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2022

## Development prospects in a fractured world: 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.

# Chapter I

## Global Trends and Prospects

# A. TOO CLOSE TO THE EDGE

## 1. A year of serial crises

After a rapid but uneven recovery in 2021, the world economy is in the midst of cascading and multiplying crises. With incomes still below 2019 levels in many major economies, growth is slowing everywhere. The cost-of-living crisis is hurting the majority of households in advanced and developing countries. Damaged supply chains remain fragile in key sectors. Government budgets are under pressure from fiscal rules and highly volatile bond markets. Debt-distressed countries, including over half of low-income countries and about a third of middle-income countries, are edging ever closer to default. Financial markets are jittery, as questions mount about the reliability of some asset classes. The vaccine roll-out has stalled, leaving vulnerable countries and communities exposed to new outbreaks of the pandemic. Against this troubling backdrop, climate stress is intensifying, with mounting loss and damage in vulnerable countries who lack the fiscal space to deal with disasters, let alone invest in their own long-term development. In some countries, the economic hardship resulting from these compounding crises is already triggering social unrest that can quickly escalate into political instability and conflict.

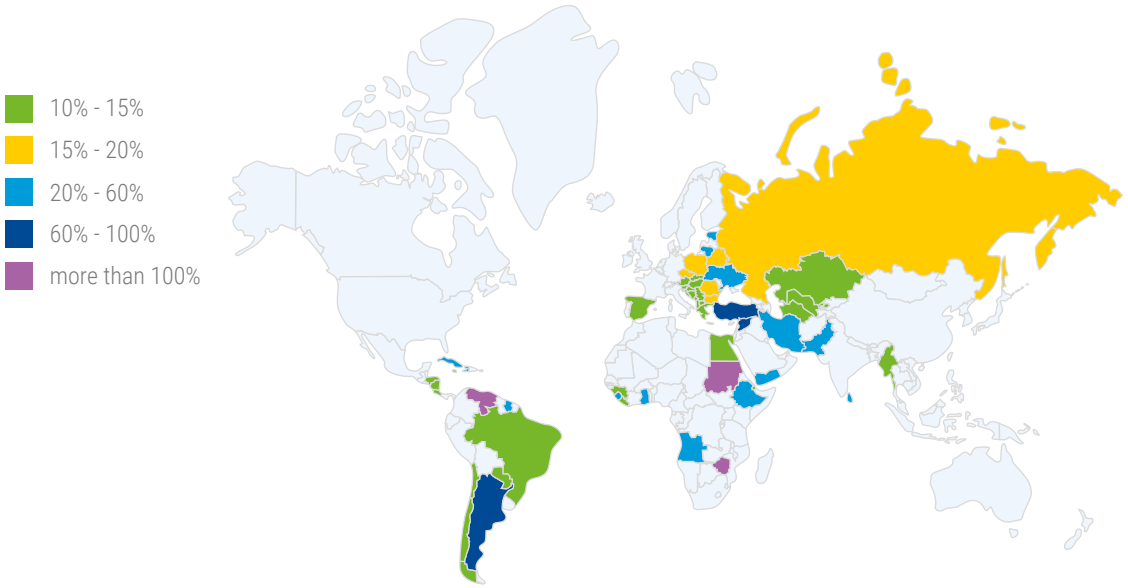
The resulting policy challenges are daunting, especially in an international system marked by rising distrust. At the same time, the institutions of global economic governance, tasked since 1945 with mitigating global shocks, delivering international public goods and providing a global financial safety net, have been hampered by insufficient resources and policy tools and options that are "rigid and old fashioned" (Syed, 2022; Yellen, 2022). Even as growth in advanced economies slows down more sharply than anticipated in last year's Report, the attention of policymakers has become much too focused on dampening inflationary pressures through restrictive monetary policies, with the hope that central banks can pilot the economy to a soft landing, avoiding a full-blown recession. Not only is there a real danger that the policy remedy could prove worse than the economic disease, in terms of declining wages, employment and government revenues, but the road taken would reverse the pandemic pledges to build a more sustainable, resilient and inclusive world (chapter III).

As noted in last year's Report, the pandemic caused greater economic damage in the developing world than the global financial crisis. Moreover, with their fiscal space squeezed and inadequate multilateral financial support, these countries' bounce back in 2021 proved uneven and fragile, dependent in many cases on a further build-up in external debt. The immediate prospects for many developing and emerging economies will depend, to a large extent, on the policy responses adopted in advanced economies. The rising cost of borrowing and a reversal of capital flows, combined with a sharper than expected slowing of China's growth engine and the economic repercussions from the war in Ukraine, are already dampening the pace of recovery in many developing countries, with the number of those in debt distress rising, and some in default. With 46 developing countries already severely exposed to financial pressure from the high cost of food, fuel and borrowing, and more than double that number exposed to at least one of those threats, the possibility of a widespread developing country debt crisis is a very real one, evoking painful memories of the 1980s and ending any hope of meeting the sustainable development goals (SDGs) by the end of the decade.

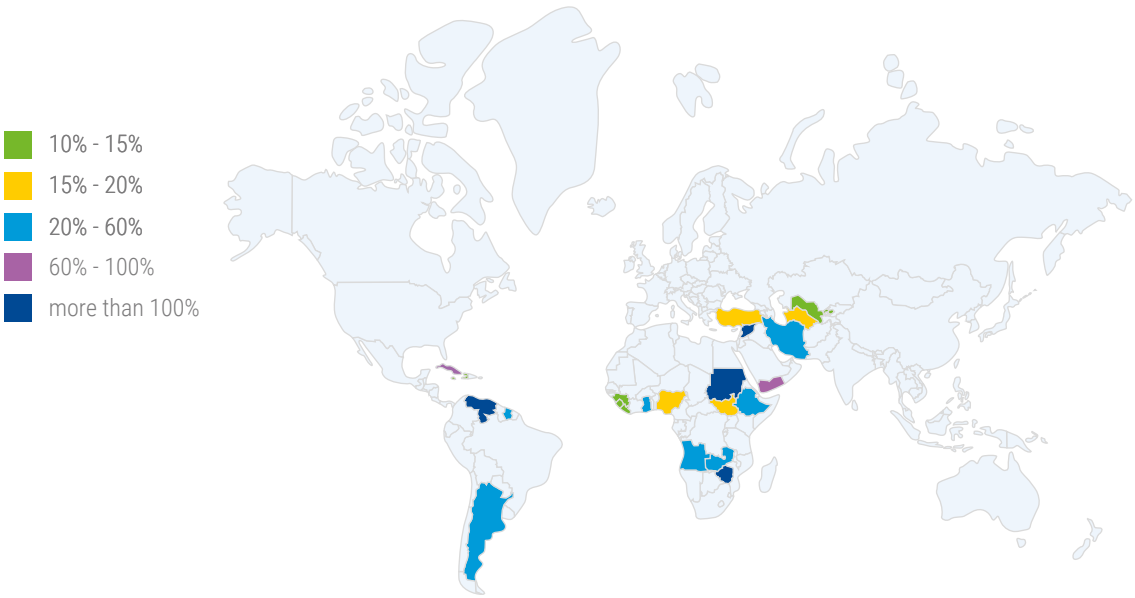
The acceleration of inflation beginning in the second half of 2021 (figure 1.1) and continuing even as economic growth began to slow down in the final quarter of the year has led many to draw parallels with the stagflationary conditions of the 1970s. Despite the absence of the wage-price spirals that characterized that decade, policymakers appear to be hoping that a short sharp monetary shock – along the lines, if not of the same magnitude, as that pursued by the United States Federal Reserve (the Fed) under Paul Volker – will be sufficient to anchor inflationary expectations without triggering recession. Sifting through the economic entrails of a bygone era is unlikely, however, to provide the forward guidance needed for a softer landing given the deep structural and behavioural changes that have taken place in many economies, particularly those related to financialization, market concentration and labour's bargaining power.

**Figure 1.1** Countries with double-digit inflation rates, June 2022 vs June 2021

**69 Economies with confirmed double-digit inflation, representing more than 2.1 billion of world population, June 2022** *(Consumer Price Index, change over respective period of previous year)*




**23 Economies with confirmed double-digit inflation, representing less than 0.9 billion of world population, June 2021** *(Consumer Price Index, change over respective period of previous year)*




*Source:* UNCTAD secretariat calculations, based on Internati al Monetary Fund (IMF) data, Refinitiv, and various national sources.[1]
*Note:* For 2022 (top figure), the latest monthly data are available for 164 of 182 economies; for 9 of them, figures are for one of the last months in 2021; another 10 are estimations for 2022 from various sources. Out of 69 economies with double-digit inflation, 18 show double-digit inflation rate (at least) since the end of 2019. For 2021 (bottom figure), out of 23 economies with double-digit inflation, 16 show double-digit inflation rate (at least) since the end of 2019.

[1] The designations employed and the presentation of material on any map in this work do not imply the expression of any opinion whatsoever on the part of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries.

The origins of this latest wave of inflation are, in fact, unique. The successful roll-out of the vaccine in advanced and some developing countries and the easing of Covid restrictions, combined with continued government support for households and firms, saw demand pressures running ahead of supply responses during the first half of 2021, creating bottlenecks, including in some key markets, such as automobiles. The surge in inflation from the end of last year belied hopes that this would be a short-lived inconvenience. However, the evidence does not suggest this surge has come from a further loosening of fiscal policy or wage pressure, but instead derives largely from cost increases, particularly for energy, and sluggish supply response due to a prolonged history of weak investment growth (chapter III). These have been 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 due to the global recovery, and in 2022, the surge in speculative trades related to a wave of global concern over the availability of particular sources of energy, with no substantial changes in overall demand or supply.

Under these circumstances, continued monetary tightening – through rising central bank rates and the normalization of their balance sheets – will have little direct impact on the supply sources of inflation and will instead work indirectly to re-anchor inflationary expectations by further reducing 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 global financial crisis (GFC) becoming increasingly global, complex unanticipated shocks, including outbreaks of financial panic or extreme price volatility, or a combination of external triggers, are a present danger. Monetary tightening poses additional 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 (NPLs) and trigger a cascade of bankruptcies. With direct price and markup controls ruled out as politically unacceptable, 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.

Finally, what does seem likely is that the impact of Fed tightening will be more severe for vulnerable emerging economies with high public and private debt, substantial foreign exchange exposure, a high dependence on food and fuel imports and higher current-account deficits (chapter II).

According to one recent estimate, an increase in United States interest rates of 1 percentage point reduces real gross domestic product (GDP) by 0.5 per cent in advanced economies and by 0.8 per cent in emerging economies, after three years (Iacoviello and Navarro, 2019).[2] These effects are comparable to the domestic effects of a one-percentage-point increase in the United States interest rate, which lowers the United States GDP by almost 1 per cent after 11 quarters (Fair, 2021). More drastic increases by 2 to 3 percentage points would therefore depress the already stalling economic recovery in the emerging economies by another 1.6 to 2.4 percentage points.

## 2. Global stagflation: spinning back down the years

Disruptions to global supply chains, armed conflicts in key commodity-producing regions, slowing economic growth, turbulence in stock markets and accelerating inflation suggest a resemblance to the stagflation of the 1970s (BIS, 2022; World Bank, 2022; Wolf, 2022). Accordingly, the recommended policy action is aggressive monetary tightening, which is supposed to pre-emptively anchor inflationary expectations and avoid the steep economic costs associated with a prolonged period of interest rate increases, such as the world painfully experienced between 1979 and 1981 when the Fed introduced a series of rate increases amounting to almost 9 percentage points.

[2] Using a structural vector autoregression (SVAR) model, Fed economists Akinci and Queralto (2021) obtained broadly similar results: an increase in United States interest rates by 1 percentage point is found to lower the United States real GDP by 0.5 percentage points and the real GDP of emerging economies by 0.45 percentage points. The new inflationary environment has changed the balance of risks. Gradually raising policy rates at a pace that falls short of inflation increases means falling real interest rates. This is hard to reconcile with the need to keep inflation risks in check. Given the extent of the inflationary pressure unleashed over the past year, real policy rates will need to increase significantly in order to moderate demand. Delaying the necessary adjustment heightens the likelihood that even larger and more costly future policy rate increases will be required, particularly if inflation becomes entrenched in household and firm behaviour and inflation expectations.

From this perspective, the Bank for International Settlements (BIS, 2022: 26) has clearly defined the task facing central bankers:

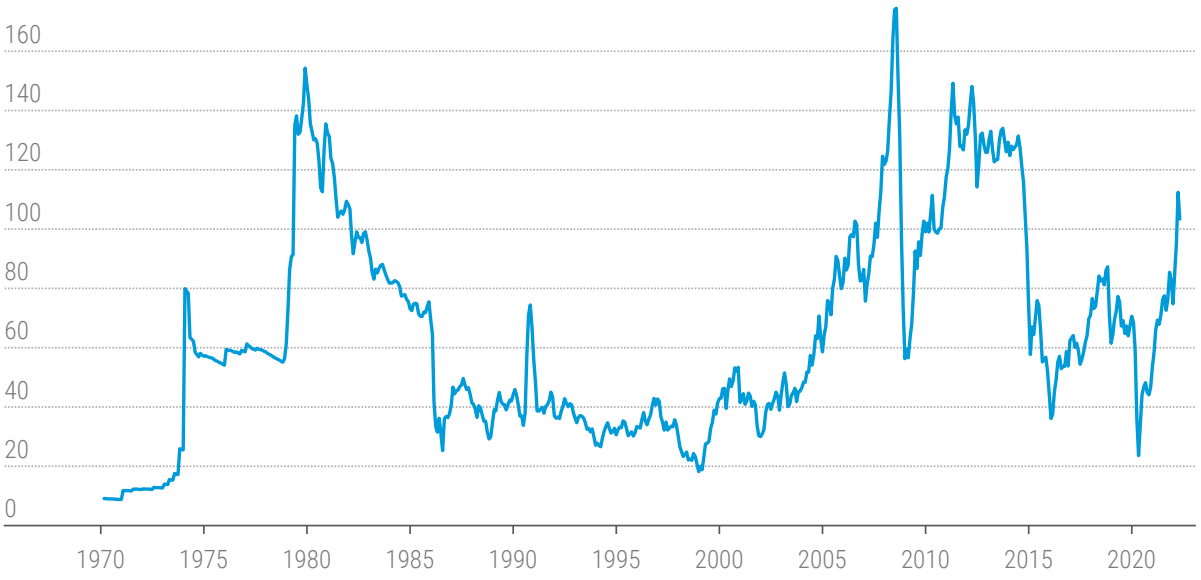
*"The new inflationary environment has changed the balance of risks. Gradually raising policy rates at a pace that falls short of inflation increases means falling real interest rates. This is hard to reconcile with the need to keep inflation risks in check. Given the extent of the inflationary pressure unleashed over the past year, real policy rates will need to increase significantly in order to moderate demand. Delaying the necessary adjustment heightens the likelihood that even larger and more costly future policy rate increases will be required, particularly if inflation becomes entrenched in household and firm behaviour and inflation expectations."*

These policy recommendations, along with calls for fiscal policy to address investor concerns by cleaning up public finances (World Bank, 2022: 69), closely resemble the dominant policy recommendations of the early 1980s, and these proved disastrous, particularly for developing countries, in terms of economic growth, inequality and poverty (*TDR*, 2021).

The primary cognitive blinder hindering adequate understanding of the key lessons from past crises is still the widely shared belief and confidence in monetary policy's singular ability to reduce output volatility and ensure stable and lasting growth in market economies in a neutral manner, without affecting potential output growth of the economy under consideration (Goodfriend, 2007; Blanchard, 2018). In fact, the aggressive monetary tightening of the early 1980s provoked deep distributional shifts within and across countries, and repeating that approach today could be equally damaging.

Moreover, while echoes of the 1970s are audible in current conditions, there are important differences between then and now – and these should caution us to avoid drawing direct policy lessons. First, the recent commodity price increases, when measured in real terms, have so far been smaller than in the 1970s. Figure 1.2 shows this for the real increase in global oil prices. Second, the energy intensity of GDP has declined considerably since the 1970s (figure 1.3), reducing the inflationary impact of higher energy prices.

