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OVERVIEW

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Global disorder and regional responses

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OVERVIEW

Close to the edge

After a rapid yet uneven recovery from the pandemic in 2021, in 2022 the global economy was confronted with new and multiple shocks. These span energy markets and the financial sector, the real economy and supply chains, climate and geopolitics.

Inflation has become the key concern for policymakers, and monetary tightening has been used as the main policy tool to address price rises. The policy consensus in advanced economies is that central banks can pilot them to a soft landing and avoid a full-blown recession. This policy stance carries short- and long-term risks. In the short run, monetary tightening will lead to declining wages and a fall in employment and government revenues. In the mid- to long-term, a monetarist pathway will reverse the pandemic pledges to build a more sustainable, resilient and inclusive world. These global effects of these risks are asymmetric.

In a system weakened by the pandemic, developing countries are particularly influenced by the policy decisions of advanced countries. UNCTAD worries the situation in the developing world is much more tenuous than recognized by the international financial community, thus undermining the ambition of a global financial safety net (GFSN). Forty-six developing countries are exposed to severe financial pressures because of the high cost of food, fuel and borrowing; more than double that number are vulnerable to at least one of those threats. The likelihood of a widespread developing country debt crisis and a potentially lost decade, therefore, is very real, as is the risk of not meeting the sustainable development goals (SDGs) by the end of the decade.

Policy measures to address these risks and avert further cascading crises are known, but they require political will and multilateral coordination to be put into action. One important step would be to deploy a mix of policy tools to address inflationary pressures. Another set of measures concerns the international financial system and includes a fairer and more permanent use of Special Drawing Rights (SDRs) to ease balance of payments constraints and reduce fiscal pressures. Additional arrangements, such as currency swaps, should be considered to deal with currency instability; discussions on a multilateral legal framework for handling debt restructuring, including all official and private creditors, should be launched.

The experience of the Covid-19 pandemic has shown a bold policy change is viable, especially in times of global crises. And despite current setbacks, the mounting pressures of 2022 present a moment for wider reform. Such a moment was largely missed in 2010–2012, when the world was dealing with the aftermath of the global financial crisis (GFC). The reform of the international financial regulations was partial, at best. Nor did it address structural problems inside and between the economies. A decade later, the world economy is in a more precarious condition, and if the current moment for multilateral reform is not seized, the multilateral system will remain at risk of further fracture.

A. The inflation spectre haunting the world

The slowdown in growth and acceleration of inflation beginning in the second half of 2021 have invoked parallels between the current moment and the stagflation of the 1970s. Policymakers appear hopeful that a short sharp monetary shock – of the kind initiated at the end of that decade – will be able to anchor inflationary expectations without triggering the kind of deep recession that marked the start of the 1980s and led to a lost decade for many developing countries.

The current context, however, is vastly different from the economy of the 1970s: structural and behavioural changes linked to deepening financialization, market concentration and labour's greatly reduced bargaining power have transformed economic dynamics in both advanced

and developing countries, with significant implications for the political economy of inflation.

First, core global inflation is driven by fewer sectors in 2022 than it was in the 1970s. Second, the recent commodity price increases, when measured in real terms, have so far been smaller than in the 1970s. Third, the energy intensity of gross domestic product (GDP) has declined considerably since the 1970s, reducing the inflationary impact of higher energy prices. Fourth, nominal wage growth is not keeping up with CPI inflation; therefore, real wages in developed and developing countries alike are stagnating or declining, ruling out a wage-price spiral as the inflationary lubricant. Fifth, both developed and developing countries have high levels of indebtedness in both private and public sectors, with much of the developing country debt denominated in foreign currency and short-term. Sixth, far more central banks are independent today than in the early 1980s, with clear mandates to prioritize inflation targeting and "transparent" monetary policy rules. Meanwhile, the spread of financial innovation and the expansion of private credit in a loosely regulated market have created a large and growing universe of non-bank financial institutions, the shadow banking system. Shading banking has continued to expand in advanced and crucially in developing economies over the past decade. In the current environment of slowing growth, underregulated financial markets pose renewed risks to stability in developed and developing countries alike.

The drivers of inflation today are also distinct. While the surge in inflation from the end of 2021 belied hopes it would be short-lived, the evidence does not suggest this surge came from a further loosening of fiscal policy or wage pressure. Instead, inflation has derived largely from cost increases, particularly for energy, and sluggish supply response due to a prolonged history of weak investment growth. These are being amplified by price-setting firms in highly concentrated markets raising their mark-ups to profit from two rare opportunities – in 2021, the surge in demand occasioned by the global recovery and in 2022, the surge in speculative trades related to a wave of global concerns about fuel supply, with no substantial changes in actual demand or supply.

Food and energy price rises pose significant challenges for households everywhere, and with added pressure on fertilizer prices caught in their vortex, the damage could be lasting. The war in Ukraine is no doubt a major

factor in this story, although commodity markets have been in a turbulent state for a decade and were in an upswing for most of 2021. To date, insufficient attention has been given to the role of speculators in provoking this situation through betting frenzies triggered by their oversize footprint in futures contracts, commodity swaps and exchange traded funds. Although the resulting price spikes are often short lived, consumers in the developing world are hit hard, pushing hundreds of millions back into extreme poverty. This UNCTAD Report offers a set of policy measures to tackle the effects of the financialization of commodity markets to bring greater transparency, oversight and regulation to these activities.

