market economy is always embedded in a legal, social and cultural setting, and is sustained by political forces. How and to what extent the framework of rules and regulations is loosened or tightened is part of a complex political process specific to each society, but it cannot be dispensed with without threatening a breakdown of the wider economic and social order.

International markets and firms, no less than their domestic counterparts, also require a framework of rules, restraints and norms. And, as at the domestic level, the loosening and tightening of that framework is a persistent feature of governance of the global economy. States must decide on whether and how much of their own independence they are willing to trade for the advantages of having international rules, disciplines and supports. Inevitably, in a world of unequal States, the space required to pursue national economic and social development aspirations varies, as does the likely impact of an individual country's policy decisions on others. The challenges of managing these trade-offs are particularly pronounced at the multilateral level, where the differences among States are significant. While the extent to which an adopted growth and development path responds to national needs and priorities can obviously be limited or circumscribed by multilateral regimes and international rules, it can equally be affected by economic and political pressures emanating from the workings of global markets, depending on the degree and nature of economic integration of the country concerned.

The interdependence among States and markets provides the main rationale for a well-structured system of global economic governance comprising multilateral rules and disciplines. The guiding principle of these arrangements should be their ability to generate fair and inclusive outcomes by providing global public goods and minimizing adverse international spillovers and other negative externalities, regardless of whether these are created by national economic policies or the profit-making decisions of private actors.

These various tensions between national policy autonomy, policy effectiveness and international economic integration are captured, in part, by the idea of "policy space"; this refers to the freedom and ability of governments to identify and pursue the most appropriate mix of economic and social policies to achieve equitable and sustainable development in their own national contexts, but as constituent parts of an interdependent global economy. It can be defined as the combination of de jure policy sovereignty, which is the formal authority of policymakers over their national policy goals and instruments, and de facto national policy control, which involves the ability of national policymakers to set priorities, influence specific targets and weigh possible trade-offs.

For some countries, signing on to multilateral disciplines can spur them to redouble their efforts to use their remaining policy space more effectively than when they had greater policy space; this seems to be true, in particular, for countries emerging from conflict, as well as for many former socialist economies. Moreover, these disciplines can operate to reduce the inherent bias of international economic relations in favour of countries that have greater economic or political power. Thus, such disciplines can simultaneously restrict (particularly de jure) and ease (particularly de facto) policy space, since constraints on one country's behaviour also apply to other countries, thereby affecting the external context as a whole.

But there are also valid concerns that the various legal obligations emerging from multilateral, regional and bilateral agreements have reduced national policy autonomy by affecting both the available range and the efficacy of particular policy instruments. In addition, the effectiveness of national policies tends to be weakened − in some instances very significantly − by forces of globalization (especially financial globalization) and by the internalization of markets, which affect national economic processes.

Inclusive multilateralism: Back to the future

History has a tendency to repeat itself, though not necessarily as tragedy or farce. Consequently, there are always positive lessons to be learned from examining how earlier generations of policymakers dealt with big challenges. The need for reconciling the requirements of policy sovereignty at the national level with the imperatives of an interdependent world economy may seem today to be relatively new. In fact, it is a long-standing challenge that has been discussed extensively, and from many different angles, for almost two centuries, though none as compelling or significant as those arising from the crises of the inter-war era.

The principal objective of the architects of Bretton Woods was to design a post-war international economic structure that would prevent a recurrence of the opportunistic actions and damaging contagion that had led to the breakdown of international trade and payments in the 1930s. Accordingly, such a structure would need to support the new policy goals of rising incomes, full employment and social security in the developed economies. But a prominent group of Roosevelt's New Dealers also struggled to place development issues firmly on the multilateral agenda in the 1930s and 1940s. This included measures that sought to expand the policy space for State-led industrialization and to increase the level and reliability of the multilateral financial support necessary to meet the needs of developing countries − efforts that eventually met with considerable resistance.

Those results set the stage for the North-South conflicts of the post-war period. In that context, the construction of a more development-friendly international economic order was a much slower and more uneven process after the war than the Bretton Woods architects had anticipated. It took the growing voices of newly independent developing countries in the late 1950s and early 1960s to shift multilateralism on to a more inclusive footing. This led to the creation of UNCTAD in 1964, and to a subsequent broadening of the development agenda around a new international economic order. The often forgotten Bretton Woods development vision and the details of its various proposals can still provide some inspiration for those seeking to advance an inclusive development agenda today.