**Figure 1.2** Real oil price, January 1970–April 2022 *(adjusted dollars per barrel)*




*Source:* World Bank (2022).
*Note:* Real oil prices are averages of Dubai, Brent, and WTI prices, deflated by the CPI index of the United States (using March 2022=100).

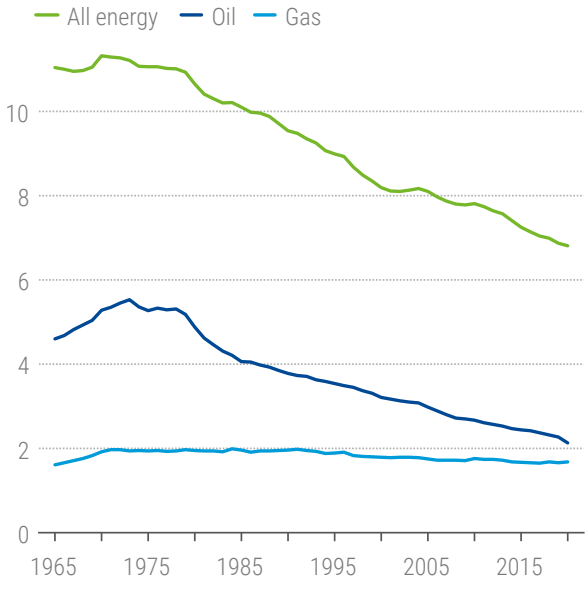
A second notable difference is that core global inflation in 2022 is driven by fewer sectors than it was in the 1970s.[3] In 1979-1980, global headline inflation (a broader measure) and global core inflation (which excludes volatile items such as food and energy) were similar: 15.2 per cent and 15.3 per cent, respectively. But in 2022, the global core inflation rate is 2.8 per cent, whereas the global headline inflation rate is much higher, at 7.5 per cent.[4]

Third, and insufficiently emphasized in many of the theorized parallels between the two periods, nominal wage growth is not keeping up with consumer price index (CPI) inflation; hence, real wages in developed and developing countries alike are stagnating or declining, ruling out a wage-price spiral as the inflationary lubricant. This is not surprising given the declining influence of organized labour and workers' bargaining power in recent decades (ILO, 2022) – something also showing up in the secular decline in the labour income share (figure 1.4).

Fourth, a final structural difference between the 1970s and the current conjuncture concerns the significantly higher levels of indebtedness today in both developed and developing countries and for both private and public sectors, with much of the developing country debt denominated in foreign currency and short-term (chapter II).

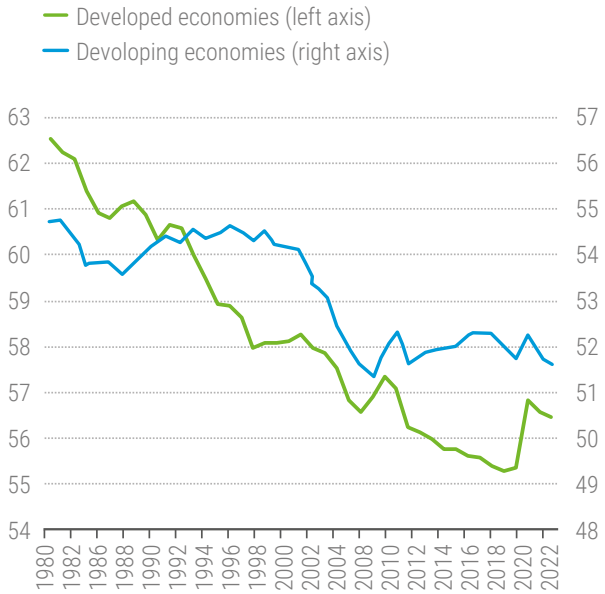
In 1980, total debt of the emerging market and developing economies (EMDEs) stood at 65 per cent of their GDP; half of this debt was sovereign debt and the other half was private-sector debt (figure 1.5). When the Fed tightened monetary policy in the late 1970s and early 1980s in response to rising inflationary pressures in the United States, it triggered the "Third World" debt crisis. Today many emerging economies are facing even tighter financial conditions against a backdrop of high debt (chapter II). Fifteen EMDEs already experienced a downgrading of their sovereign debts in the first five months of 2022. Monetary tightening by the Fed thus has a considerable risk of triggering a new chain of financial crises in EMDEs (chapter II).

**Figure 1.3** Energy intensity, 1965–2020
*(percentage, megajoule to GDP)*




*Source:* Bank for International Settlements (2022).

**Figure 1.4** Labour share, 1980–2022
*(percentage of GDP)*

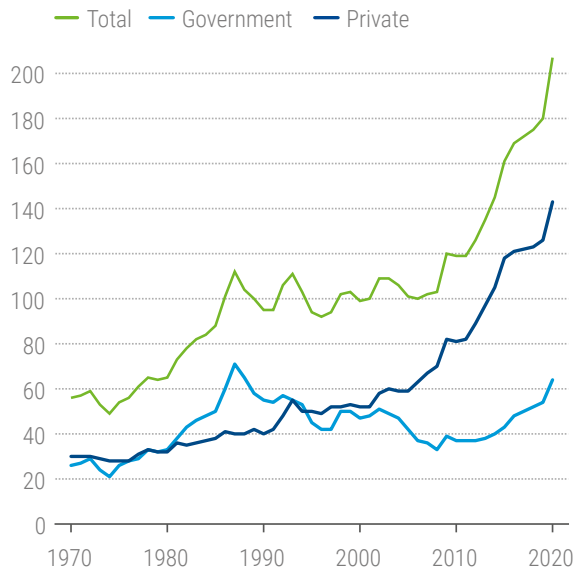



*Source:* *United Nations Global Policy Model database*.
*Note:* Labour share is calculated as the ratio of the sum of compensation of employees and mixed income to GDP.

[3] According to BIS (2022), inflation in the emerging economies is rapidly becoming more broad-based.
[4] The global inflation rates are averaged for 66 countries, using CPI data for January to April 2022.

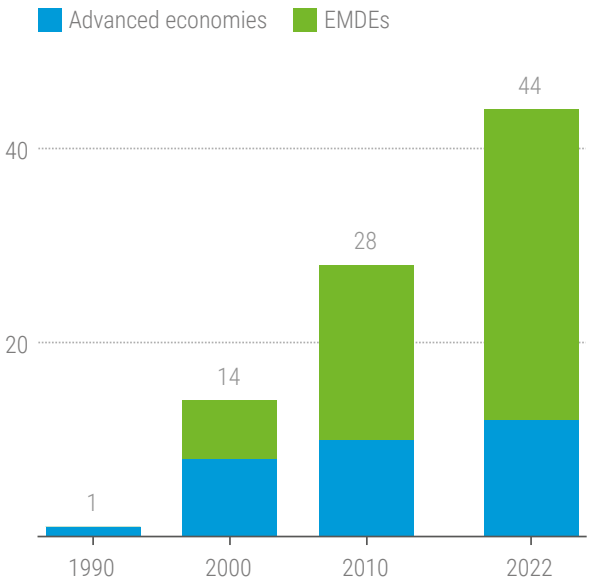
Finally, far more central banks are independent today than in the early 1980s, with clear mandates to prioritize inflation targeting (figure 1.6) and follow "transparent" monetary policy rules. Some assessments (e.g. World Bank, 2022) say this "revolution" in monetary policy is better placed to anchor inflation expectations, with core inflation becoming less sensitive and more resilient to (unexpected) inflation shocks. What is missing in this narrative is that commercial banks have become progressively less important financial actors in the intervening years, and a variety of non-bank financial institutions have emerged as credit providers in a loosely regulated market environment (box 1.1). This evolving "shadow banking" system, largely ignored (or worse yet, encouraged) by the authorities in the run-up to the GFC, greatly complicates the transmission of monetary policy (chapter III). More than a decade later, shadow banking poses renewed risks to financial stability, in advanced and developing countries alike.

**Figure 1.5** Debt, emerging market and developing economies, 1970–2020
*(percentage, of GPD)*




*Source:* World Bank (2022).
*Note:* GDP-weighted averages based on a sample of up to 153 EMDEs.

**Figure 1.6** Number of countries with inflation-targeting central banks, 1990–2022




*Source:* World Bank (2022).

## Box 1.1 Exile on Wall Street: shadow banking and financial fragility

Non-bank financial intermediaries carry out many of the same fundamental functions as regulated banks,[5] yet they remain unregulated. The universe of non-bank financial institutions and credit providers, known as a shadow banking system, came under the spotlight during the GFC. It comprised the markets for asset-backed commercial paper, repurchase (repo) deals, securitization products, money market funds, private currency swaps and other over-the-counter (OTC) transactions and off-balance sheet activities, often sponsored or owned by official banks. Largely unnoticed until then, the vast network of unregulated credit intermediaries, their opaque connectivity to the official banks and the hidden risks of such connections were at the epicentre of

[5] Including lending, deposit taking and similar operations that create credit.

the global financial implosion. Having started in the relatively isolated segment of the United States mortgage market, the financial crisis spread through shadow banking channels, was magnified by the speculation by hedge funds and other operations involving complex, unregulated financial products and threatened the viability of the official banking sector.

The system of shadow banking not only endangered commercial banks, but also placed additional demands for public bailouts provided by governments trying to prevent bank failures over the period 2007 to 2008. Despite some efforts to contain and regulate parts of non-bank finance, over the past decade, the global shadow banking has expanded in size, geography and diversity. The share of global financial assets held at shadow banking institutions increased globally from 42 per cent in 2008 to close to 50 per cent at the end of 2019. In 2020, shadow banking institutions originated more than two-thirds of all United States mortgages; the share of loans to businesses they hold is nearly equal to the share held by banks (Kelleher and Basil, 2022). And while during the pandemic, the shadow banking sector's relative share of total global financial assets decreased from 49.7 per cent to 48.3 per cent in 2020, in 2021, shadow banks controlled $226.6 trillion of assets out of the total of $468.7 trillion (FSB, 2021).

In advanced economies, shadow banking accounts for, on average, 56 per cent of total financial assets (compared to 27 per cent in emerging markets). At the same time, the rate of growth of shadow banking sectors has been faster in the emerging markets than in the advanced economies, especially in the loan provision by non-bank entities dependent on short-term funding. According to the Financial Stability Board (FSB), in 2021, shadow banks controlled $226.6 trillion of assets (out of a total of just over $468.7 trillion). More than $57 trillion of the assets controlled by shadow banking entities are the result of their credit creation functions, such as short-term market funding, credit intermediation and securitization base funding (FSB, 2021).

This continuous expansion poses systemic and financial stability risks in advanced and developing countries alike. In the United States, during the 2008 crisis and again in the 2020 pandemic, when funding markets all but shut down, the Fed stepped in with trillions of dollars in support as a backstop for virtually every asset class. This made the Fed the "market-maker of first resort" and a buyer in the asset backed securities (ABS) market (Kelleher and Basil 2022). Today, similar pressures are mounting in the financial system in China, where earlier attempts to reduce the shadow banking sector did not reduce financial fragility. The debts accumulated by local banks through shadow banking facilities domestically, as well as the debt exposures internationally, are threatening the China's growth prospects in 2022–2023.

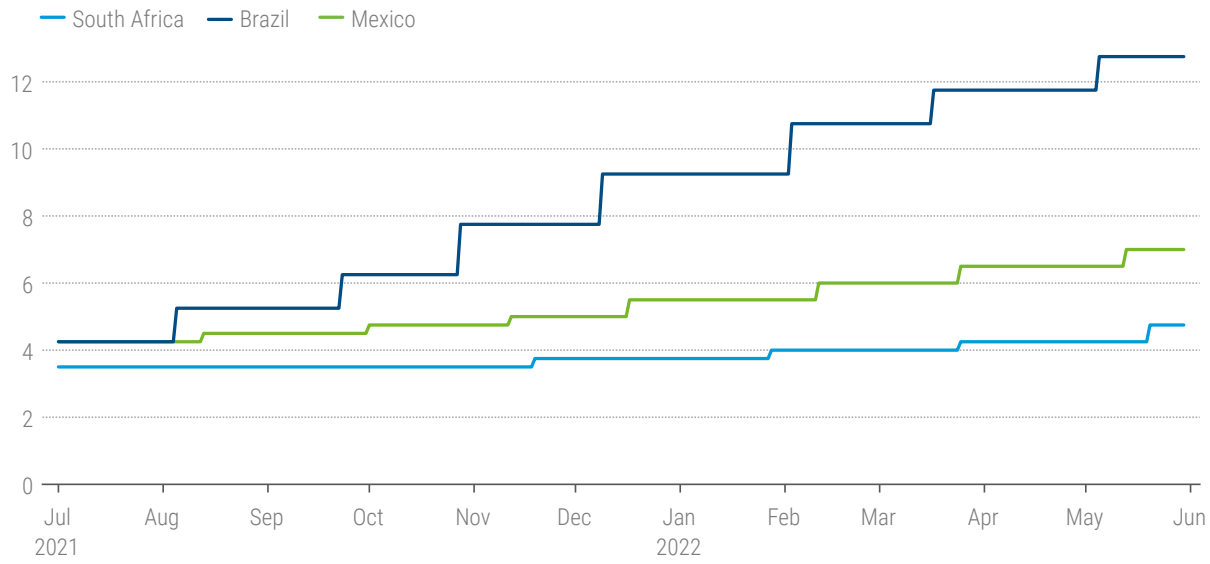
In other words, not only were the risks of the unregulated system of shadow banking not addressed in the wake of the GFC, but they were magnified in the decade that followed. Today, shadow banking poses new challenges to financial stability and is likely to require new intervention by the central banks in 2022–2023. In the context of the uncertainty of global growth prospects and high inflation expectations, such interventions may not be as forthcoming as they were during the two previous financial crises. The situation is much starker in the developing countries.

The large role of the shadow banking sector means central banks have limited capacity to control credit expansion in large segments of the financial system. That is even more true for central banks in many developing economies, as they have more fragile financial systems, higher debt denominated in foreign currency and greater exposure to commodity price shocks. In fact, many of them began to raise interest rates already in late 2021 (figure 1.7), but the inflationary pressures have not abated, and the financial vulnerabilities have continued to build.

A recent analysis of 129 monetary policy tightening episodes over the period 1985 to 2018 has shown that hard landings are more likely when monetary tightening is preceded by a build-up of (household)

indebtedness – as is the case now (BIS, 2022). Hard landings are also historically associated with low real interest rates before the start of the tightening cycle. To be precise, the average real interest rate at the start of tightening cycles that end in hard landings is 0.4 per cent, compared to 1.4 per cent at the start of those that end in soft landings. Given that real interest rates were relatively low at the start of the current monetary tightening cycle, the initial conditions do not augur well for a soft landing.

**Figure 1.7** Nominal interest rates, selected emerging economies, July 2021–May 2022 *(percentage)*




*Source:* Bank for International Settlements (2022).

Today, inflation is caused by a mixture of disruptions in global supply chains, high (container) shipping costs, the impact of war on key sectors, higher mark-ups, commodity-market speculators and the ongoing uncertainty of an evolving pandemic. In this situation, central banks cannot bring inflation down at a socially acceptable cost. Instead, supply-chain disruptions and labour shortages require appropriate industrial policies to increase the supply of key items in the medium term; this must be accompanied by sustained global policy coordination and (liquidity) support to help countries fund and manage these changes (*TDR*, 2022; Gallagher and Kozul-Wright, 2022).

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.

If monetary tightening in the advanced economies continues over the coming year, however, a global recession is more likely, and, even if it is looser than the 1980s, it will almost unavoidably harm potential growth rate in the developing economies. The permanent damage to economic development in these countries will not only be substantial but will also leave the ambition to achieve a better world by 2030 dangling by the most precarious of threads.

## 3. Global stagflation redux: bad news on the doorstep

The decade following the GFC brought the global economy to its current precarious state. The period was characterized by low levels of capital formation, weak (and in many cases falling) productivity growth, stagnant wages and flagging aggregate demand. Since 2010, government budgets have been kept on a tight leash (*TDR*, 2021). Yet financial markets remained buoyant, as central banks maintained a loose monetary policy, with efforts to normalize their balance sheet proving ephemeral

and in some cases (as in the 2013 taper tantrum) counterproductive. Profits also remained high, with a large-firm bias, benefitting from weak regulatory oversight and a policy environment geared to lowering production costs, with wages in particular showing little sign of picking up even as unemployment dropped (chapter III).