Under present circumstances, continued monetary tightening will have little direct impact on the principal sources of inflation. Rather, they will re-anchor inflationary expectations by choking off investment demand and pre-empting any incipient labour market pressures. A more immediate impact could be a sharp correction in asset and commodity prices, from crypto currencies to housing and metals. With financial entanglements since the GFC becoming increasingly global, complex unanticipated shocks remain a real and present danger.

Monetary tightening thus poses a two-fold risk to the real economy and the financial sector: given the high leverage of non-financial businesses, rising borrowing costs could cause a steep increase in non-performing loans and trigger a cascade of bankruptcies. With direct price and markup controls ruled out as politically challenging, and if monetary authorities are unable to stabilize inflation quickly, governments might resort to additional fiscal tightening. This would only help precipitate a sharper global recession. The impact of the United States Federal Reserve (the Fed) tightening will be more severe for emerging economies with high public and private debt, substantial foreign exchange exposure, a high dependence on food and fuel imports and high current-account deficits.

In this situation, central banks cannot bring inflation down at a socially acceptable cost. Needed instead are appropriate industrial and employment policies to target supply chain disruptions and labour shortages and to increase the supply of key items in the medium term; this should be accompanied by sustained global policy coordination and (liquidity) support to help countries fund and manage these changes. In the meantime, policymakers should seriously consider alternative paths of action to lower

inflation in socially desirable ways, including strategic price controls, better regulation to reduce speculative trades in key markets, targeted income support for vulnerable groups and debt relief.

B. Growth prospects through the fog of war and inflation

Based on the United Nations Global Policy Model, the world economy is expected to grow 2.5 per cent in 2022. The downward revision from last year derives from three factors:

- The policy stimulus enacted in 2020 and 2021 proved less effective than expected. In particular, in the bounce-back from the recession, the fiscal and financial stimuli turned out to be smaller than expected, with a weaker impact on growth. This made the subsequent policy tightening (both fiscal and monetary) more recessionary than it would have been if the recovery had been stronger.
- The supply response of key goods and commodities was insufficient to match the post-lockdown demand surge. This outcome is unsurprising; many governments were reluctant to boost public investment and employ an active industrial policy, thus leading to a situation where the "policy tapering" underway (to liquidate excess central bank assets) was compounded by the interest rate hikes meant to counter inflationary pressures.
- Unexpected headwinds coming from the war in Ukraine brought down growth in the Russian Federation and Ukraine and triggered a swing in commodity prices and are now acting as an adverse supply shock in both advanced and developing economies.

The slowdown in activity is unable to provide decent jobs, is inadequate to generate incomes to overcome inherited (and excessively large) debt burdens, is too unstable to offer long-term prospects for economic development and is deepening the inequalities of income and wealth that were entrenched even before the pandemic hit.

For developing economies, the deceleration is a particular cause for alarm. Excluding China, the group is projected to grow 3.0 per cent this year, below the pre-Covid average of 3.5 and diminishing the room for rising per

capita incomes. To put this into context, in the early 2000s, the last period of sustained progress for industrialization and development, the group grew at 5 per cent per year, on average. China will slow down as well, to an estimated 4 percentage points compared to 2021, although it is projected to continue growing faster than other countries, at approximately 4 per cent in 2022, and to accelerate in 2023, one of the few countries expected to do so.

Developed economies are projected to grow 1.7 per cent in 2022 and 1.1 per cent in 2023. On average, this is 0.5 percentage points below the mean of the pre-Covid-19 period and 0.9 per cent below the pre-GFC mean. The slowdown is particularly marked in the United Kingdom and the European Union, especially in France, Germany and Italy. As discussed in previous UNCTAD Reports and the section above, this reflects policymakers' excessive reliance on monetary policy to manage the direction of the economy.

While the global increase in inflation has sparked concerns about economic overheating in some economies, in most G20 economies, real GDP is expected to be below its pre-Covid-19 trend by the end of 2023. Projecting average 2016–2017 growth into the future, we argue the world economy will still be over 3 percentage points below its pre-Covid-19 trend in 2023, with no sign of the gap closing any time soon.

The current macroeconomic and financial conditions place developing economies in a vulnerable position, as they are exposed to ever-more frequent shocks from commodity markets, capital flows, inflationary bursts, exchange rate instability and debt distress. Meanwhile, South–South trade has weakened, while geopolitical trade disruptions, increased market concentration and restricted policy space are weakening developing countries' position in global value chains. Many liquidity constrained economies are now allocating their limited fiscal space to emergency price subsidies, sacrificing public investment in infrastructure and welfare programs, while advanced economies are once again warning of a fiscal cliff and raising the spurious claim of the expansionary effects of austerity. The war in Ukraine and the growing risks of geopolitical tensions are pushing the world towards a disjointed multipolar configuration, diminishing the hope, at least for the moment, of a more cooperative global order.