Managing creative destruction

None of today's developed countries depended on market forces for their structural transformation and its attendant higher levels of employment, productivity and per capita incomes. Rather, they adopted country-specific measures to manage those forces, harnessing their creative side to build productive capacities and provide opportunities for dynamic firms and entrepreneurs, while guiding them in a more socially desired direction. They also used different forms of government action to mitigate the destructive tendencies of those same market forces. This approach of managing the market, not idolizing it, was repeated by the most rapidly growing emerging market economies − from the small social democratic economies of Northern Europe to the giant economies of East Asia − in the decades following the end of the Second World War.

Weak initial economic conditions and low administrative and institutional capabilities, as well as policy errors and external shocks explain, to varying degrees, why other developing countries have been less successful in replicating these earlier experiences. However, international economic governance has also increasingly posed greater constraints on the options for individual countries to pursue economic policies to achieve their development objectives.

The post-war multilateral trade regime was essentially designed not to compromise the policy space of the developed countries to achieve an appropriate level of economic security through the pursuit of full employment and extended social protection. But it also sought to limit mercantilist practices among its members and provide predictability in international trading conditions. What emerged was a regime of negotiated, binding and enforceable rules and commitments with built-in flexibilities and derogations.

Subsequent multilateral trade negotiations under the auspices of the GATT culminated in the Uruguay Round Agreements (URAs), which entered into force in 1995. The scope of those negotiations was considerably widened, both in terms of the countries participating and the tariff lines involved. They also extended into trade-related areas beyond trade in goods, with the most-favoured-nation and national-treatment principles being applied not only to trade in goods, but also to trade in a wide range of services, such as finance, tourism, education and health provision. As a result, all WTO member States accepted restrictions on their conduct of a wider set of policies, including some designed to promote and direct the structural transformation of their economies. Yet some of the policy space they gave up had played an important role in successful development processes in the past. The following are some examples.

- The use of subsidies, circumscribed by the Agreement on Subsidies and Countervailing Measures (SCM), had been a preferred instrument to support structural transformation, particularly in East Asian countries.
- Performance requirements on foreign investors with respect to exports, domestic content and technology transfer, restricted under the Agreement of Trade-related Investment Measures (TRIMs), had been frequently used to enhance the creation of linkages between foreign investors and local manufacturers.
- Reverse engineering and imitation through access to technology, curtailed under the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS), had previously been used by many countries, including the now developed ones.

Despite greater restrictions on the use of certain policy instruments, WTO members retain some flexibility to support structural transformation, including in tariff policy where some lines are still unbound, and where the difference between bound and applied tariffs provides room for modulating them in support of development goals. WTO members can also continue to use certain kinds of subsidies and standards to promote research and development and innovation activities, as well as exploit flexibilities in the use of export credits. Under the TRIMs Agreement, policymakers may continue to impose sector-specific entry conditions on foreign investors, including industry-specific limitations. The agreement also allows some flexibility through the mechanism of compulsory licensing (whereby authorities can allow companies other than the patent owner to use the rights to a patent) and parallel imports (i.e. imports of branded goods into a market which can be sold there without the consent of the owner of the trademark in that market).

Weighing the loss of policy space in specific areas against the potential gains of a more predictable open multilateral trading system is no easy task. In any event, the more immediate question is how best to use the space that remains to support more sustainable and inclusive outcomes than have been achieved by most developing countries over the past three decades. In this respect, practices and capacities linked to the institutional construct of a developmental State are still key, as UNCTAD has long insisted. But it is also important to recognize that inconsistencies and gaps across the multilateral architecture, particularly at the interface of trade and financial flows, continue to make it difficult for developing countries to make the most of the space that remains. Moreover, many of them need much better support from the international community to use the current arrangements in a way that will help their transformation efforts. In many respects that support has been given reluctantly, or has not been forthcoming at all. UNCTAD's proposal for an independent commission to undertake a development audit of the multilateral trading system to examine these and other tensions that disturb the smooth workings of this system could offer a way forward.

The steady erosion of policy space

Since the early 1990s, there has been a wave of bilateral and regional trade agreements (RTAs) and international investment agreements (IIAs), some of which contain provisions that are more stringent than those covered by the multilateral trade regime, or they include additional provisions that go beyond those of the current multilateral trade agreements.

Provisions in RTAs have become ever more comprehensive, and many of them include rules that limit the options available in the design and implementation of comprehensive national development strategies. Even though these agreements remain the product of (often protracted) negotiations and bargaining between sovereign States, there is a growing sense that, due to the larger number of economic and social issues they cover, the discussions often lack the transparency and the coordination − including among all potentially interested government ministries − needed to strike a balanced outcome.