In this high-profit-low-investment environment, financial engineering became an instrument of rent-seeking behaviour, particularly among larger international corporations. Thanks to their market power, they have often generated income from the manufacture of scarcity rather than the production of goods or delivery of services (*TDR*, 2017; 2018). The spread of such behaviour through knowledge monopolies, mergers and acquisitions, government procurement contracts etc. has been accompanied by systematic tax avoidance, including the channelling of profits through offshore tax havens, the accompanying growth of illicit financial flows and the widespread use of leveraged buyouts and share buybacks. In many cases, this has led to a growing divergence between large cash-rich corporations and small cash-strapped firms and an accompanying trend towards more highly concentrated markets (Akcigit et al., 2021). These trends have locked in and in some cases exaggerated the high levels of inequality that had emerged prior to the GFC (*TDR*, 2017; 2018; 2021).

The scarring effects of these trends reflect what some observers have dubbed "super-hysteresis" whereby external shocks lead not only to a permanent loss of output due to recession but also to a permanent reduction in the potential growth rate because the decline in capital formation (and in aggregate demand) lowers labour productivity growth. In many developing countries, this threat has been amplified by a process of stalled industrialization (and in some cases, premature deindustrialization) rooted in the rapid liberalization of both the capital and current accounts under structural adjustment programs in the 1980s and 1990s, which has led, in turn, to an even greater dependence on commodity exports as a source of foreign exchange.

As noted in previous Reports, the slowdown in growth in the second half of the decade did little to dampen the irrational exuberance in financial markets, further stretching the balance sheets of both firms and households and creating new sources of fragility. This decoupling of finance and the real economy was particularly evident in developing and emerging economies, as capital inflows from advanced countries intensified after a sudden stop in 2013, driven by a search for higher yields. By the end of the decade, on a wide variety of measures of debt sustainability, there were clear signs of growing trouble ahead, unless growth picked up sharply or significant debt relief could be agreed upon (*TDR*, 2019). Neither happened with the onset of Covid. At the end of 2015, the IMF classified 29 low-income (Poverty Reduction and Growth Trust (PRGT) eligible) countries as in high risk of, or already in, default; by 2019, there were 52, and in 2022, that figure had risen again to 59 (UNDESA, 2022).

The Covid shock in March 2020 was quickly and predictably registered by sharp turmoil in financial markets, forcing the leading central banks to inject an unprecedented $9 trillion into them by the end of the year, approximately nine times the amount injected between late 2008 and 2009. This included liquidity support to financial institutions, direct credit lines to corporations and in the case of the Fed, extended swap lines to select central banks in other countries, thus earning it, somewhat hyperbolically, the title of the global lender of last resort (chapter III). However, the Fed's move steadied financial markets.

With Covid, governments were obliged to reassess their spending priorities, as the health and safety of their citizens took precedence over narrower economic goals. With a mixture of voluntary social distancing and mandated lockdowns – particularly in the developed world – in place, governments had little option but to put a floor under household spending through stimulus checks, enhanced unemployment benefits and housing support, and extend financial support to businesses through tax relief, loan guarantees and job retention schemes. As a result, government spending surged, largely through increased transfers to households and businesses, albeit with considerable variation across countries, particularly between developed and developing countries, reflecting their differing fiscal space and sovereign debt issuing capacities.

Despite their scale and the support extended to people in the most precarious economic situations, these programs had little redistributive impact, reflecting pre-existing inequalities and interests (Tooze, 2021). Even with historically low (and in many cases negative) interest rates and the willingness of central banks to assume private sector risks, investment, both public and private, remained subdued, further locking in the supply-side weaknesses that had emerged during the previous decade. Moreover, as central bank support triggered a surge in stock markets, the boom was skewed towards larger firms in select sectors, notably high-tech and pharmaceuticals, whereas many in the old economy remained in difficulty, further propelling the polarization of the previous decade (*TDR*, 2022).

In this sense, today's combination of slowing growth and rising prices is rooted in the constraints and contradictions of the financialized capitalism of our times, which are quite unlike those of 1970s managed capitalism. The policy agenda needs to respond accordingly, beginning with a much more pragmatic approach to bringing down inflationary pressures.

## B. GROWTH PROSPECTS THROUGH THE FOG OF WAR AND INFLATION

Two and a half years after the Covid shock, with many parts of the world economy still fighting the pandemic, a new round of shocks has complicated the policy landscape. The V-shaped Covid shock and recovery left many global supply chains disrupted, triggering wide inventory fluctuations and multiple production bottlenecks. In the first phase of the pandemic, the demand for goods soared, and the demand for services collapsed. Then, as countries eased their health-related restrictions on the economy, the demand for services recovered even as the demand for goods remained high. The two processes put upward pressure on both producer and consumer prices, even before the war in Ukraine, pushing inflation in advanced economies above established monetary targets and in many emerging and developing economies to a level not seen since the first Gulf War in the early 1990s.

Even though the risk of another mutation of the virus cannot be discarded, combatting inflation has pushed public health down the economic policy priority list, particularly in advanced economies. The increase in inflation sparked a debate about whether the Covid stimulus policies were too expansionary in some countries, especially in the United States, or whether the problem was the inevitable consequence of an ongoing adaptation to a new post-pandemic production and consumption structure. In the end, the response has been driven more by policy routine and political expediency than measured assessment.

Starting in mid-2021, the inflationary pressure led some countries to begin tightening monetary policy to fight the secondary effects of the unbalanced recovery (box 2.2). Monetary tightening gained momentum in the beginning of 2022, when the start of the war in Ukraine triggered another adverse global supply shock. Fuel and food prices, which were already rising, shot up further. For oil, this was clearly the consequence of speculative trades, as the price increases far outpaced any changes in supply and consumption. Supplies of some key grains and fertilizers were disrupted, and consumer prices accelerated everywhere (chapter II). As of mid-2022, even previously low-inflation economies were facing inflationary pressures, dangerously close to double digits, which, in the absence of other policy measures, forced their central banks to raise short-term interest rates, at a pace not experienced in decades.

In the second half of 2022, higher short-term interest rates and the end of any remaining Covid-related fiscal and financial stimuli are expected to further constrain income growth across much of the global economy, leading to a "growth recession" – conventionally defined as annual global output growth below 3 per cent at both market and purchasing-power-parity prices. This echoes what happened

after the GFC, when many countries were quick to adopt austerity budgets, dampening the budding economic recovery. But unlike then, today's situation is led by monetary tightening, with the threat, against a backdrop of higher debt levels and inequality, of greater macroeconomic volatility and more country heterogeneity (making the consequences of the Fed's rate increases vastly different from country to country). Compared to early 2021, when the economic policy debate revolved around a shared ambitious policy agenda of inclusive recovery and the building of resilience to future shocks, the prospect of coordinated policy programs that would make the global economy fairer and more sustainable has dimmed. With the partial exception of the United States, plans for the energy transition have been largely put on hold, while countries scramble to increase supplies of coal, oil and gas in order to contain fuel and electricity prices, especially in Europe. High food price inflation and exchange-rate volatility have undermined the livelihoods of millions of people, especially in low- and middle-income countries, upending any plans to tackle high levels of inequality. 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 more warning of a fiscal cliff and raising the spurious claim of the expansionary effects of austerity (chapter III). Finally, the war in Ukraine and the growing United States-China rivalry are pushing the world towards a conflictual multipolar configuration, diminishing the hope, at least for the moment, of a more cooperative global order.

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 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. Elements for such a program are considered further in Section C below and in chapter III.

## 1. Global growth and inflation outlook

Based on the United Nations Global Policy Model, the world economy is expected to grow 2.5 per cent in 2022 (table 1.1). This is 1.0 percentage points below the rate projected for this year in the Trade and Development Report 2021 but broadly in line with our March update (TD R, 2022). The downward revision from last year derives from three factors:

I - 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 (*TDR*, 2021: box 1.1), with a weaker impact on growth. This made the subsequent policy tightening (both fiscal and monetary) more recessionary than it would have been had the recovery been stronger.

II - 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.

III - Unexpected headwinds coming from the war in Ukraine brought down growth in the Russian Federation and Ukraine and also triggered a swing in commodity prices (mostly abated by now) and are now acting as an adverse supply shock in both advanced and developing economies.

The ongoing war in Ukraine and geopolitical tensions are adding to economic anxieties. The *TDR* update in March 2022 already factored in the possible consequences: energy and commodity shocks, trade disruptions, financial and exchange rate instability, inflationary pressures, forced migration and unstable remittance flows. Since most of these consequences have so far played out as anticipated, our projection is largely unchanged from 6 months ago. But this also serves as a reminder that the most critical problems faced by the global economy today predate the war in Ukraine.

**Table 1.1.** World output growth, 1991–2023 *(annual percentage change)*

Revisions for 2022 against *TDR* March

| Country groups | 1991–1999[a] | 2000–2009[a] | 2009–2019[a] | 2015–2019[a] | 2019 | 2020 | 2021 | 2022[b] | 2023[b] | Reported March 2022 | Revision for 2022 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **World** | **9** | **3.3** | **3.0** | **3.0** | **2.6** | **-3.4** | **5.8** | **2.5** | **2.2** | **2.6** | **-0.1** |
| **Africa** | **2.4** | **5.5** | **3.0** | **2.9** | **2.8** | **-2.6** | **5.1** | **2.7** | **2.4** | **1.8** | **+0.9** |
| North Africa (incl. South Sudan) | 3.0 | 5.2 | 1.6 | 3.8 | 3.1 | -3.7 | 7.4 | 3.0 | 2.4 | 2.2 | +0.8 |
| South Africa | 2.0 | 4.0 | 1.7 | 1.0 | 0.1 | -6.3 | 4.9 | 1.4 | 1.3 | 1.1 | +0.3 |
| Sub-Saharan Africa (excl. South Africa and South Sudan) | 1.9 | 6.3 | 4.3 | 2.8 | 3.3 | -1.0 | 3.7 | 2.8 | 2.6 | 1.8 | +1.0 |
| **America** | **3.4** | **2.5** | **2.1** | **1.9** | **1.8** | **-4.3** | **5.8** | **2.1** | **1.0** | **2.4** | **-0.3** |
| Latin America and the Caribbean | 3.3 | 3.4 | 1.6 | 0.4 | 0.0 | -7.2 | 6.6 | 2.6 | 1.1 | 2.3 | +0.3 |
| Central America (excl. Mexico) and Caribbean | 2.9 | 4.4 | 3.4 | 3.1 | 2.3 | -8.6 | 7.8 | 3.7 | 2.5 | 3.5 | +0.2 |
| Mexico | 3.0 | 1.9 | 2.7 | 2.1 | -0.2 | -8.3 | 4.8 | 1.8 | 1.4 | 1.3 | +0.6 |
| South America | 3.5 | 3.9 | 1.0 | -0.5 | -0.3 | -6.6 | 7.0 | 2.7 | 0.7 | 2.4 | +0.3 |
| Argentina | 4.6 | 3.8 | 0.9 | -0.3 | -2.0 | -9.9 | 10.2 | 4.1 | -0.8 | 4.6 | -0.4 |
| Brazil | 2.9 | 3.6 | 0.7 | -0.4 | 1.2 | -3.9 | 4.6 | 1.8 | 0.6 | 1.3 | +0.5 |
| North America | 3.4 | 2.3 | 2.2 | 2.3 | 2.3 | -3.5 | 5.6 | 2.0 | 1.0 | 2.4 | -0.4 |
| Canada | 2.8 | 2.3 | 2.1 | 2.0 | 1.9 | -5.2 | 4.6 | 3.2 | 2.2 | 3.0 | +0.2 |
| United States | 3.5 | 2.3 | 2.2 | 2.3 | 2.3 | -3.4 | 5.7 | 1.9 | 0.9 | 2.4 | -0.4 |
| **Asia (excl. Cyprus)** | **4.4** | **5.6** | **5.1** | **4.7** | **3.7** | **-1.1** | **6.2** | **3.5** | **4.1** | **3.8** | **-0.2** |
| Central Asia | -4.4 | 8.2 | 5.1 | 3.9 | 3.5 | -1.5 | 5.2 | 3.6 | 3.5 | 0.2 | +3.5 |
| East Asia | 4.4 | 5.6 | 5.2 | 4.8 | 4.1 | 0.4 | 6.5 | 3.2 | 4.3 | 3.9 | -0.7 |
| China | 11.0 | 10.6 | 7.5 | 6.7 | 6.0 | 2.3 | 8.1 | 3.9 | 5.3 | 4.8 | -0.9 |
| Japan | 1.2 | 0.9 | 1.2 | 0.9 | -0.2 | -4.5 | 1.7 | 1.0 | 1.8 | 2.0 | -1.0 |
| Republic of Korea | 6.8 | 4.9 | 3.1 | 2.9 | 2.2 | -0.7 | 4.1 | 2.2 | 2.0 | 1.7 | +0.5 |
| South Asia | 4.8 | 6.4 | 5.8 | 5.9 | 3.1 | -4.5 | 6.8 | 4.9 | 4.1 | 4.0 | +0.9 |
| India | 5.9 | 7.2 | 6.9 | 7.0 | 4.5 | -6.6 | 8.2 | 5.7 | 4.7 | 4.6 | +1.1 |
| South-East Asia | 5.3 | 5.4 | 5.1 | 4.9 | 4.3 | -4.2 | 3.8 | 4.1 | 3.8 | 3.4 | +0.7 |
| Indonesia | 4.8 | 5.2 | 5.3 | 5.0 | 5.0 | -2.1 | 3.7 | 4.3 | 4.4 | 4.4 | -0.1 |
| Western Asia (excl. Cyprus) | 4.0 | 5.0 | 4.0 | 2.7 | 1.5 | -3.5 | 6.2 | 4.1 | 2.9 | 3.4 | +0.8 |
| Saudi Arabia | 1.7 | 4.0 | 3.4 | 1.4 | 0.3 | -4.1 | 3.2 | 6.6 | 3.9 | 4.8 | +1.8 |
| Türkiye | 3.9 | 5.0 | 5.9 | 4.3 | 0.9 | 1.8 | 11.0 | 2.4 | 2.4 | 2.5 | 0.0 |
| **Europe (incl. Cyprus)** | **1.4** | **2.2** | **1.6** | **2.1** | **1.8** | **-5.9** | **5.5** | **1.2** | **0.5** | **0.9** | **+0.2** |
| European Union (EU 27) | 1.9 | 1.8 | 1.5 | 2.2 | 1.8 | -5.9 | 5.4 | 2.0 | 0.6 | 1.6 | +0.4 |
| Euro area | 1.9 | 1.6 | 1.3 | 2.0 | 1.6 | -6.4 | 5.4 | 2.0 | 0.6 | 1.7 | +0.3 |
| France | 1.8 | 1.6 | 1.3 | 1.7 | 1.8 | -7.8 | 6.8 | 2.0 | 1.0 | 2.4 | -0.4 |
| Germany | 1.6 | 1.0 | 1.8 | 1.8 | 1.1 | -4.6 | 2.9 | 1.1 | 0.0 | 1.4 | -0.3 |
| Italy | 1.5 | 0.7 | 0.1 | 1.1 | 0.5 | -9.0 | 6.6 | 2.5 | 0.5 | 1.6 | +0.9 |
| Russian Federation | -5.9 | 6.2 | 1.6 | 1.2 | 2.2 | -2.7 | 4.7 | -7.4 | 1.3 | -7.3 | -0.1 |
| United Kingdom | 2.6 | 2.0 | 2.1 | 2.1 | 1.7 | -9.3 | 7.4 | 2.6 | -0.9 | 1.3 | +1.3 |
| **Oceania** | **3.6** | **3.2** | **2.7** | **2.6** | **2.1** | **-2.2** | **4.8** | **3.6** | **2.1** | **3.0** | **+0.6** |
| Australia | 3.7 | 3.3 | 2.6 | 2.5 | 2.0 | -2.1 | 4.8 | 3.9 | 2.3 | 3.3 | +0.6 |
| **Memo items:** | | | | | | | | | | | |
| Developed (M49, incl. Republic of Korea) | 2.3 | 2.2 | 1.9 | 2.1 | 1.8 | -4.5 | 5.2 | 1.7 | 1.0 | 1.8 | -0.1 |
| Developing (M49) | 4.9 | 6.4 | 5.0 | 4.4 | 3.7 | -1.7 | 6.8 | 3.7 | 3.9 | 3.7 | 0.0 |

*Source:* UNCTAD secretariat calculations, based on United Nations Global Policy Model; United Nations, Department of Economic and Social Affairs (UNDESA), National Accounts Main Aggregates database, and World Economic Situation and Prospects (WESP): Update as of mid-2022; ECLAC, 2022; Organisation for Economic Co-operation and Development (OECD), 2022; International Monetary Fund (IMF), World Economic Outlook, June 2022; Economist Intelligence Unit, EIU CountryData database; JP Morgan, Global Data Watch; and national sources.