Our downward growth prognosis for 2022–2023 is midway between optimistic soft-landing scenarios and pessimistic alternatives centred on deepening geo-political tensions and military escalation. As of mid-2022, assuming the war in Ukraine turns into a political and military stalemate, with a growing human toll but without further negative economic impact on the rest of the world, we expect inflation to fall later in 2022 and the beginning of 2023. A recession in Europe and a sharper growth slowdown in the United States and China would pull commodity prices down faster and further reduce inflationary pressures. At the same time, the appreciation of the dollar, driven by the interest rate hikes, may generate recessionary shocks in developing economies, further slowing world output and prices in 2023. There is considerable contingency surrounding these trends.

These policy trends notwithstanding, a path to overcome the current economic setbacks and achieve the SDGs is still available. It requires simultaneously dealing with the urgency of the cost of living crisis and the necessity of advancing structural transformation towards a fairer and greener economy, while addressing a deteriorating growth outlook by boosting productive investment and expanding redistributive measures to bolster local markets and boost the confidence of firms and households.

C. Debt distress

With the deterioration of financial conditions starting in the last quarter of 2021, net capital flows to developing countries have turned negative; some 90 developing countries have seen their currencies weaken against the dollar this year and over a third by more than 10 per cent; bond spreads are rising, with a growing number posting yields 10 percentage points higher than United States Treasury bonds, and exchange reserves falling. At the moment, 46 developing countries are severely exposed to financial shocks and another 48 seriously exposed; the threat of a global debt crisis is a serious one. Developing countries have already spent an estimated $379 billion of reserves defending their currencies in 2022, almost double the amount of new SDRs received in the recent allocation (excluding China).

Global financial conditions, including the United States monetary tightening cycle, have put the already fragile debt sustainability in many, though not

all, developing countries in further and acute peril. The ratio of total external debt stocks to exports (of goods and services, including tourism revenues) provides an indication of countries' solvency, given the importance of export revenues to service foreign-currency denominated debt obligations.

For all income groups (low- and middle- income countries, according to the World Bank income classification and excluding China), this indicator rose from an average of 100 per cent in 2010 to 159 per cent in 2020. By 2021, this figure had fallen to 127 per cent, reflecting the much stronger growth in export revenues compared to that of external debt stocks in this year. This is still 18 percentage points above the average value for this indicator at the height of the taper tantrum crisis in 2013 (108 per cent) but below the value for 2016 (142 per cent) when the first cycle of monetary tightening started. A core danger of current financial conditions is that this recent positive development will be reversed.

Three factors have been critical in pushing most developing economies further towards the financial precipice. First, after many announcements over the past decade, United States monetary policy has set on a decisive tightening cycle that has seen the 10-year Treasury yield increase almost six-fold between mid-2020 and mid-2022. Second, price hikes in some commodity markets have added to inflationary pressures on a global scale. This has negatively affected developing country commodity importers but has benefited some developing country commodity exporters. While, for now, commodity prices for gas (United States), wheat and oil have returned to near pre-war levels, uncertainty remains about the extent to which continuation of the war in Ukraine will affect commodity prices in the future. Third, the Covid-19 pandemic lingers in many countries, with high, unresolved debt burdens in developing countries.

The flight of capital from developing economies to safer assets and jurisdictions continued unabated in the second quarter of 2022, reaching levels comparable to those following the onset of the Covid-19 pandemic by the end of June 2022. This is borne out in the data on emerging market sovereign bond spreads. These spreads – an important indicator of sovereign financial risk and distress – rose sharply between September 2021 and July 2022, following the Fed's more aggressive stance on monetary policy normalization in response to concerns about domestic inflation. Contrary to earlier episodes of steeply rising emerging market sovereign bond spreads

in the wake of the GFC and at the height of the Covid-19 pandemic, when 10-year United States Treasury bond yields actually fell, the emerging market bond spreads moved in tandem with their yield curve – a clear indicator of the central role played by the tightening monetary policy cycle in the United States in mid-2022.

Economies already suffering from severe balance of payment constraints and high external vulnerabilities well before the onset of the Covid-19 pandemic have been hit harder. Thus, for example, low- and middle-income countries whose external sovereign bonds traded in distressed territory in June 2002 had already seen their bond yields rising to above 10 percentage points relative to the most common benchmark – the yield on 10-year United States Treasury bills – in mid-2019 (including Egypt, the Republic of Türkiye, Pakistan, Uganda and Zambia). In contrast, for emerging market economies with larger and more liquid markets and investment grade ratings, sovereign bond spreads were relatively contained.

A response to this challenge requires, first and foremost, the deterioration of financial conditions in developing countries to be addressed. So far, policy and financial commitments made by the international community in recent months have fallen short of what is required. Three areas of multilateral action require urgent response: the provision of Official Development Assistance (ODA), the allocation and effective deployment of SDRs and policies to address debt distress in developing countries.