Regardless of the countries involved, by signing those agreements developing-country governments relinquish some of the policy space they have been endeavouring so hard to preserve at the multilateral level. This may seem puzzling, but it could be mainly because some governments fear exclusion when other countries signing up to such agreements gain preferential market access and become potentially more attractive as destinations for FDI. They may also see participation in a free trade agreement as a means to facilitate the entry of their domestic firms into international production networks.

However, as discussed in previous *TDR*s, participation in international production networks runs the risk of generating adverse terms-of-trade effects on countries, particularly those at the lower ends of production chains, and it creates few domestic linkages and technology spillovers. Moreover, developing countries at an early stage of industrialization may become locked into low-value-added activities due to stiff competition from other suppliers to keep labour costs low, and because the tight control over intellectual property and expensive branding strategies of the lead firm block them from moving up the value chain. Even relatively successful middle-income countries do not face a level playing field in many of these networks. China is an interesting case in point. Considerable attention has been given to its rise as a dominant exporter of electronics goods, to the extent that it now accounts for as much as one-third of total trade in this sector. But there are, in fact, very few Chinese firms that control the different parts of the electronics chain. More telling still, Chinese firms, on one recent estimate, account for just 3 per cent of total profits in this sector. Thus, developing countries need to carefully weigh both the costs and benefits when considering an industrialization strategy that places considerable emphasis on participation in international production networks if this pushes them to a race to conclude ever more and increasingly stringent agreements without a full and proper understanding of their development potential.

Policy space is not only reduced by free trade agreements, but also when countries sign up to IIAs. When most such agreements were being concluded in the 1990s, any loss of policy space was seen as a small price to pay for an expected increase in FDI inflows. This perception began to change in the early 2000s, as it became apparent that investment rules could obstruct a wide range of public policies, including those aimed at improving the impact of FDI on the economy. Besides, empirical evidence on the effectiveness of bilateral investment treaties and investment chapters in RTAs in stimulating FDI is ambiguous. Moreover, the lack of transparency and coherence characterizing the tribunals established to adjudicate on disputes arising from these agreements, and their perceived pro-investor bias, added to concerns about their effectiveness. A range of possibilities is currently under consideration to rebalance the system and recover the needed space for development policies. These include: (i) progressive and piecemeal reforms through the creation of new agreements based on investment principles that foster sustainable development; (ii) the creation of a centralized, permanent investment tribunal; and (iii) a retreat from investment treaties and reverting to national law.

Along with the proliferation of trade agreements and their expansion into trade-related areas, there has been a global revival of interest in industrial policy. Reconciling these two trends is a huge challenge. Many developed countries, especially since the recent financial crisis, have begun to explicitly acknowledge the important role that industrial policy can play in maintaining a robust manufacturing sector. The United States, while often portrayed as a country that takes a hands-off approach to industrial policy, has been, and remains, an avid user of such a policy. Its Government has acted as a leading risk taker and market shaper in the development and commercialization of new technologies, adopting a wide range of policies to support a network of domestic manufacturing firms that have the potential for innovation, exports and the creation of well-paid jobs. By contrast, the experience of the EU illustrates how intergovernmental agreements can constrain the policy choices of national policymakers, and how industrial policies that are limited to the adoption of only horizontal measures may hamper the achievement of stated objectives.

As some developing countries have reassessed the merits of industrial policy in recent years, they have also used some of their policy space to induce greater investment and innovation by domestic firms so as to enhance their international competitiveness. Some of the measures adopted include, sector-specific modulation of applied tariffs, using the difference between bound and applied tariff rates; applying preferential import duties; offering tax incentives; providing long-term investment financing through national development banks or subsidizing commercial loans; and using government procurement to support local suppliers. Various policy measures continue to be used in countries at different levels of development − from Viet Nam to Brazil − in an effort to create a virtuous circle between trade and capital accumulation.

Safeguarding policy space while strengthening multilateral mechanisms

UNCTAD has been arguing for some time that if developing countries are to maintain and improve their recent growth trajectories, they should widen and deepen the structural transformation of their economies. The resulting policy challenge is a familiar one in commodity exporters, where a lack of diversification makes their economies vulnerable to exogenous shocks and policy shifts. But also, stronger growth does not automatically translate into improved living standards for the majority of the population. While structural transformation is imperative for all developing countries for similar reasons, in the coming years they are likely to find a much less favourable global economic environment than existed in the opening decade of this century. Consequently, structural transformation will be extremely difficult without greater flexibilities in policymaking.