*Note:* Calculations for country aggregate are based on GDP at constant 2015 dollars.

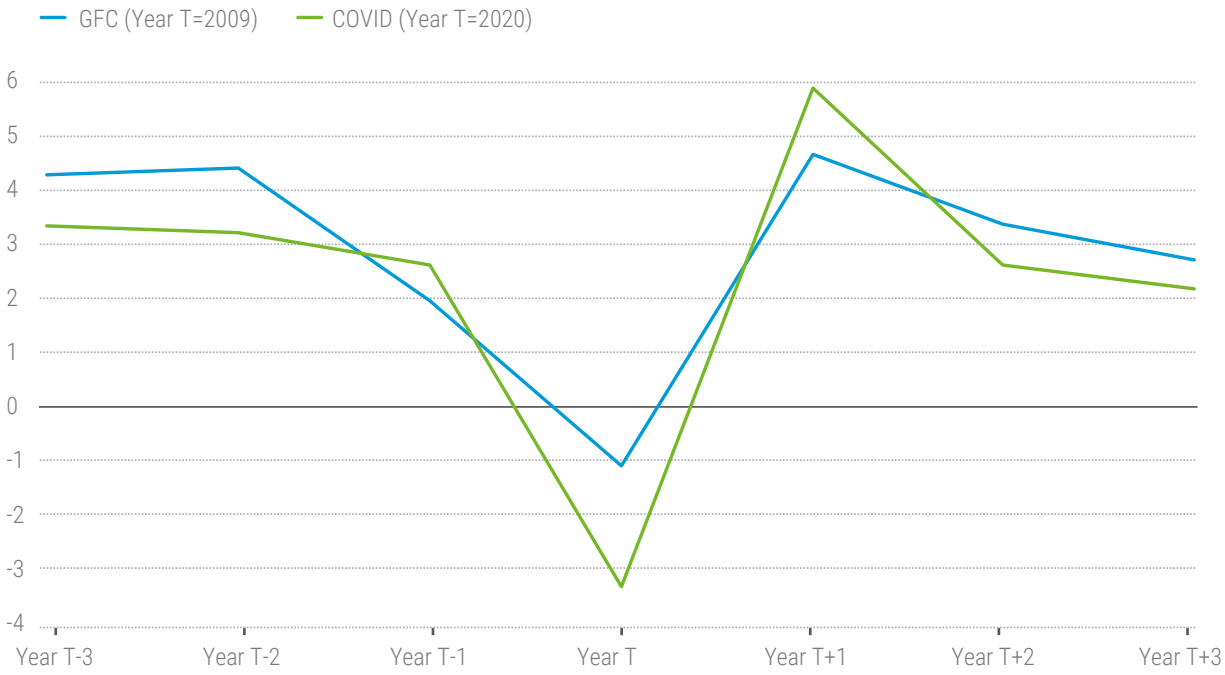
[a] Average.

[b] Forecasts.

Today's growth performance points to a troubling pattern observed in the post-GFC decade, in which the timing and size of policy responses were such that the recovery lost steam over time. UNCTAD assessment is that the trend is worsening, with growth expected to decelerate further in 2023, to 2.2 per cent.

The estimated 2.5 per cent growth in 2022 is less than half the growth rate of 5.6 in 2021, when economic activity resumed after the sharpest recession in living memory. Part of the growth deceleration this year was to be expected, as countries used up their idle capacity once vaccine programs were rolled out and lockdowns eased. A similar fluctuation happened after the GFC, with a strong recovery in the year immediately after the shock followed by a subsequent slowdown. The distinctive feature of the current episode is its exaggerated form. So far, the downswing and upswing have been wider in 2020 and 2021, respectively, than in 2009 and 2010, and the post-bounce-back deceleration is expected to be more abrupt in 2022–2023 than in 2011–2012 (figure 1.8).

**Figure 1.8** Global growth cycles before and after the GFC and the Covid shock, global economy *(percentage change)*




*Source:* UNCTAD secretariat calculations based on the United Nations Global Policy Model.

Further increases in global real interest rates are expected to reduce world output growth in 2023, compounded by political divisions that continue to block compensatory fiscal action in advanced Western economies and by foreign exchange constraints that do the same in many developing economies. UNCTAD expects the world economy to grow just 2.2 per cent in 2023, but with risks of a further drop if financial conditions deteriorate in leading economies and contagion hits emerging economies. If such a low-growth scenario persists for two or more years, world output will be on course for a slower expansion than after the GFC, itself substandard for many economies (table 1.1).

Our projections point to a worrisome trend whereby 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 had become entrenched even before the pandemic hit.

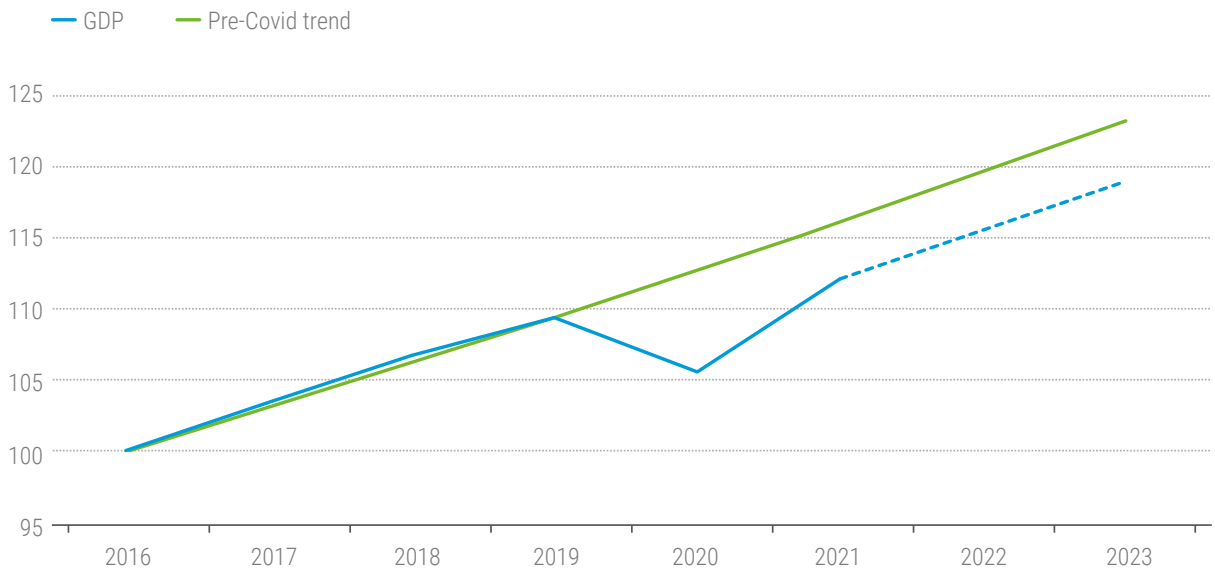
For developing economies, the deceleration is particular cause for alarm. Excluding China, the group is projected to grow 3.0 per cent this year, below the pre-Covid average of 3.5 per cent, and diminishing the room for rising per capita incomes. To put this into context, in the early 2000s, the last period of sustained progress for industrialization and development, the group grew at 5 per cent per year on average. China will slow down too, an estimated 4.2 percentage points less than 2021, although it is projected to continue growing faster than other countries, at almost 4 per cent in 2022, and to accelerate in 2023, one of the few countries expected to do so.

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, and friend-shoring, increased market concentration, reduced policy space and a North-centred climate policy weaken developing countries' position in global value chains.

Developed economies are projected to grow 1.7 per cent in 2022 and 1.0 per cent in 2023. On average, this is 0.5 percentage points below the mean of the pre-Covid 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 Reports and the section above, this is a reflection of policymakers relying excessively 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 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 trend in 2023 (figure 1.9), with no sign of the gap closing any time soon.

**Figure 1.9** Covid recovery compared to pre-Covid trend, 2016–2023 *(index numbers, 2016=100)*

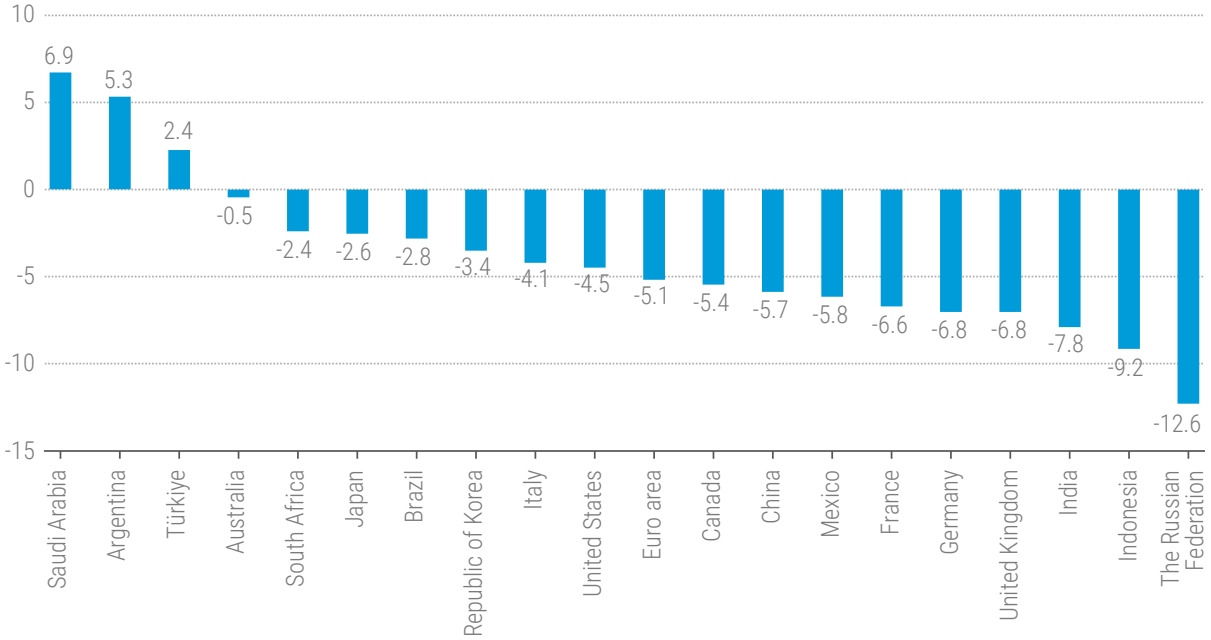



*Source:* UNCTAD secretariat calculations based on the United Nations Global Policy Model.

Among the G20 economies, only Türkiye, Saudi Arabia and Argentina are expected to be above trend next year, for idiosyncratic reasons that are not clearly sustainable. In Türkiye, persistent inflation makes the current above-trend growth fragile. Some restrictive macroeconomic adjustment is expected in the short term. In Saudi Arabia, the quick recovery is linked to the fluctuation in the world oil market, which, in turn, reflects the increase in prices and Saudi output after the breakout of the war in Ukraine. And in Argentina, above-trend GDP is actually a reversion to the mean because the economy contracted 0.6 per cent per year in the three years before the pandemic. The rest of the G20 countries will continue their partial recovery in 2023, with the largest gap in the Russian Federation because of the lasting negative effects of the war on the Russian economy (figure 1.10).

UNCTAD slow growth projections for 2022–2023 are subject to caveats. Domestic political decisions and international coordination (or lack thereof) can make a difference for the better (or for the worse). Progressive and coordinated policy actions in the direction of the SDGs could still propel the world economy onto a sustainable and inclusive development path (chapter III).

**Figure 1.10** Expected output gap in 2023 in G20 countries *(percentage)*



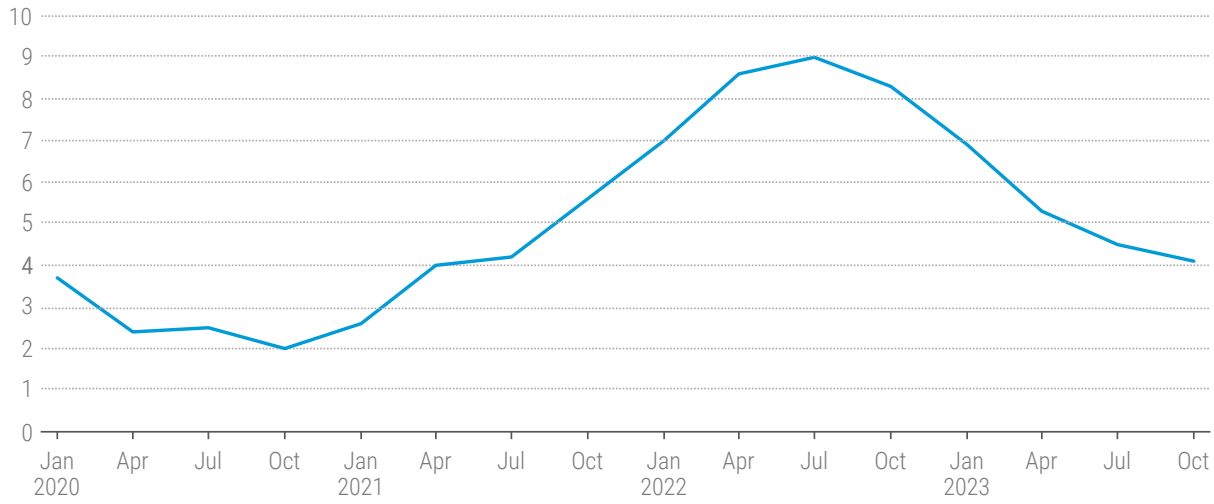

*Source:* UNCTAD secretariat calculations based on the United Nations Global Policy Model.

On the downside, a lasting war in Ukraine, persistently high inflation, a Volcker-like shock to real interest rates and heightened financial turbulence could push the world economy into a deeper recession, followed by a long stagnation, with macro-financial complications in many developing countries and some developed ones, especially in Europe, where the energy crisis is likely to bite hardest (Thompson, 2022) and the combination of currency union and fiscal disunion magnifies the risk premium paid by some governments in times of crisis.

UNCTAD slow 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 in the second half of 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 down world output and prices in 2023. There is considerable contingency surrounding these trends. Still, according to the IMF, global annual consumer inflation will peak at 9 per cent, in the third quarter of 2022, and then fall rapidly to 4 per cent, by the end of 2023 (figure 1.11).