- In 2021, ODA reached $178.9 billion, equivalent to 0.33 per cent of gross national income (GNI) of the members of the Development Assistance Committee (DAC). This figure is less than half of the established commitment of 0.7 per cent of GNI. Over the last 50 years, the failure of DAC members to hit that target has cost developing countries over $ 5.7 trillion in developing financing. Moreover, resources allocated to least-developed countries (LDCs) are under threat because of the declining share of grant financing and the expected increase of in-donor country refugee costs.
- Developing countries have made active use of their share of resources received through the allocation of $650 billion in SDRs by the International Monetary Fund (IMF) in August 2021. At least 69 developing countries have included SDRs in government budgets or deployed them for fiscal

purposes, for a total of $81 billion since this allocation. But additional resources are urgently needed, including a new emission of SDRs, reform of existing allocation rules and a development link in SDR allocations, as long advocated by UNCTAD.

- Piecemeal measures to provide short-term debt relief are inconsistent with the magnitude of the challenges faced by debt countries in terms of both existing liabilities and future financing needs. Actions ought to focus on two broad areas. First, a multilateral legal framework for debt restructuring is required to facilitate timely and orderly debt crisis resolution with the involvement of all official (bilateral and multilateral) and private creditors. The framework would facilitate the provision of debt relief linked to a debt sustainability assessment incorporating long-term finance needs, including for the achievement of the 2030 Agenda and the Paris Climate Agreement. Second, a publicly accessible registry of debt data for developing countries is needed to address debt transparency challenges. Following the UNCTAD Principles for Responsible Sovereign Borrowing and Lending, this registry would allow the integration of the debt data of both lenders and borrowers at the level of specific transactions in a way that ensures interoperability of data across direct and indirect sources of reporting.

D. Trends in international markets

Despite tensions and policy risks, global trade is expected to grow almost at par with the global economy in 2022, in the range of 2 to 4 per cent. This would represent a sharp deceleration from 2021, due mainly to a combination of continued supply chain disruptions, weakened demand for consumer durables, unduly aggressive monetary policy and elevated freight charges. Beyond 2022, the prospects for trade remain weak, mirroring the expected deceleration of economic growth discussed in the previous chapter and suggesting a return to the subdued long-term trend before Covid-19.

At the level of inernational trade governnace, while the agreement reached at the 12th Ministerial Conference of the World Trade Organization (WTO) seemed to send a positive message, unresolved issues around a fully and well-functioning dispute settlement system pose an ongoing challenge

to multilateralism. The outcomes of value to developing countries mainly concern emergency responses to food insecurity and the Covid-19 pandemic, notwitstanding the resistance of some advanced economies to the waiver agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) legislation that could help developing countries combat the pandemic.

The outbreak of war in Ukraine came at a time of historically high prices across the various commodity categories, and the conflict exacerbated the upward price pressures at play in world markets before February 2022. The war has had a truly global impact on commodity markets, however, because of the key role played by the Russian Federation and Ukraine in international food, mineral and energy supplies. Between them, Ukraine and the Russian Federation provide approximately 30 per cent of the world's wheat, 20 per cent of maize and over 50 per cent of sunflower oil. The Russian Federation and neighbouring Belarus account for approximately 20 per cent of global fertilizer exports.

A combination of factors unleashed by the war, including production disruptions, interruptions to transportation links and the imposition of economic restrictive measures, have put a severe constraint on the supply of these materials from these three countries. The result has been international supply shortages and acute spikes in prices, reflected in an increase of 15 per cent in the aggregate commodity price index in March–April 2022. The most drastic spike in prices was observed in energy commodities; these rose by 25 per cent in the two months following the start of war.

World oil and gas prices were immediately affected, with the price of the Brent crude oil benchmark rising rapidly from just under $100 on the eve of the invasion to over $120 only two weeks later. Yet the release of 180 million barrels from the United States strategic petroleum reserves, as well as the readiness of China and India to receive Russian Federation oil exports and thus take advantage of the significant discounting of the country's Urals brand of crude oil trades compared to other benchmark prices, proved sufficient to ensure global oil supplies did not tighten further.

The natural gas market has been particularly sensitive to the conflict, given the dependence of numerous European countries on natural gas supplies from the Russian Federation. Given the fixed distribution systems

(i.e. pipelines) required to deliver gas, ready substitutes for these energy products are not easy to come by. The decision by Germany to halt the Nord Stream-2 Baltic Sea gas pipeline project, the pledge by the European Union to reduce Russian gas imports by two-thirds by the end of the year and the intermittent shutting off of gas flows to the continent by Russian Federation authorities provoked a surge in European natural gas prices; these increased more than four-fold in April 2022 compared to April 2021. As liquified natural gas (LNG) is a substitute for natural gas, LNG prices were almost 30 per cent higher in June 2022 than in January 2022 and over double the level registered a year earlier in June 2021. These price movements add to the import bills of LNG-importing developing countries and could potentially exclude some developing countries from the LNG supplies on which they depend to meet their energy needs.