Thus, strengthening the governance of global trade in support of development goals will need to be part of a more comprehensive and integrated package to help preserve the policy space for proactive trade and industrial policies. Such reform should complement macroeconomic and financial reforms. It will need to include various elements, foremost among them being the strengthening of multilateral mechanisms. The new momentum from the WTO's Bali Ministerial Conference in December 2013 should be taken forward to achieve an outcome of the Doha Round negotiations that justifies its description as a "development round". Any renewal of such a commitment could include an emphasis on implementation issues and maintaining the principle of a single undertaking, rather than moving towards a variable geometry whereby a range of mandatory core commitments is supplemented by plurilateral agreements. The greatest benefit from this may well be simply maintaining the public good character of multilateral rules.

A refocusing of trade negotiations on multilateral agreements would imply reconsidering provisions that go beyond existing WTO agreements; but it should also look into greater flexibility in the application of the URAs by responding constructively to a number of recent developments. For example, the flexibilities introduced into the system of intellectual property rights protection with respect to public health could be extended to support technology adoption and innovation at all stages of structural transformation. Further negotiations on industrial tariff reductions could also provide greater flexibility for sector-specific public support policies. The latter would imply changing the sector-specific level and structure of tariffs over time, while maintaining considerable dispersion of tariffs across economic sectors.

Fiscal space in the global context

Fiscal space goes hand in hand with policy space. Even if governments are allowed to design and implement the development policies of their choice within the existing international framework of negotiated rules and accepted norms, they will still need to finance the investment and other general and targeted expenditures required for implementing those policies. Thus, strengthening government revenues is key.

Fiscal space is both a cause and an effect of economic growth and structural change. Higher average levels of income, expansion of the modern sectors of the economy and a shrinking of the informal economy broaden the tax base and strengthen the governments' capacities to mobilize fiscal revenues. This, in turn, allows for higher growth-enhancing public spending, both on the supply side (e.g. investment in infrastructure, research and development, and education) and on the demand side (e.g. social transfers). Conversely, limited, or even a diminished, fiscal space is often part of a vicious circle of underdevelopment. The need for reclaiming and expanding fiscal space faces particular challenges in an increasingly globalizing economy. Official development assistance (ODA) can support the expansion of fiscal space, particularly in the least developed countries (LDCs), as can foreign borrowing, and on a more sustainable basis if it is used for expanding productive capacities. However, the unpredictability of ODA can make it difficult for long-term policy planning, and it can also delay the establishment of political mechanisms that support the developmental State. Moreover, in most cases, relying on others' savings to fund basic State activities raises questions about voice and legitimacy. Also, excessive reliance on foreign sources has led to overindebtedness and chronic deficits in countries' fiscal and external balances, thereby reducing fiscal space in the long run. Therefore, expanding fiscal space should rely, as far as possible, on domestic revenue sources if it is to sustain a national development strategy. Foreign finance can complement, but not replace, such revenues.

A major problem is that globalization has affected the ability of governments to mobilize domestic revenues. Their lowering of tariffs has resulted in reduced revenues in many developing countries, often significantly so, while the increased mobility of capital and its greater use of fiscal havens have considerably altered the conditions for taxing income – both personal and corporate – and wealth. The dominant agenda of market liberalism has led to a globalized economy that encourages tax competition among countries, at times pushing them to a "race to the bottom" in offering incentives in the form of reduced direct taxation. Corporate tax rates have been on a declining trend in developed and developing countries alike, often accompanied by subsidies or exemptions to attract or retain foreign investment. In addition, finance-led globalization has led to the proliferation of off-shore financial centres, tax havens and secrecy jurisdictions that provide various means of tax avoidance or evasion on a scale that is measured in billions, if not trillions, of dollars.

Taxation problems for the international community

Trade mispricing, including through transfer pricing (i.e. the valuation of intra-firm cross-border transactions by international company groups), has become the evasion mechanism of choice for many companies. If the intracompany or intragroup price does not reflect the price that would be paid in a market where each participant acts independently in its own interest, profits within a company group can be effectively shifted to low-tax or no-tax jurisdictions, while losses and deductions are shifted to high-tax jurisdictions. Another way of shifting profits and losses among jurisdictions is through "thin capitalization", which occurs when a company has a high proportion of debt in relation to its equity capital, and mixes and matches intragroup debts and interest payments across its subsidiaries to minimize tax payments and generate higher overall profits.