**Figure 1.11** IMF global consumer inflation estimate and forecast, Jan. 2020–Oct. 2023 *(percentage)*



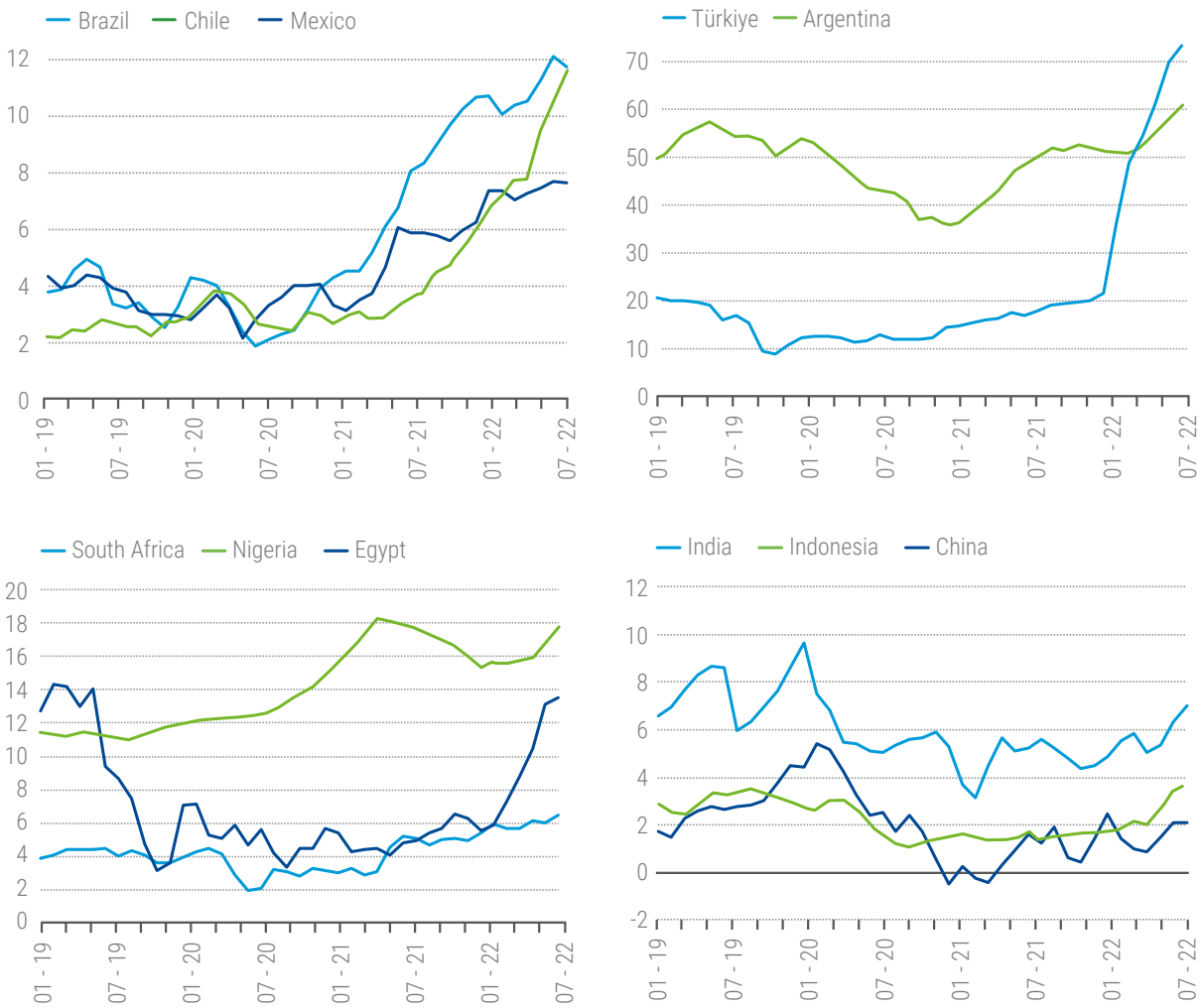

*Source:* IMF (2022) World Economic Outlook (July update).

Compared to the GFC, the Covid recovery has been relatively more inflationary for advanced economies than for developing countries, where inflation rates are structurally higher. In developed countries, inflation has been highly correlated (Schnabel, 2022). The rate of CPI inflation in the United States increased from 1.5 per cent in January 2019 to 8.5 per cent in May 2022; CPI inflation in the European Union rose from 1.4 per cent in January 2019 to 8.8 per cent in May 2022. In May 2022, the CPI inflation rates for Germany, France and the United Kingdom were 8.7 per cent, 5.8 per cent and 9 per cent, respectively, while Canada's inflation rate in May 2022 was 7.7 per cent.[6] In all these cases, the main drivers of resurgent inflation turned out to be commodity prices and Covid-related bottlenecks in global supply chains (Schnabel, 2022). Accordingly, in these countries, inflation measures that exclude energy prices are considerably lower than the (headline) CPI inflation rate. However, while imported inflation is already subsiding, commodity prices remain high as does the index of supply chain pressure (chapter II), suggesting that there might still be room for consumer prices and nominal wages to keep climbing. In the European Union, where a large share of wages is set in multi-year contracts, nominal wage adjustments take longer to materialize than in the United States, where labour contracts have shorter duration.

Figure 1.12 shows the monthly CPI inflation rates (from January 2019 to May 2022) for selected developing countries. These were generally higher than in advanced countries, and with some notable exceptions, they increased earlier. The economies in the figure are all relatively large commodity importers: on average, commodities make up slightly less than one-third of their imports (in dollar terms) from 2018 to 2020.

[6] There is, however, a wide variation among developed economies with inflation in Japan in July 2022 annualized at 2.6 per cent but close to 23 per cent in Estonia.

**Figure 1.12** Consumer price inflation, major emerging economies, Jan. 2019–May 2022 *(percentage)*

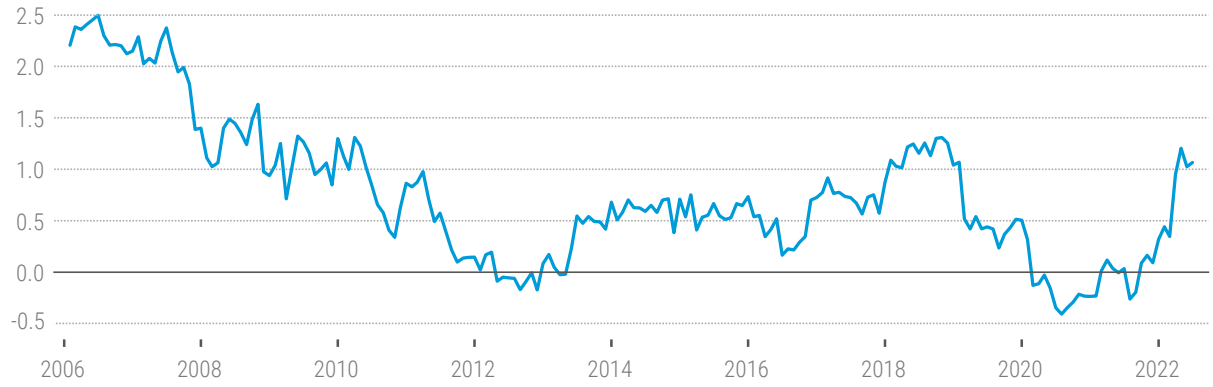



*Source:* For Brazil, China, Chile, India, Indonesia, Mexico, South Africa and Türkiye: Federal Reserve Economic Data (FRED); for Argentina: World Bank (World Development Indicators database); for Nigeria: National Bureau of Statistics (Composite Consumer Price Index); for Egypt: Central Bank of Egypt (Inflation Data).

The share of commodities in China's and Egypt's imports is 38 per cent, and more than 50 per cent of India's imports are (primary) commodities including food and fuel. As a result, higher commodity prices have a strong impact on domestic prices via imports. Recent estimates covering the past five decades suggest a 50 per cent increase in oil prices (approximately the increase in 2021) is associated with an increase in inflation of between 3.5 and 4.4 percentage points, with a lag of about two years (Choi et al., 2018; Ha et al., 2019). These findings suggest that in emerging economies, as in advanced economies, a considerable part of the inflation experienced in 2021–2022 has been caused by higher commodity (oil) prices.

There is a possible silver lining to the past year of high inflation: it has pushed real interest rates, at least for advanced economies, deep into negative territory (figure 1.13). As a result, if nominal interest rates do not climb too much, the net cost of public debt (the real interest rate minus the GDP growth rate) may continue to be negative or zero after the disinflation process, assuaging concerns about sovereign debt and providing more room for expenditure plans, including for the energy transition.

**Figure 1.13** 10-year real interest rate in the United States, 2006–2022 *(percentage)*



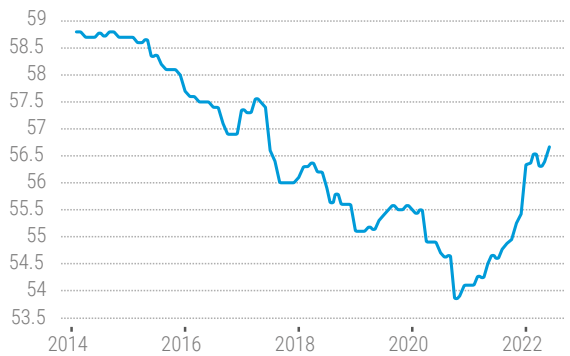

*Source:* Federal Reserve Bank of St. Louis.

## 2. Multiple adverse supply shocks

As pointed out in *TDR* 2021, the Covid pandemic led to a sudden stop and a gradual reopening of the world economy, causing serious disruption to global supply chains, trade logistics and key international prices. The first part of the shock was clearly deflationary, especially for urban services, with a combined fall in demand and supply. Then, as the economy started to adapt to health-mandated lockdowns, the demand for goods recovered, creating supply and logistical bottlenecks around the world which registered as price swings. Two key price indices, one for semiconductors (figure 1.14) and the other for freight (figure 1.15), illustrate the point.

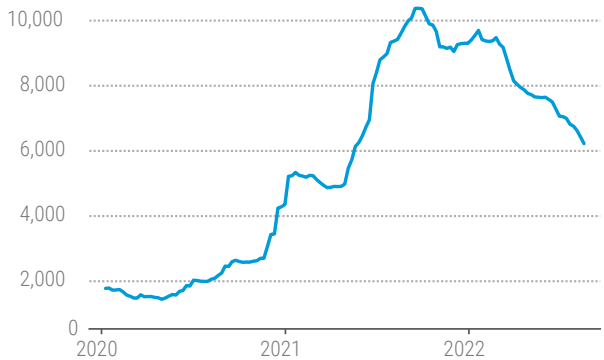
The increase in world inflation has also been driven by a deep V-shaped fluctuation in commodity prices, as discussed in chapter II. For the moment, it suffices to say that the first impact of Covid was deflationary for food, fuel and mineral commodities, but this phase did not last long. After a 30 per cent fall between December 2019 and April 2020, the IMF world commodity index climbed almost uninterruptedly until the beginning of 2022, with a cumulative increase of 187 per cent (figure 1.16), driven by three main forces. First, the post-Covid boom for consumer goods and construction materials was commodity intensive.

**Figure 1.14** United States producers' price index for semiconductors and other electronic components *(index numbers, 1984=100)*



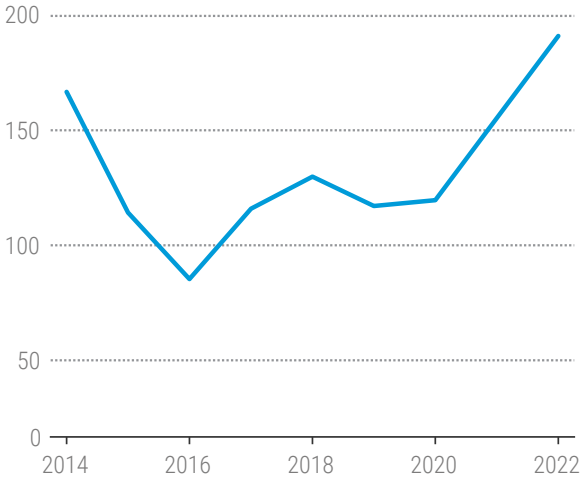

*Source:* Federal Reserve Bank of St. Louis.

**Figure 1.15** Drewry world container index (DWCI) freight cost *(dollars per 40 feet)*



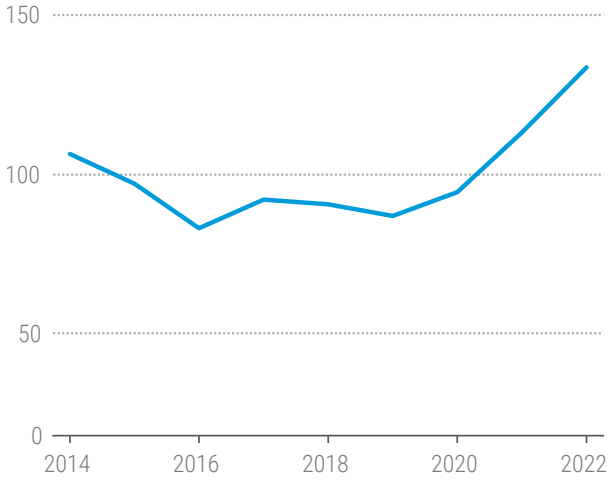

*Source:* Drewry Supply Chain Advisors.

**Figure 1.16** Commodity price index, 2014 to 2022 (April) *(index numbers, 2016=100)*




*Source:* IMF Primary Commodity Prices dataset.

**Figure 1.17** Commodity food price index, 2014 to 2022 *(index numbers, 2016=100)*




*Source:* IMF Primary Commodity Prices dataset.

Second, the initial reduction in global nominal interest rates to fight the Covid recession created an incentive to speculate with any financial assets, including commodities. The quantitative easing of 2020 and 2021 led to more speculation and inflation in asset markets, from crypto currencies to oil, food and minerals. Third, the war in Ukraine pushed fuel and food prices further up in early 2022, initially in a context of low global interest rates.

As of mid-2022, the monetary tightening in the United States and the deceleration in world output seem to have stopped the global inflationary trend in commodities. There is still much uncertainty surrounding the consequences of the war in Ukraine for food and fuel prices, but with high interest rates and slower demand growth, the most probable scenario for 2023 is a further, if more gradual, fall in commodity prices. However, because the starting point of the disinflationary trend is very high, the relative prices of commodities in terms of world per-capita income will continue to be high in the short term. In fact, despite its recent fall, in June 2022, the commodity food price index was still 64 per cent above its pre-Covid value (figure 1.17).

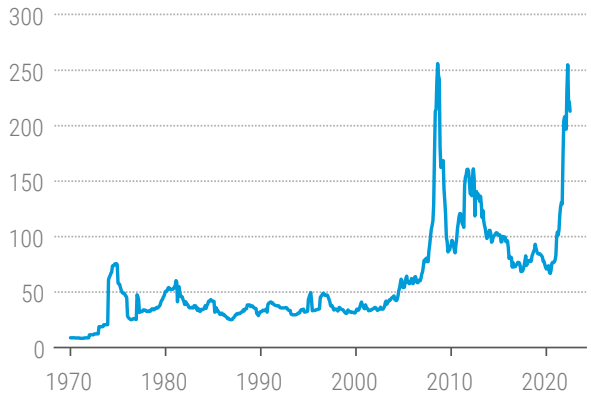
Food price inflation poses significant challenges for households in developing economies, as they spend a larger share of their income on food. Higher food prices imply sharp decreases in real incomes for the majority of low-income workers, whose wages do not increase with inflation, and may push millions into poverty. Higher food prices alone are estimated to be pushing an additional 75 million to 95 million people into extreme poverty in 2022, compared to pre-pandemic trends (Gerszon Mahler et al., 2022). Energy inflation may be even more detrimental with Oxfam (2022) warning that higher food and energy prices and persistent crisis conditions may raise the number of people living in extreme poverty by 263 million in 2022.

Higher food prices also force households in the emerging economies to lower their spending on non-food items; hence, demand for manufactured goods and services will go down. The result will be a slowdown of growth in non-primary sectors, if not a recession, and the stagflation may well trigger social unrest and food riots, especially in foreign-exchange-constrained countries that are net food importers.

In theory, high relative prices stimulate investment today and more output tomorrow, so the current increase in food prices should be attenuated in 2023. In practice, because of the long-term effects of global warming and the short-term implication of high fertilizer prices for the next harvest cycle (figure 1.18), the normalization of the world food market is far from taken-for-granted, with the situation in sub-Saharan Africa of particular concern. On top of the uncertain post-Covid adaptation of world food supply to demand, the war in Ukraine has created an adverse supply shock for wheat and fertilizers, pushing some countries to restrict their exports of the two products. In the absence of global coordination, the localized war in Eastern Europe can lead to trade wars in the global food market.