Notwithstanding wheat and maize price hikes, fears of a sustained upward trend in commodity prices were eased as substantial declines were observed in the price of a range of commodities from April 2022 onwards. By mid-2022 grain prices had returned to the levels observed prior to the war. A confluence of factors lies behind this generalized retreat in commodity prices, chief among which is a steeper than anticipated tightening of monetary policy in developed economies and a subsequent deceleration in economic growth, thereby softening the global demand for these raw materials.

Similarly, a sharp slowdown of the expansion of the Chinese economy has dampened demand for commodities. This is particularly so in the case of industrial metals for which Chinese demand is an outsized component of global demand. On the supply side, an agreement signed between the Russian Federation and Ukraine in mid-July 2022 and renewed in November allowed some Ukrainian ports in the Black Sea to be reopened to ship grains and other materials and also served to ease upward price pressures on these products.

In addition to these physical demand factors, the financialization of commodity markets is a main factor driving price movements. As commodities have increasingly become a financial asset, huge quantities of money are traded daily in commodity futures throughout global markets, with investors' decisions having an outsized impact on prices. In fact, much of the recent downturn in prices relates to the impact of monetary tightening in advanced markets on investors' decisions.

The recent drop in dollar-denominated international commodity prices has not, however, translated into a significant easing of domestic inflationary pressures on these products in many developing countries where depreciating local currencies – an inevitable consequence of the abrupt tightening of monetary policy in developed economies – have kept local prices of energy and staple food products at high levels. As a result, poorer households in the developing world continue to suffer difficulties meeting their basic needs, while governments in numerous developing countries see their already limited fiscal resources eaten away because of the substantial energy and food subsidies they provide.

As a result, a "return to normalcy" appears ever-more elusive. The mix of macroeconomic and financial constraints left as a legacy of past crises, together with the inadequacy of policy responses, heralds cascading crises that can threaten our economic, environmental and political systems, causing successive crises and diminishing the likelihood of attaining SDG goals by 2030.

Alternative policy stances able to yield meaningful if modest advances for the achievement of the SDGs are increasingly implausible. If at all, countries in the Global South must make initiatives towards policy coordination around different principles than those dictated by market forces. In such a path, though, developing economies would need to harness the involvement of the most industrialized and financially stronger economies. Gaining such a degree of policy coordination requires political will across many layers of common interests.

E. The challenge of institution building in a divided world

As crises affecting the global economy become increasingly complex, policy-makers at all levels of the multilateral system seek solutions to safeguard against future shocks and amend the existing asymmetries across the global economy. For many developing countries constrained by the limited size of their own domestic markets, establishing closer economic ties with their neighbours has been a longstanding part of the development policy agenda. The record has so far been uneven, with only East Asia exhibiting a more lasting process of successful regional ties and cooperation.

Governments' political will to coordinate policies in some areas is a prerequisite for building regional integration. In this respect, developmental regionalism, defined as a set of proactive policies and institutions coordinated by the states of the region in question, has historically proven to help build resilient economies able to compete in the global market, while safeguarding national goals of economic growth and development.

After a series of unsuccessful starts and disappointments, there are signs that such integration is gaining converts in parts of the developing world. The extent to which these efforts can be capitalized upon by regional integration fora across the developing world will be determined by the capacity of regional governance institutions to balance national and regional developmental goals against the challenges of the deeply asymmetric global economy.

1. Trade regionalism

Proposals to forge greater consistency in trade, investment and industrial policies are back on the agenda. However, some trade rules have increasingly come to foster incentives skewed to boosting cost competitiveness through labour market flexibility, wage restraint and pollution offshoring, rather than through capital formation and sustainable productivity gains.

Certain rules and regulations in the WTO agreements and, even more so, in the many bilateral and regional Free Trade Agreements (FTAs) between developed and developing countries, constrain the use of industrial and environmental support policies needed to enhance the structural transformation of developing countries and to reduce their energy and material throughput. Without renewed support and application of the principles of special and differential treatment and common but differentiated responsibilities, it will be difficult for developing countries to transition towards diversified and higher value-added activities in a world facing widening inequality and increasing natural disasters and environmental catastrophes.

Trade regionalization can, if effectively designed, play a role in reducing trade-embodied CO2 emissions, which increased by 90 per cent between 1995 and 2018, mostly on the back of pollution offshoring and growing extraregional imports of developed regions where per capita emissions remain around 10 times higher than in developing regions.

At the same time, trade integration should not be confined to trade liberalization but be part of a broader development strategy promoting regional specialization, economies of scale and mutual economic interdependence, without preventing linkages among firms and across sectors at the national level to build a strong nexus between profits, investment and exports and allow each economy to upgrade and diversify its productive base. The establishment of virtuous cycles of rising productivity, increasing economic sophistication and growing intraregional trade can, in turn, underpin greater cooperation around a widening range of non-trade issues that emerge with closer economic interdependence and address emerging imbalances and divergences among participating countries that may, if they persist, undermine the stability of regional arrangements.

