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Explanatory notes

Classification by country or commodity group

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

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

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

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

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

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

Other notes

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

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

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

The term "billion" signifies 1,000 million.

The term "tons" refers to metric tons.

Annual rates of growth and change refer to compound rates.

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

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

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

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

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

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

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

Abbreviations

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

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

OVERVIEW

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

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

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

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

From global financialization to global financial crisis

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

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

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

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

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

Tepid recovery in developed countries

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

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

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

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

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

Stagnation: Secular or seasonal?

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

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

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

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

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

Financial spillovers to developing and transition economies

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

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

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

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

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

Managing capital flows: New vulnerabilities, old challenges

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

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

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

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

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

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

Slowdown and diversity in the developing world

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The liquidity conundrum: Too much and too little

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

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

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

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

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

Possible steps towards the reform of the international monetary system

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

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

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

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

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

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

International financial regulation: A work in progress

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

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

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

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

Outstanding issues: Shadow banking and credit rating agencies

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

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

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

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

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

Towards a bolder agenda

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

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

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

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

The recurrent problem of external debt crises

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

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

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

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

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

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

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

Alternative approaches to sovereign debt restructuring

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

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

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

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

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

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

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

Restating the case for additional official development assistance

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

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

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

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

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

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

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

Public-private partnerships

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

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

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

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

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

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

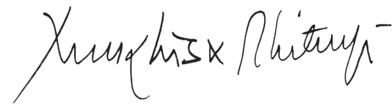
One such institution is the sovereign wealth fund (SWF). These special purpose vehicles are owned by national or regional authorities with large amounts of foreign assets to invest rather than hold as international reserves. SWFs are gaining increasing attention, not only because of the immense scale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

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

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

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

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



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