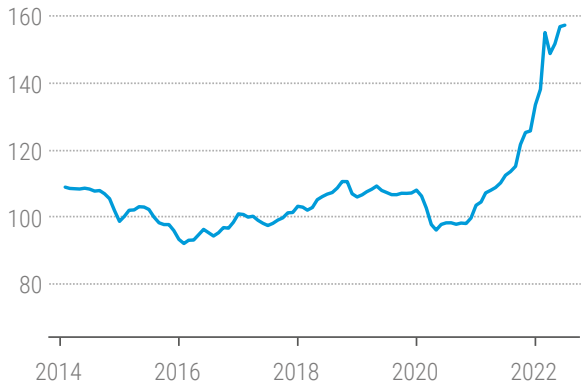
The war in Ukraine and the economic sanctions against the Russian Federation have also caused a major shock in Europe, with a record increase in electricity and fuel prices in 2022 and the risk of rationing later in the year (figure 1.19).

**Figure 1.18** Fertilizer price index, January 1970–June 2022 *(index numbers, 2010=100)*




*Source:* World Bank Commodity Price data (The Pink Sheet).

**Figure 1.19** Energy prices in the euro area, 2014–2022 *(index numbers, 2015=100)*




*Source:* FRED database.
*Note:* Data refer to the monthly Harmonized Index of Consumer Prices: Energy for the euro area (19 countries), which is not seasonally adjusted.

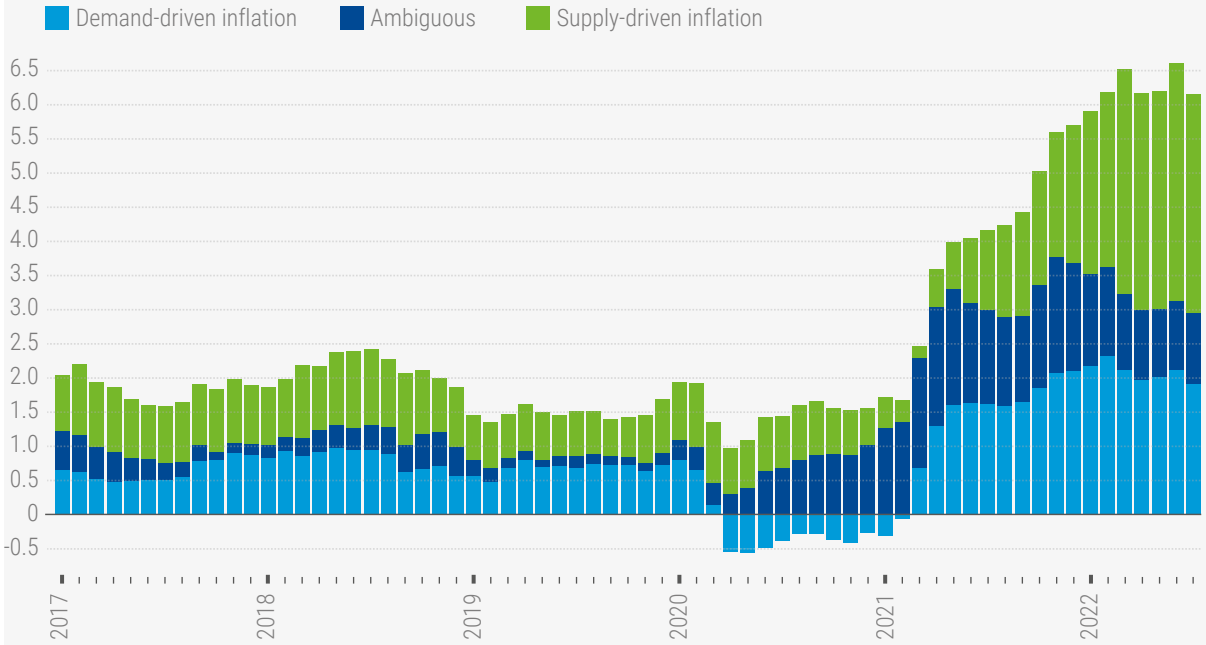
### Box 1.2 Demand-driven and supply-driven inflation in the United States

In a recent analysis, the United States Federal Reserve Bank of San Francisco (Shapiro, 2022) decomposed consumer price inflation into demand-driven, supply-driven and ambiguous components. Demand-driven products are those for which unexpected changes in price and quantity happen in the same direction. By analogy, supply-driven products are those for which unexpected changes in price and quantity go in opposite directions. Whatever does not fall in one of the two categories is labelled ambiguous, that is, a result of both supply and demand forces. Figure 1B2.1 shows the results for the United States personal consumption expenditure (PCE) and can be summarized as follows:

- The first impact of Covid was a negative (disinflationary) demand shock. The supply component also fell in early 2020, but it remained positive (inflationary).

- The demand-driven component of the United States PCE inflation turned positive in early 2021; as of mid-2022, it was at running 2 per cent per year, the country's long-term inflation target and twice its value before Covid.
- Despite the recent surge in United States demand-driven inflation, supply shocks continue to be the main determinant of United States consumer prices, accounting for more than 50 per cent of the 6.1 per cent PCE annual inflation rate registered in June 2022. This raises concerns about an inflation response based on interest rate increases, which are mainly effective on demand factors while having serious consequences for developing countries.

**Figure 1B2.1** Decomposition of United States consumer inflation, measured by personal consumer expenditures (PCE), January 2017–July 2022 *(percentage)*




*Source:* Federal Reserve of San Francisco.
*Note:* Data refer to year-over-year changes in headline PCE inflation.

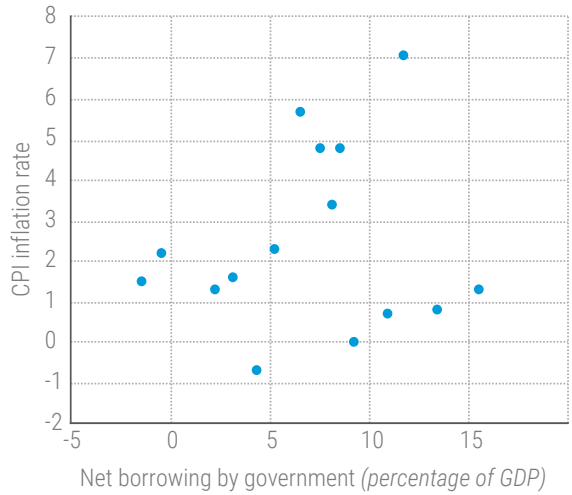
## 3. Localized demand pressures

Differences in the magnitude of fiscal responses to the Covid crisis do not show up in differences in CPI inflation rates. Figure 1.20. A plots net borrowing by the government (as a percentage of GDP) against the CPI inflation rate during the years 2019–2021 for leading developed economies. The correlation coefficient between net government lending and the CPI inflation rate is 0.14 and is not statistically significant.

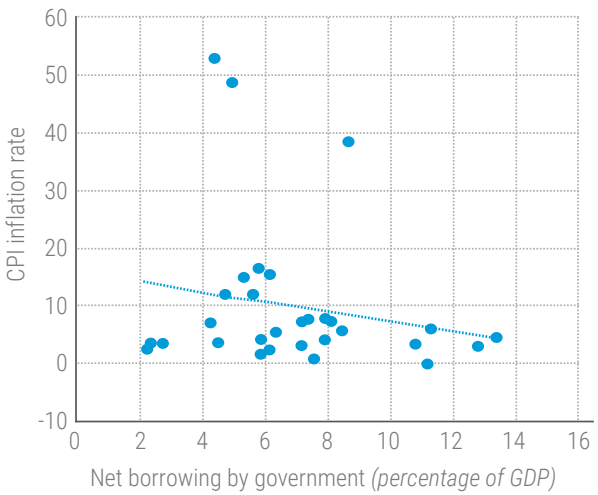
Most concerns about overheating after Covid have been concentrated on the United States for three reasons. First, because of the initial deflationary impact of Covid and the increase in the average real earnings (due to massive job loss among low-wage workers), real wages in the United States spiked 6 per cent above trend in early 2020 and remained high throughout the year. Then, in 2021, as the economy recovered, and prices started to accelerate, real wages began to fall. The process is still under way but, as of mid-2022, the purchasing power of United States workers has already fallen 3 per cent below its pre-Covid trend (figure 1.21).

**Figure 1.20** Government borrowing and the consumer price index, selected developed and emerging economies, 2019–2021

**A. Developed economies**

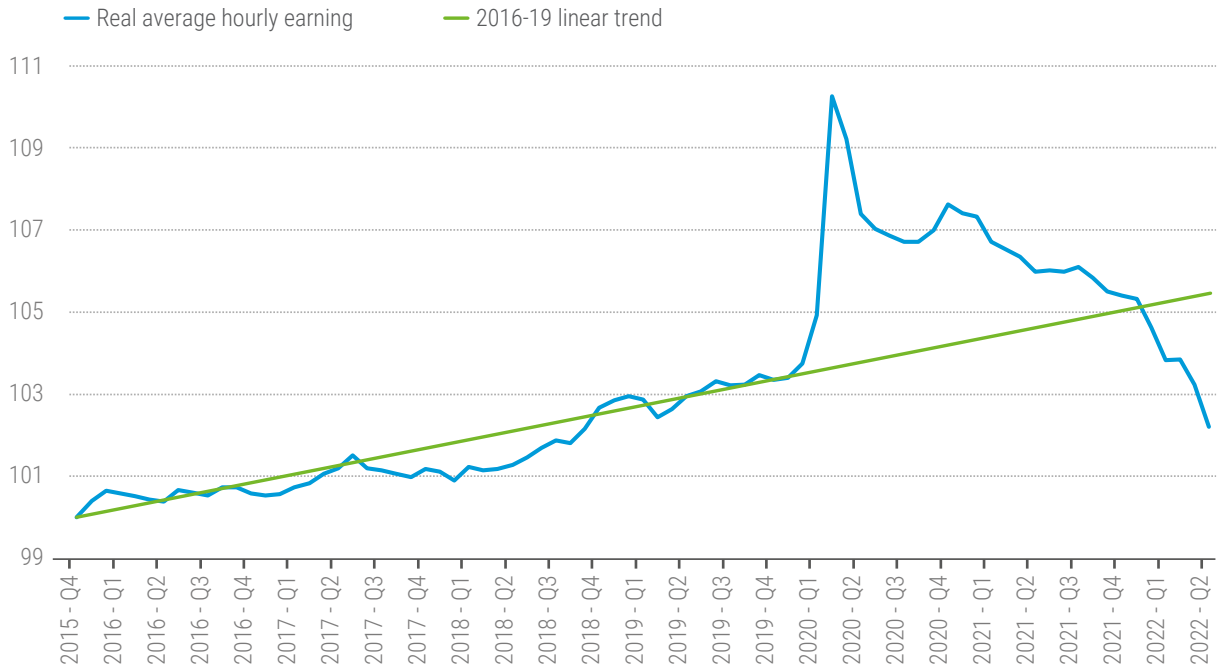



**B. Emerging economies**




*Source:* UNCTAD secretariat calculations, based on Federal Reserve Economic Data (FRED) database; European Commission, Macro-economic database AMECO and Eurostat database; International Monetary Fund (IMF), World Economic Outlook, October 2021; World Bank, World Development Indicators DataBank; and national sources.
*Note:* Dots represent observations for each country-year Selected developed economies are Canada, France, Germany, United Kingdom, United States. Selected emerging economies are Argentina, Brazil, Chile, China, Egypt, India, Indonesia, Mexico, Nigeria, South Africa and Türkiye.

**Figure 1.21** Real wages, United States, 2015–2022 *(index numbers, December 2015=100)*



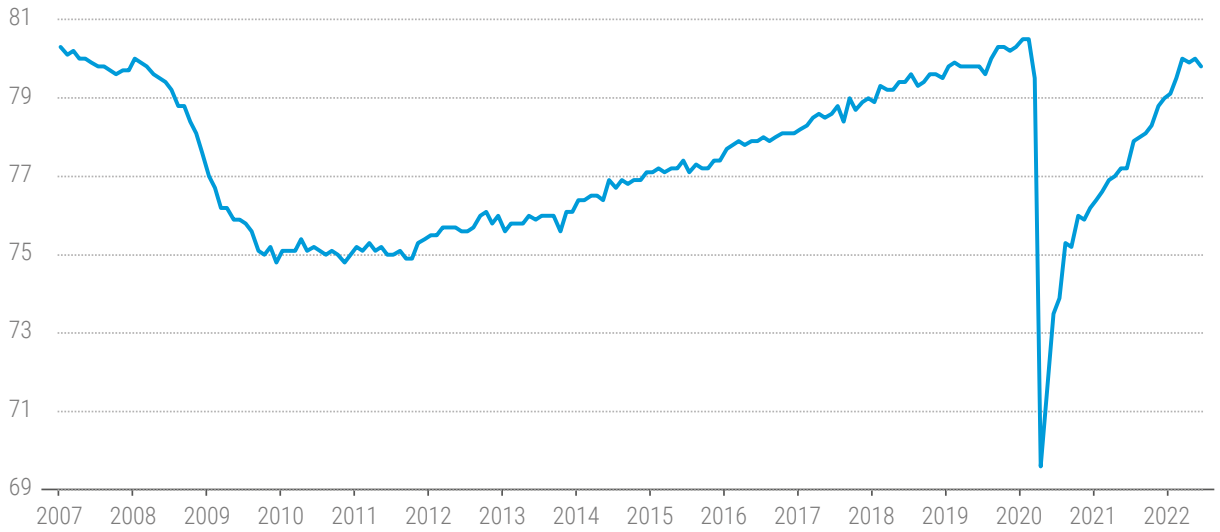

*Source:* United States Bureau of Labor Statistics.

Second, the United States economy seems to have returned to full employment. The unemployment rate of the whole labour force was just 3.6 per cent in July 2022, basically the same as in February 2020 when many economists thought the United States labour market was overheating. Since the previous peak of unemployment happened at 4.5 per cent in early 2007, before the subprime crisis started to unravel, any number below 4 per cent is thought to harbour dangerous inflationary pressures. However, the employment-population ratio of prime-age workers (25 to 59 years) paints a different picture. As of mid-2022, the United States was still one percentage point below the ratio of early 2007 and was apparently turning downwards (figure 1.22), with the situation worse for those lacking a college degree.

Third, United States consumer demand for durable and non-durable goods, as well as residential investment, boomed after the Covid shock, but demand for services has yet to return to its pre-pandemic trend (figure 1.23). In other words, there seems to have been a change in the composition of household spending; this has caused production bottlenecks and wide inventory fluctuations in the short run and will last until supply finally adjusts to effective demand. As of mid-2022, the sales of consumer goods seem to have stabilized at a high plateau, and residential investment is falling fast. Both changes will reduce further inflationary pressures in the United States, and, for 2023, the monetary tightening by the Fed, the looming increase in unemployment and the reduction in consumers' confidence levels are expected to eliminate any remaining demand pressure created by the Covid shock.