The increasing attention to geopolitics in the design of trade policy reflects growing tensions at the global level that are challenging the rationale for multilateralism. Greater fragmentation also leads to diverging interests. As a result, regional identities and historically embedded norms and values may come to play a more relevant role and shape distinct regional policy orders. Managing economic interdependence in such a polycentric world will require a more synergetic relationship between global institutions and regional arrangements. Accordingly, the appropriate call is to strengthen "open developmental regionalism", as this does not unduly reduce the policy space available to developing countries.

Contrary to deep FTAs or the recent mega-regional agreements, open developmental regionalism could help developing countries' voices be heard and reinforce South–South cooperation towards achieving a more development-oriented international trade governance. An open and proactive regional trade governance could shield developing economies from adverse global effects, even as it supports stronger production links (including through regional value chains) among neighbouring countries.

In terms of rulemaking, open developmental regionalism would limit binding commitments to border measures, while relying on cooperation and creating flexible policies aimed at regional harmonization of behind-the-border trade measures as, for example, in the Association of Southeast Asian Nations (ASEAN) model. Supported by institutional structures, such as the developmental state, and augmented by cooperation in non-trade areas and regional regulatory frameworks that manage the interface between

the global and regional economies, open developmental regionalism may thus facilitate the management of the diverging interests and sensitivities of developing and developed countries for a more inclusive and developmental international trade governance.

For regionalism to support multilateralism, the connections between regional and global governance should be properly managed. Some WTO rules need to be improved, and experience suggests it is a difficult and lengthy process to amend and add flexibilities to the implementation of WTO commitments. For example, such added flexibilities could have been obtained (i) by creating an expeditious solution to deal with TRIPS restrictions on exporting medicines under a compulsory license mandated in 2001, yet it took 15 years before the amendment to TRIPS came into force, and the amendment itself has been regarded as unworkable; (ii) by agreeing to longer transition periods, such as in Trade-Related Investment Measures (TRIMs) as proposed by developing countries as an implementation issue, but despite a 2001 mandate (including that they could be an early harvest of the Doha Round), they have not been agreed upon; or (iii) by allowing countries who graduate from LDC status to continue enjoying this status for 12 years after graduation, but this has not yet been agreed to either.

2. Regional development finance

Along with regional production and trade networks, developmental regionalism needs to be supported by a well-capitalized regional financial system, including institutions of monetary coordination and financial crisis resolution. These arrangements can be categorized as follows:

- Regional funds for short-term balance of payments shortfalls. In practice, all these funds have proven throughout three decades to be too small to withstand balance of payments crises.
- Regional payment systems to reduce exposure to exchange rate fluctuations and promote interregional trade. These are mostly customs unions and payment systems that target transaction costs. These mainly exist in Latin America, although initiatives to introduce payment systems in Africa have been discussed for a long time.

- Publicly financed regional development banks with a long-term lending horizon and broad economic (rather than narrowly financial) mandates which recognize many development challenges go beyond national borders.

Such regional development finance institutions are likely to play a key role in the remainder of the decade to meet Agenda 2030 and lower (or zero) carbon pledges, given the poor record of private capital markets to provide the scale and variety of financial and technical support required to meet these goals.

The need to scale-up these financing arrangements means funds should be raised and invested with some degree of cross-border cooperation and co-ordination. Much has already been achieved, and the record of public Development Finance Institutions (DFIs) shows a steadily increasing momentum in institution building, finance and transformational vision. Yet some important policy changes are required to give them the necessary capacity and policy space.

In the wake of the 1997 Asian financial crisis and the GFC, developing countries sought and created regional solutions as a "first resort" complement to the IMF's lending of last resort. Within a few decades, there was a multiplicity of regional funds and eventually bilateral swaps between central banks from different countries, all adding warp and weft to the GFSN. Their expansion over the years meant that by 2020, developing countries had ten times as much firepower to call on in terms of volume, as well as a variety of providers, terms and conditions from which they could, albeit to varying degrees, choose.

Given their potentially game-changing role, it is notable that these regional institutions and mechanisms were not used widely during the Covid-19 shock. Compared to the GFC, when regional institutions were used substantially, Regional Financing Arrangements (RFAs) contributed limited financing compared to the IMF, particularly bilateral credit swaps between central banks. Early UNCTAD research suggests this is related to the institutional setup of some funds: those contingent on an IMF package were less called upon, as were those with a less evenly balanced or autonomous governance structure. Hence, small autonomous funds were relied on

heavily, while much more voluminous but less equitably organized funds were used less, or not at all.

An open discussion is long overdue about the implications of governments' reluctance to provide adequate and reliable finance to their development banks. Possible responses include revisiting government owners' AAA credit rating strait/jacket, because this limits the way banks can use the capital they do have, or designing new credit rating agencies better suited to the purpose of rating public Development Finance Institutions (DFIs). One of the most promising recent developments is the potential to redistribute unused SDRs to low-income countries needing them, through their regional development banks.

One compelling reason for this policy is that SDR allocations are a global mechanism already in existence, whose usefulness was shown during Covid-19, and Regional Development Banks (RDBs) are natural candidates to re-channel them. This matches the policy objectives underlining the SDR general allocation with banks' existing public mandates, tools and experience. Therefore, instead of inventing new solutions, this link could be expanded in the light of new information about what is possible and what is needed.