The international tax architecture has failed, so far, to properly adapt to this reality, thereby allowing a massive haemorrhaging of public revenues. The opacity surrounding tax havens may partly explain the difficulties faced by policymakers in collecting public revenues, but the main obstacle is political: the major providers of financial secrecy are to be found in some of the world's biggest and wealthiest countries, or in specific areas within these countries. Indeed, offshore financial centres and the secrecy jurisdictions that host them are fully integrated into the global financial system, channelling large shares of trade and capital movements, including FDI.

Recently, a number of developments aimed at improving transparency and exchange of information for tax purposes have taken place. They include a declaration by G20 leaders to promote information sharing with respect to all kinds of abuses and fraudulent activities, an OECD Action Plan on Base Erosion and Profit Shifting (BEPS), increased monitoring by several national tax authorities of tax abuses by rich individuals and TNCs, and numerous bilateral tax treaties (BTTs) and tax information exchange agreements (TIEAs).

While these initiatives are steps in the right direction, their implementation and enforcement have generally been very slow. This is particularly so with regard to transfer pricing abuses, which are extremely harmful for developing countries. Because these initiatives are mostly led by the developed economies – the main homes to TNCs and to some secrecy jurisdictions – there are risks that the debate will not fully take into account the needs and views of developing and transition economies. It will therefore be important to give a more prominent role to institutions like the United Nations Committee of Experts on International Cooperation in Tax Matters, and to consider the adoption of an international convention against tax avoidance and evasion.

Although the very nature of the problem suggests the need for a multilateral approach, governments can also apply measures at the national level. They can, for instance, legislate for the adoption of a general anti-avoidance rule (GAAR) so that "aggressive" tax schemes can be declared illegal when challenged in courts. They can also be more effective in combating transfer mispricing in their international trade by using reference pricing for a number of homogeneous traded goods.

Natural resources for public revenue

In many developing countries, collecting higher public revenues through rents from natural resources – and particularly from the extractive industries – is of particular importance for the financing of development. The main contribution of these activities to development is what they pay in government revenues, as they often generate enclave economies with weak or no linkages with the rest of the economy. However, as the rise of commodity prices during the past decade or so led to a tenfold increase in the profits of the world's largest mining companies, it became obvious that the public gains from resource rents were lagging far behind. Corruption may be partly to blame, but the main reason has been overly generous taxation regimes established at a time of low prices, and often on the recommendation of the Bretton Woods institutions, with the aim of attracting international firms and investors to the sector.

As a result, many governments – both from developed and developing countries – have begun to revise their policies relating to the extractive industries. This has included renegotiation or cancellation of existing contracts, increases in tax or royalty rates, introduction of new taxes and changes in the degree of State ownership of the extractive projects. Host governments can also benefit from a strengthening of their bargaining positions in contract negotiations with TNCs involved in the extractive industries due to the emergence of new major players, such as companies from emerging economies. However, these changing market conditions should not obscure the wider policy challenges faced by producing countries in making the most of extractive industries for development.

A comprehensive policy aimed at improving revenues from natural resources needs to incorporate several elements. First, governments should retain their right to review the tax regimes and ownership structures whenever deemed necessary for the economic and development interests of the country. A minimum level of taxation could also be negotiated at the regional or international levels to avoid a race to the bottom. Second, they should have the means to enforce the rules and obtain the due revenues by being able to control TNCs' transfer pricing manoeuvres and underreporting of export volumes. Third, they should be allowed to do so without the threat of legal retribution through the existing investment dispute mechanisms.

Most of the needed measures can be taken at the national level, but multilateral cooperation is still of the utmost importance. Transparency initiatives such as the Extractive Industries Transparency Initiative (EITI) should be made mandatory and extended: they should not focus only on governments, but also on producing firms and commodity trading companies. There should also be a greater focus on monitoring, auditing and accountability, as well as enforcement of the fiscal conditions and regulations under which extractive industries operate. Institutional development and capacity-building are crucial, in particular to improve the capacity to negotiate contracts, but also to ameliorate the monitoring of production costs, import and export prices, volumes, qualities and time of delivery of the natural resources extracted, as well as for data collection and processing. Given its expertise in the area of commodities, transport, customs and trade, UNCTAD could provide support in this domain. Regional cooperation in capacity-building can also prove very useful. The international donor community has an important role to play in supporting such initiatives.

Preventing the resource drain caused by illicit financial flows and tax avoidance can help provide the necessary revenues to finance the attainment of new development goals. Thus, given their relevance for many developing countries and transition economies, fiscal space and related governance issues should be prominent components of the post-2015 development agenda.

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