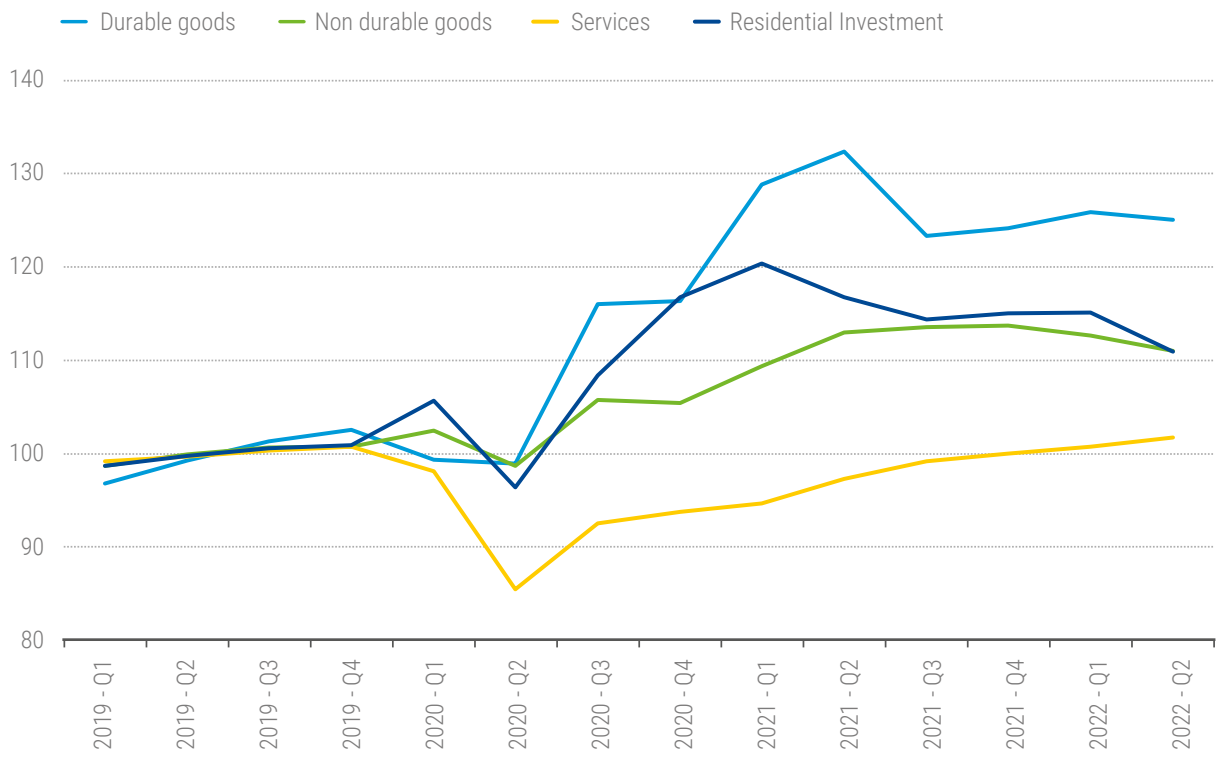
In the wake of the Covid-19 crisis, higher spending on social protection and lower revenues from taxation led to higher public budget deficits in some emerging economies. Government deficits in 2020 (2021) ranged from 4.5 per cent (4.2 per cent) of GDP in Mexico to 12.8 per cent (11.3 per cent) of GDP in India. The largest category of direct fiscal relief was cash transfers of various kinds; on average, such transfers amount to 30 per cent of monthly GDP per capita, for an average of three months. Much like advanced economies, the differences in the magnitude of fiscal responses to the Covid crisis in emerging economies do not show up in differences in their CPI inflation rates (figure 1.20.B); The correlation coefficient between net government lending and the CPI inflation rate is -0.18 and not statistically significant.

**Figure 1.22** Employment/population ratio, United States, 2007–2022 *(percentage)*




*Source:* Bureau of Labor Statistics.
*Note:* Age range is 25-54.

**Figure 1.23** United States private consumption and residential investment *(index numbers, 2019=100)*




*Source:* United States Bureau of Economic Analysis.

## 4. Wages and markups

Even when the source of high inflation is on the supply side, mainstream economic theory recommends monetary tightening to stop the supply shocks from affecting workers' expectations and reinforcing higher wage claims, as these may create a destabilizing price-wage spiral. On a more practical level, policymakers hope that through speculation and financial carry costs, a high dollar interest rate puts negative pressure on international commodity prices and helps disinflation in the United States and elsewhere, but usually at a large social cost in terms of unemployment and foregone output, depending on the size of the tightening and the state of the economy.

To analyse the implications of the current monetary restriction we have therefore to check the state of economic activity, especially the labour market, which is usually done by comparing nominal wage growth to labour productivity. In fact, if unit labour costs (ULC) – measured by the ratio of the average wage to productivity – are rising significantly, the monetary tightening needs to be larger, to produce any effect on inflation, with significant damage caused to output growth and employment. Moreover, in normal times, with balanced growth, stable relative prices, and fixed markups, the difference between nominal wage growth and labour productivity growth should equal inflation. However, during crises and adjustment periods, changing relative prices and moving markups add other short-term determinants to inflation. When firms setting higher profit margins are, a source of higher prices, monetary restrictions are a particularly inefficient and unfair response.

Data from OECD on ULC show a common pattern during the Covid shock in 2020, but a divergent behaviour thereafter. More specifically, the first economic impact of the Covid crisis on most firms was to reduce their productivity, which in the face of a constant nominal wage, raised the ULC. Then, as

economies recovered, labour productivity moved up and the ULC moved down. This cyclical pattern emerged in the main OECD economies between early 2020 and early 2021, but then economies diverged (figure 1.24). In the United States, nominal wage growth outpaced labour productivity, pushing the ULC substantially up in late 2021 and early 2022 even as real wages declined. In the first quarter of 2022, the ULC was up 7.1 per cent. In contrast, in the European Union, at the beginning of 2022, annual growth rate of ULC was 2 per cent, in line with the region's long-term inflation target. In Japan, the ULC was practically stable in the beginning of 2020 (zero growth rate), also ruling out excessive demand pressures in the labour market. The most remarkable case is the United Kingdom, where the ULC growth rate shot up to double digits during the lockdown of 2020 and then collapsed to negative double digits during reopening. The United Kingdom ULC continued to fall in first half of 2022, with nominal wage growth almost 3 points below labour-productivity growth on an annual basis.

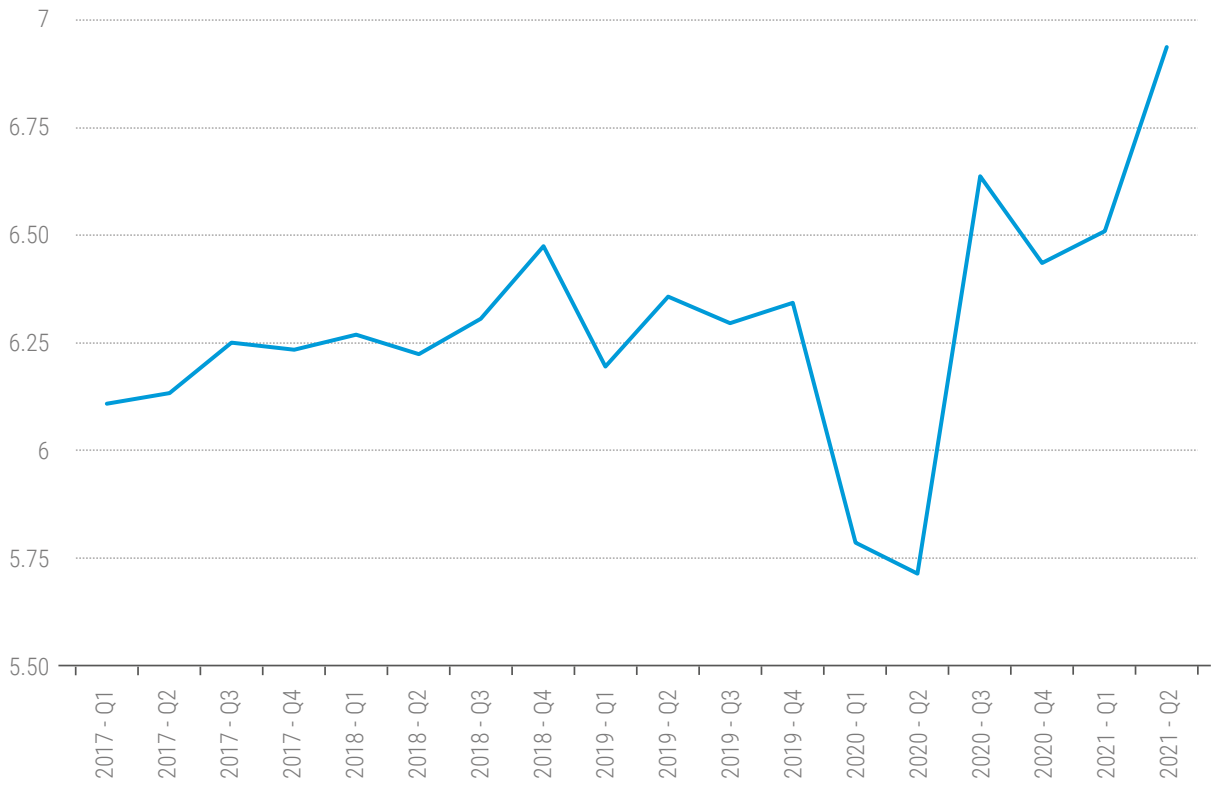
**Figure 1.24** Unit labour cost per employed person
*(percentage change over respective quarter of previous year)*


*Source:* Organisation for Economic Co-operation and Development.

Changes in ULC, however, do not automatically translate into price level variations. Their transmission depends on the firms' decision to set a markup over production costs. In theory, prices can still go up when the ULC goes down, provided firms are hiking their gross profit margins (EBITDA: earnings before interest, taxes, depreciation and amortization) faster than the ULC is falling. Using the ratio of corporate profits to gross production value (which includes intermediate consumption) as a proxy of the aggregate markup margin, the recent behaviour of the United States economy shows a fall during the first impact of the pandemic in early 2020, followed by a quick recovery in 2021. By mid-2022, the ratio of corporate profits to GDP was 7 per cent, against 6.25 per cent before the pandemic (figure 1.25). And between 2020 and 2022, an estimated 54 per cent of the average price increase in the United States non-financial sector was attributable to higher profit margins, compared to only 11 per cent in the previous 40 years (Bivens, 2022; Konczal and Lusiani, 2022). High wage costs and non-wage costs (for energy and fuel) cannot fully explain the recent price acceleration in the United States. Procyclical markups have been a major factor. In this context, competition policy and price controls have a critical role to play.

For most developing countries, data on non-wage costs and profit margins are patchy, but two factors suggest dynamics similar to those in the United States may be at play. First, labour shares have been falling overall in developing countries, pointing to a reduction of (real) unit labour costs (chapter III). Second, the factors that drove up profit margins in the pre-pandemic period (*TDR*, 2018) likely reappeared after the first Covid shock of 2020.

**Figure 1.25** Aggregate markup, United States, 1st quarter 2017–2nd quarter of 2021 *(percentage)*




*Source:* UNCTAD secretariat calculations based on OECD data.
*Note:* Data refer to the ratio of corporate profits to gross production value.

# C. OBSCURED BY MONETARY CLOUDS: TOWARDS A MORE SUSTAINABLE AGENDA

In the decade following the GFC, an opportunity was missed to put the world economy on a more stable, sustainable and inclusive growth path. Once the panic had been extinguished, the banking system propped up and growth somewhat restored, advanced country governments immediately began to cut spending, while central banks continued to prime financial markets with continued purchases of assets from private actors (quantitative easing). With this backing, non-bank financial institutions greatly expanded their portfolios (chapter III), while large corporations indulged in share buy backs and acquired rival companies. Yet weak capital formation, wage stagnation and unchecked wealth and income inequality held back a strong and inclusive recovery. Rising levels of indebtedness in developed and developing countries alike and across all sections of the economy kept economies ticking, although financial stress mounted, even before Covid struck.

The recent supply-driven rise in inflation has pushed many governments into a somewhat muddled strategy. The emphasis is on interest-rate hikes, tempered to varying degrees by tax breaks and subsidies and combined with a disjointed mixture of military build-up and cuts to social programs, in the hope that "cooling down" some parts of the economy will restrain wage growth and stop runaway prices. The promise is a soft landing in advanced economies and a return to pre-Covid normalcy (chapter III). In developing countries, fiscal consolidation looks less ambiguous: it will likely be more contractionary in hope of stabilizing financial markets, curbing capital outflows, halting devaluation and boosting investor confidence. All of this, as outlined in this chapter, comes with a good deal of wishful thinking.

While interest rate hikes can fight temporary inflationary pressures and help contain expectations, they also, as noted earlier, add to household and business costs (Deleidi and Levrero, 2020). In this sense, they will cause damage to the productive economy and increase exposure to future supply-side shocks, perpetuating the line of policy action that privileges financial markets over non-financial businesses. This is especially concerning as the current policy mix does not consistently include a strategy to eliminate production bottlenecks, raise investment rates, increase productivity and rebalance budgets in a progressive direction.

In theory, coordinated monetary action by the IMF and leading central banks can help reduce the risk of financial shocks and, if a shock does occur, limit contagion. But if recent history is any guide, the most probable scenario, particularly for developing countries, is one in which policy action is "too little, too late", taken only after crises have erupted and with a strong bias to creditor interests.

The world is facing a systemic crisis and only systemic action can solve it. Focusing solely on a monetary policy approach – without addressing supply-side issues in trade, energy and food markets – to the cost-of-living crisis may indeed exacerbate it. Under current supply-chain challenges and rising uncertainty, where monetary policy alone cannot safely lower inflation, pragmatism will need to replace ideological conformity in guiding the next policy moves.

The challenge is complicated by the legacy of forty years of predominantly neoliberal economic policies in the main economies of the world that have left state capacity and international coordination in poor condition. Fortunately, institutions can adapt fast; a point confirmed by the initial response to the Covid-19 pandemic. With a focus on linking immediate macroeconomic policy challenges to boosting investment in the SDGs and drawing on suggestions made in past Reports, 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 requires a pragmatic mix. First, while subsidies to ease the cost-of-living are important in the short term, price and markup controls are paramount, as they also allow for overdue increases in real wages. This requires a reinforcement of anti-trust measures and a reconsideration of regulation in specific markets (box 1.3). As detailed in chapter III, 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 growth (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 (*TDR*, 2021: box 1.3). This will require not only rethinking the independence of central banks from any development and social goals but also considering, where appropriate, new regional arrangements (chapter VI).

III - Investment 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 around common global objectives. But crowding in private investment will also require taming financial institutions to make sure they serve the broader social good. Industrial policies will also be required to target desired sectors and guide investment, along with better capitalized public banks 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 help 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 - 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 on from the foundational conference in New Hampshire, the international financial architecture is struggling to address the imbalances and inequities of a hyperglobalized world order. A stable multilateral monetary and financial system with 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, combine with stronger price and quantity-based controls and incentives to ensure that complementary private finance flows towards productive transformation.

### Box 1.3 Cereal killers: Cracking down on commodity market speculation

There is a good deal of evidence to suggest speculation is contributing to rising food and energy prices (chapter II). The financialization of commodity markets, linked to the creation of tradable commodity indexes by the big banks, was already visible with the commodity price boom and bust in the first decade of the new millennium. The details of these price movements have been examined in previous Reports; the conclusion was that the growing participation of financial investors in commodity trading for purely financial motives was a contributing factor to price rises (*TDR*, 2011: chap V). Today, there is strong evidence that the disconnect between financial speculation and commercial hedging is one important factor driving up energy, food and commodity prices.

While a balance between speculators and commercial hedgers is necessary for price discovery and sustained liquidity in regulated financial markets (ideally, this ratio is around 3 to 7), the participation of large financial institutions – investment banks, pension funds, sovereign wealth funds etc. – in commodity price bets has come to outstrip the role of commercial hedgers. Before 2002, the average composition of non-commercial speculators in the United States oil futures market was 20 per cent; in 2009, it rose to approximately 50 per cent. More recent estimates put it between 70 per cent and 80 per cent (Greenberger, 2018a). All the major oil companies, leading United States banks and private energy trading houses led by Vitol, Trafigura, Mercuria and Glencore are involved in speculative energy trading (Juhasz, 2022). The effect of the excessive speculation is overwhelming volatility in oil prices, often driving the price of a barrel of crude oil $25 to $30 above what market fundamentals dictate (Juhasz, 2022). Likewise, speculative activity by hedge funds, investment banks and pension funds has driven up wheat prices (box 2.3; Kornher et al., 2022). The resulting super profits enjoyed by these firms stand in sharp contrast to the economic hardship experienced by households in developed and developing countries alike, as the price of these basic necessities has spiked.

Without undermining the positive role financial instruments can play in boosting liquidity and reducing hedging costs in these markets, UNCTAD (*TDR*, 2011) proposed a series of market-level reforms that could help reduce the distortions and volatility such instruments can introduce.