These financing options may prove more promising than other alternatives, such as regional capital markets. While experience in Asia and elsewhere suggests regional markets can raise local currency bonds in the tens of trillions of dollars, these have not typically been directed to the kinds of investments needed for Agenda 2030 or climate mitigation and adaptation. Another limitation to their usefulness at the regional level is that this kind of spending needs a degree of harmonization of development plans and objectives, rules and regulations, as well as agreement on how to divide the respective costs and benefits. Moreover, regionally integrated markets require complete capital account liberalization among the participating countries, and for well-known reasons, this is seen as a risky strategy with uncertain benefits.

Assuming public banks and funds will continue to be relied upon, they may need clearer mandates and a stronger sense of what the governments involved expect from their lending activities. This can be expressed as a vision

statement, in the legislation enacting them or in the reporting requirements and indicators of performance.

3. Confronting corporate arbitrage

An additional set of barriers to the developmental gains promised by regionalization comes from the financialization of the corporate sector. Developing countries are particularly vulnerable in the current structure of global financial and corporate governance, for two reasons. First, at the level of global political economy, regulatory complexity has been conducive to the rise of the "fragmented firm." Modern multinational enterprises (MNEs) are organized as a network of entities held directly or indirectly by the parent firm through equity ownership but trading with one another "as if" they were separate companies. Estimations made by UNCTAD and other organizations suggest that between one-third and roughly two-thirds of global trade today is intra-firm – that is, trade between subsidiaries and affiliates of the same MNE, many of which are located in different countries.

Second, indirect forms of investment create a distinction between the ultimate and the immediate owners of assets and can thus pose a major challenge for governments in exercising control over the investment regime. Along with the changes that parallel technological, financial and regulatory shifts in the global economy, indirect forms of corporate ownership mean that notwithstanding the macro-financial data on FDI flows, the economic substance of international investment, including in developing countries, is often structured much like a variant of asset management. This is pertinent for the developmental outcomes at both national and regional levels.

In our study, we examined the functional role of corporate subsidiaries of top 100 MNEs globally. We found that a quarter of large multinational subsidiaries in the Global South only maintain balance sheets. This indicates that they perform very few, if any, economic activities, in the host jurisdiction. This contrasts to their behaviour in some economies of the Global North, whereby nearly all directly held subsidiaries display an income statement, which is an indication of their real economic activity. This difference in the registration of value-creating operations allows corporate players to exploit the financial, accounting and regulatory infrastructure offered to them

by certain jurisdictions, leaving most developing economies structurally disadvantaged in the process of rent extraction and competition for capital.

This has multiple implications for policymakers at the national level, but also at at the regional (and multilateral) level. The use of intermediary subsidiaries creates statistical anomalies in FDI accounts, because flow of investment through intermediary subsidiaries located in third countries inevitably creates data inconsistencies in FDI statistics. As data on aggregate FDI positions are typically based on immediate asset ownership, they provide a potentially biased measure of international financial ties, the distribution of asset ownership and the risks associated with investment – for home and host countries alike. By using intermediary subsidiaries in a third country, the owners and managers of an entity or the parties to a contract can, if they so choose, register these in the same jurisdiction where they reside or work or where the underlying assets held by an entity are located. This is important for a number of reasons.

While regional trade and investment agreements may well encourage investment into the region, the way investment is structured through subsidiaries is crucial for the economic impact of the investment. MNEs can (and do) structure those investments indirectly through intermediaries and ensure a considerable portion of the operational activities takes place elsewhere. They may do so because certain countries offer a better regulatory environment, lower taxation and other advantages. Because of statistical anomalies associated with financial and legal innovation at the corporate level, none of these outcomes is picked up in FDI statistics.

Success in attracting FDI is not, in and of itself, conducive to making incoming foreign capital work for the host economy and increase its productive capacity, levels of employment and welfare. Large corporate groups can be structured in such a way that local subsidiaries exploit the local economic advantages of inexpensive labour, natural resources and so on, while other subsidiaries in the corporate group located in other jurisdictions contribute to and benefit from value extraction via the localization of profits, low taxes, and other types of corporate arbitrage.

In terms of the macroeconomy, earning stripping through the use of corporate subsidiaries affects the fiscal space of any host economy. Developed countries can potentially offset a significant part of the direct corporate tax

revenue loss by collecting increased investor-level tax revenues on dividends, interest and capital gains, which themselves tend to be boosted by higher rates of global corporate tax avoidance. Developing countries, in contrast, are generally unlikely to recover any significant revenues this way. They also face an additional disadvantage in the long term: their cost of borrowing is higher than that of advanced economies.

In the absence of a globally developed set of regulatory standards and systemic framework of regulation, developing countries need to lead efforts to build the relevant financial, accounting, legal and data expertise at national levels. This, in turn, will be an important step towards enhancing communication, coordination and regulation at the level of regional blocs, long established and currently emerging. Public authorities tasked with monitoring, analysing and regulating the behaviour of corporate subsidiaries operating within the region can work to enhance the visibility of corporate behaviour at national and regional levels. This can help overcome the regulatory gap in the current structure of regionalism governance and advance multilateral efforts to combat the various forms of corporate arbitrage.

F. Conclusion

An incorrect policy response to the key challenges of 2022 – inflation, the global slowdown, debt distress and a potential financial crisis – will increase the risk of further fracture in a global economy already marked by troubling asymmetries and inequality.

Preventing inflation scaremongering from monopolizing the attention of policymakers is urgent, given the multitude of other policy challenges. While the cost of living crisis needs immediate resolution, there are ways to use the present moment strategically to make progress towards shared prosperity. Under current supply chain challenges and rising uncertainty, when monetary policy alone cannot safely lower inflation, pragmatism must replace ideological conformity in guiding the next policy moves.

Problematically, geopolitical risks to trade, increased market concentration, reduced policy space and an unresolved climate agenda are further weakening developing countries' position in global governance. Institutional reform should therefore focus on linking immediate macroeconomic policy

challenges with boosted investment in SDGs. Drawing on suggestions made in past Reports, UNCTAD proposes policy programs, appropriately tailored to local economic circumstances, should be built around the following elements:

i) Containing inflation (not cutting wages). Policymakers should avoid an undue reliance on monetary tightening and foreswear a premature return to austerity budgets. The alternative to a damaging rise in interest rates to bring down inflation is a pragmatic mix. Subsidies to ease the cost of living are important in the short term, but price and markup controls are paramount, as they allow overdue increases in real wages. This requires a reinforcement of anti-trust measures and a reconsideration of regulation in specific markets. These policies can be bolstered at a regional level, so that single countries are shielded from external constraints, such as exchange rate movements and capital flows.

ii) Managing expansions (not mismanaging booms and busts). Monetary and fiscal rules need to be better adapted, not just to respond to shocks, but also to support much-needed structural changes in the economy, such as industrialization in developing countries and the energy transition. Maintaining sustained job creation and industrial upgrading will require governments to have sufficient fiscal space for the necessary investments and ongoing support measures. Liquidity creation should always be allowed for development projects that guarantee, in the medium-long term, higher income and tax revenues. This will require not only rethinking the independence of central banks from any development and social goals but also considering, when appropriate, new regional arrangements.

iii) Investing first (second and third). There needs to be higher public investment in economic and social infrastructure to boost employment, raise productivity, improve energy efficiency and reduce greenhouse-gas emissions in an internationally coordinated effort centred on common global objectives. But crowding in private investment will require taming financial institutions to make sure they serve the broader social good. Industrial policies will be required to

target desired sectors and guide investment, and better capitalized public banks must be committed to lengthening the investment horizon of private businesses, including through the productive leveraging of reinvested profits.

iv) Levelling up. While anti-trust measures and incomes policies to boost productivity growth can help achieve more equitable distribution of income, redistributive policies can mitigate unbalanced outcomes. These include the reinforcement of public service provisions and progressive tax reform, such as wealth and windfall taxes, together with a reduction of regressive tax cuts and loopholes. Clamping down on the use of tax havens by firms and high-wealth individuals will require legislative action at both national and international levels. Interim efforts in this direction could include a global financial register, recording the owners of financial assets throughout the world.

v) Curbing corporate arbitrage. The central role of legal and financial infrastructure in corporate arbitrage and value extraction poses a particular challenge to development at all levels. Most developing countries lack the resources and capacities required to tackle the legal dimensions of the activity of MNEs. Therefore, an attempt to consolidate available resources at the regional regulatory level could be an important first step towards harmonizing regulatory policies and curbing opportunities for corporate arbitrage.

vi) Creating stronger South–South ties aimed at avoiding environmental meltdown and promoting employment generation. In this strategy, trade, finance, credit and macroeconomic policies would be coordinated and instrumental to the overarching goals of employment generation (especially in some advanced economies) and green industrial development (especially in the Global South). UNCTAD's proposed strategy for South-led industrialization and coordination, thanks to the concatenation of industrialization and agrarian development goals, could generate an additional 530 million jobs globally (with the current patterns and no policy change, the estimated increase is about 330 million jobs). Most importantly, the

changes envisaged would liberate much-needed policy space for developing countries and allow a successful energy transition.

vii) Establishing a new Bretton Woods. In an interdependent world, calling for greater ambition from domestic policymakers requires rethinking global economic governance from a development perspective. Almost eight decades after the foundational conference in New Hampshire, the international financial architecture is still struggling to address the imbalances and inequities of the global economic structure. A stable multilateral monetary and financial system will require more timely balance of payments and liquidity support, a swap facility open to all, a public credit rating facility and rules for managing sovereign debt crises. A bolder agenda to scale up public development finance will require an increase in base capital of multilateral financial institutions, along with a reassessment of their lending headroom and priorities, combined with stronger price and quantity-based controls and incentives, to ensure complementary private finance flows towards productive transformation.

The burning question is political will. A window of opportunity is still open, but countries need to acknowledge the systemic nature of the multiple crises the world faces and share responsibility in addressing them.

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