These included:

- Greater transparency in physical markets through the provision of more timely and accurate information about commodities, such as spare capacity and global stock holdings for oil, and for agricultural commodities, such as areas under plantation, expected harvests, stocks and short-term demand forecast.
- A better flow of, and access to, information in commodity derivatives markets, especially with respect to position-taking by different categories of market participants.
- Tighter regulation of financial market participants, such as setting position limits, to reduce financial investors' impacts on commodity markets; for example, proprietary trading by financial institutions involved in hedging transactions of their clients could be prohibited because of conflicts of interest.
- Market surveillance authorities could be mandated to intervene directly in exchange trading on an occasional basis by buying or selling derivatives contracts with a view to averting price collapses or deflating price bubbles.

Progress on these fronts has been slow or has not advanced at all, leaving gaps and loopholes in the regulatory system (Greenberger, 2018b) and limiting the space for policymakers to reduce the incidence of commodity price volatility (Larsen, 2022). In the meantime, financial innovation and arbitrage strategies, especially those deployed in over-the-counter (OTC) deals with financial swap contracts, have made the conceptual distinction between commercial hedging and financial speculation more challenging (Chadwick, 2017).

In light of recent developments, revisiting earlier proposals and considering more radical regulatory steps would be timely. Even within the existing legislation, the Commodities Futures Trading Commission (CFTC) can discourage speculators by tightening position limits in energy futures markets to discourage speculative, market momentum-based speculators, for example, limiting the number of shares or derivative contracts that a trader or any affiliated group of traders and investors may own.

On top of introducing position limits, the CFTC should increase margin requirements, forcing a trader to hold larger capital reserves for a given number of positions, making it much more expensive to corner the market and gain from speculation. There also needs to be better oversight and control of clearing platforms, with a possibility of disallowing those types of transaction that point to excessive speculation.

An outright ban on commodity index funds and compulsory premarket government licensing of complex financial instruments (Chadwick, 2017) can be part of a strong regulatory toolset as well. These could shift the burden of proof concerning the social utility and risks posed by a given financial instrument onto those seeking to profit by its trade.

As previous experience shows, to be effective, these proposals need to be implemented systemically, in line with other institutional measures aimed to protect the most vulnerable parts of the world population from the crises driven by financial speculation, corporate arbitrage and market manipulation.

# D. REGIONAL TRENDS

### 1. The Americas

The United States economy is decelerating. Growth will fall from 5.7 per cent in 2021 to 1.9 per cent in 2022, and then continue to slide, reaching 0.9 per cent in 2023. This deceleration is driven by three forces. First, the increase in real interest rates to reduce inflation is already slowing demand down, especially residential investment and consumer demand. Second, the phasing out of the American Rescue Plan's fiscal stimulus adds a negative impulse to United States demand. Third, the adjustment of asset prices to higher interest rates has imposed huge capital losses to United States firms and families, reducing private demand temporarily. Most of the growth deceleration will happen between mid-2022 and mid-2023, with a marginal recovery in late 2023.

Canada is expected to follow the United States fluctuation, but with a lower volatility because interest-rate-induced capital losses have a relatively lower effect on the Canadian economy.

Recessionary dynamics are also at play in Mexico for 2022–2023. Growth in 2022 is expected to reach 1.8 per cent, even though the recovery in 2021 was only half-way back, after the sharp recession of 2021. Part of the slowdown is due to economic policy, as the Mexican government refrained from adopting a large fiscal stimulus after the pandemic. For 2023, because of its close ties to the United States business and monetary cycle, Mexican GDP is expected to decelerate further, to a 1.4 per cent growth rate.

Similarly, after a brief recovery in 2021, the Brazilian economy is now at risk of an abrupt deceleration, reaching 1.8 per cent growth in 2022. Regardless of 2022 election results, there will probably be a negative fiscal impulse in 2023, which together with the lagged effects of monetary tightening, is expected to reduce GDP growth to just 0.6 per cent in 2023.

Argentina is also on the way to a growth recession. Even if the momentum from 2021 contributes to yield a robust 4.1 per cent growth in 2022, a sharp deceleration starting in the second half of the year will bring about an economic contraction of about 0.8 in 2023. In addition to the global headwinds created by higher international real interest rates, Argentina's turn-around reflects the recessionary impact of exchange-rate depreciation. The economy is at risk of entering a trap of high inflation and sharp falls in real income.

Chile and Colombia have comparatively more diversified economic structures. Their respective governments aim to shift economic policy towards social inclusion and employment generation, but the global monetary tightening and the balance of payments constraints on Latin American economies reduce their fiscal space.

Other economies of South America and of Central America and the Caribbean will, with some differences among them, follow the trend of the larger economies, with moderate growth this year and a deceleration in 2023.

### 2. European Union

France experienced two quarters of relatively strong growth, especially in agriculture and industrial sectors, but it is expected to slow down the second half of 2022, affected by the slowdown in global demand, the increase in interest rates that is already being felt on residential investment and the rising cost of energy. France is one of a few countries in the region whose electricity production relies more than 90 per cent on renewable sources and nuclear power; yet the increases in fuel prices have taken a visible toll on private demand for goods and services. France is projected to grow 2 per cent in 2022 and 1 per cent in 2023.

Germany relies more heavily on fossil fuels for electricity production, with 24 per cent of electricity deriving from coal and 18 from gas, for a total of approximately 44 per cent of electricity from fossil fuels. The energy crisis and possible rationing of gas are expected to take a toll on manufacturing activity, employment creation and, through rising costs, on households' real spending. Meanwhile, Germany's export sector, a long-time driver of growth, is expected to suffer from the slowdown of global demand in an environment of rising interest rates. The main drivers of Germany's growth in 2022 have been external demand and fiscal policy, while the private sector has been dramatically reducing its claims on real output. In 2022, growth is projected to reach 1.1 per cent. In 2023, with the fiscal stimulus thinning down, the economy is projected not to grow.

The Italian economy experienced a growth rebound in the second quarter of 2022 after a flat first quarter, mostly because of an increase in demand for services after the last Covid-related restrictions were lifted in March and the strong activity in construction, buoyed by state subsidies. Industrial production remains a positive factor but is expected to slow due to rising energy and component costs, as well as subdued global demand. The net external position has turned negative because of the price of energy imports. Overall, we expect Italy to grow 2.5 per cent in 2022 and 0.5 per cent in 2023.

Overall, the European Union is expected to slow down because of higher energy costs and subdued global demand, with Germany and Italy particularly exposed. Inflation has been highest in Germany and Spain, where incomes are still below pre-pandemic levels (-0.2 per cent from the last quarter of 2019 in Germany, -2.5 per cent in Spain). Various measures have been taken at the national level by member countries to cushion the impact of the rising cost of living, in some cases funded by windfall taxes on energy companies. While the disbursement of the Recovery and Resilience Facility fund continues, with €100 billion in loans and grants disbursed out of €723.8 billion, no European Union-wide provision to face the energy crisis has been announced.

### 3. The Russian Federation, Belarus, Ukraine

The strong rebound of the Russian economy in 2021 was short-lived. The full impact of the sanctions imposed on the country following its invasion of Ukraine in February 2022 is yet to become clear. While the effect of financial sanctions has already been registered, the impact of trade restrictions is expected to become more acute in late 2022, after companies exhaust the stocks of their imported inventories. The embargo on Russian oil imposed by the European Union which puts federal budget revenues under pressure is due to come into effect in late 2022.

Reflecting this uncertainty, estimates of the depth and duration of the Russian Federation recession in 2022–2023 vary. But despite continued state support of selected industries, redirection of exports away from Europe and other traditional markets, a decline of GDP in the order of 7 per cent is expected in 2022. More pessimistic readings, based on the absence of growth stimuli in an economy heavily dependent on imports in key sectors and where pre-war growth has been driven by consumer demand, see the recession continuing into 2023. UNCTAD expects that after the sharp contraction of 2022, the Russian economy may post a weak growth rate of 1.3 per cent in 2023.

The GDP of Belarus is expected to drop by about 4 per cent in 2022, as a consequence of the loss of export revenues due to sanctions and a breakdown in logistical chains. While reliance on Russian imports has helped to limit the effect of the crisis to individual sectors, IT and the external sector have weakened in 2022. In 2023, the Belarussian economy is likely to show a growth rate of no more than 1 per cent.

Ukraine, in addition to humanitarian losses, faces an estimated cost of $10 billion per month for the war, approximately half of which is covered by external finance. Estimates of the ultimate economic costs of the war vary. While it is impossible to offer definitive estimates at a time of ongoing conflict, it is apparent that the resilience of the economy is waning.

### 4. The United Kingdom

The economy of the United Kingdom grew rapidly in 2021, by 7.4 per cent, but still not compensating for the contraction of 9.3 per cent with the Covid-19 shock. While the growth momentum continued into the first quarter of 2022 (with an annualized growth rate of 3 per cent), a series of headwinds, some resulting from Brexit and others from international conditions, are impacting the outlook. Gross fixed capital formation, virtually stagnant in real terms since 2017, remains subdued. External adversities stemming from sluggish global demand, exchange rate instability and yet unresolved Brexit shortcomings are contributing to current account challenges. The stimuli from government spending in response to the Covid shock started to weaken mid-2021, and all indications suggest fiscal tightening will become the norm. At the same time, consumer demand is weakening due to the cost-of-living crisis. Given these conditions, while the economy will exhibit an annual growth of 2.6 per cent in 2022 (on the heels of the inherited growth momentum), it is likely going to contract by 0.9 per cent in 2023.

### 5. East Asia

The East Asian region registered a strong recovery in 2021, but UNCTAD estimates a moderation in the growth rate in 2022. Our baseline scenario envisages an expansion of 3.2 per cent this year, compared to 6.5 per cent growth in 2021. A confluence of factors – including a significant increase in the prices of the region's imported commodities, as well as a softening in global demand for the region's exports and a tightening in international monetary conditions – is weighing on growth throughout the countries in East Asia. For 2023, we expect growth to pick up moderately to 4.3 per cent.

UNCTAD expects a significant deceleration in economic activity in China in 2022, from 8.1 per cent in 2021 to 3.9 per cent, mainly because of the protracted lockdowns. Continued uncertainty weighs on consumer spending, despite a loosening of credit conditions by the authorities. The property sector

is locked in an evolving financial crisis. While certain export industries have performed strongly (most notably the semiconductor industry), others are seeing slowing external sales as international demand weakens amidst growing inflationary pressures and monetary tightening.

State support has largely concentrated on the supply side of the Chinese economy. The government has relied on boosting infrastructure investment and providing support to businesses, along with some deregulation in the financial and real estate sectors. Monetary policy stimulus has been limited despite subdued domestic inflation. The authorities have reduced the 5-year loan prime rate for mortgage lending and directed banks to increase lending. While these sets of policy measures will help to buttress growth, they are not of the same scale as the stimulus measures applied in the last two years. We expect growth in 2023 to yield 5.3 per cent, falling slightly short of the authorities' annual target of 5.5 per cent.

In Japan, growth of GDP in 2021 was 1.7 per cent, after a negative 4.5 per cent in 2020. It is estimated that a relatively strong positive rate for the second quarter of 2022 will be followed by positive but faltering growth in the next quarters, leading to an annual growth of 1.0 per cent in 2022. The economy, which continues to rely on the growth of exports, is affected by the deceleration of growth in China and a more generalized slowdown of global trade and high prices for imported commodities. These factors together suggest Japan's GDP growth will reach 1.8 per cent in 2023, allowing the level of economic activity to surpass that of the peak of 2019 only towards the end of 2023.

In the Republic of Korea, growth is expected to slow following the robust bounce-back observed in 2021, at 4.0 per cent, when a dynamic export sector and continued fiscal and monetary support measures helped to propel economic activity. For 2022, we estimate a less dynamic expansion of 2.2 per cent. High household debt and increasing inflation are dampening consumption spending. With inflation mostly imported, the impact of monetary tightening on prices will likely be very limited. We expect growth to decelerate further in 2023 to 2.0 per cent, as weakening external demand impacts the export sector; in addition, more restrictive fiscal and monetary policies are expected to inhibit consumption and investment spending.

### 6. South-East Asia

South-East Asia registered a relatively anaemic growth of 3.8 per cent in 2021, far below the rate of expansion observed in recent years. For 2022, the economic performance of the region has so far been stronger, albeit uneven. UNCTAD estimates the region will grow by 4.1 per cent in 2022, yet growing inflationary pressures and a subsequent tightening of domestic monetary stances, along with more costly international financing conditions, will dampen activity. For 2023, we expect the region's growth rate to decelerate to 3.8 per cent in the context of sluggish growth of global trade and the expected effects of tightened domestic monetary policy, as the region's vulnerability to financial and exchange rate instability weighs on policymakers' minds.

UNCTAD expects the Indonesian economy to grow 4.3 per cent in 2022, after having registered a relatively weak recovery in 2021. The stronger growth performance in 2022 is largely a result of the lifting of Covid restrictions, favourable conditions for the export sector and the accommodative stance of the Central Bank. Yet the pronounced increase in domestic food and energy prices was met by the introduction of a temporary ban on the export of palm oil and increases in energy subsidies. For 2023, UNCTAD estimates 4.4 per cent growth, as the positive impact of continued high prices for Indonesia's commodity exports will be somewhat tempered by a more restrictive monetary stance, dampening the growth in activity.

In Malaysia, UNCTAD expects economic activity to pick up from 3.1 per cent in 2021 to 5.4 per cent this year. This is partly thanks to the use of increased fiscal revenues – from the country's commodity exports to cushion imported inflation and export bans on certain agricultural products. Tempering this broadly positive outlook is the country's vulnerability to tightening international financial conditions,

due to its relatively high levels of external debt. As a result, we expect growth to slow to 3.5 per cent in 2023, as more costly international financing conditions will only be partially offset by the continued favourable terms of trade for the country's commodity exports.

In Thailand, despite the expected expansion of 3.0 per cent in 2022, the recovery has been subdued. The over-reliance of the economy on the tourism sector continues to weigh on activity: the shortfall in tourism-related services exports, together with the increased cost of energy imports, has led to a deterioration in the current account balance precisely as external financing conditions become more costly. On the domestic front, increased inflationary pressures have proven detrimental to households' purchasing power and have only been partially countered by government subsidies. For 2023, we expect growth of 4.0 per cent largely thanks to tourism flows beginning to recover to their pre-pandemic levels.

UNCTAD expects a strong 6 per cent GDP growth in Viet Nam in 2022. The dynamism of manufacturing exports and services will drive the expansion, as international companies continue to start productive operations in the country. Although weakness in private consumption will temper growth, and energy and food prices will be high, we expect growth to remain robust in 2023, at about 6.5 per cent.

### 7. Western Asia

The Western Asian region will register a relatively strong growth rate of 4.1 per cent in 2022, substantially above pre-pandemic rates. Revenues from energy exports have been further boosted by significant increases in oil production volumes in line with the OPEC+ agreement's gradual relaxing of output restrictions. However, the higher import bill for both fuel and food products is putting a significant strain on the region's economies, and the situation is aggravated by the tightening of international financing conditions. Meanwhile, in the region's commodity-exporting countries, higher fiscal revenues from energy exports have endowed states with greater resources to provide relief to households from increased consumer prices, but in the region's commodity-importing countries, households are being squeezed, particularly by food prices, with very limited state support. We expect the region's growth to moderate in 2023 to 2.9 per cent, as a slowdown in international demand and increasingly tight monetary stances will temper the expansion in economic activity.

In Saudi Arabia, UNCTAD estimates growth of 6.6 per cent in 2022. The strong performance will be driven by the oil sector in line with the output increases contained in the OPEC+ agreement. For 2023, we expect growth to moderate but to remain robust at 3.9 per cent. Increased fiscal revenues from oil export earnings will continue to help finance the government's ambitious public investment plans, particularly for large-scale infrastructure projects. Continued tightening of monetary policy in 2023 to respond to United States policy will prove a drag on growth.

Türkiye, having registered an extraordinary growth of 11.0 per cent in 2021, is expected to decelerate abruptly in 2022 to 2.4 per cent. Weakening global demand and higher prices for imported commodities will cause a deterioration in the current account deficit; meanwhile, inflation topped 70 per cent by mid-2022, and this will dampen consumption growth. The sharp depreciation of the lira has added further upward pressure on prices and increased the costs of servicing the country's considerable foreign-currency denominated debt. For 2023, we expect growth to remain constant at 2.4 per cent, as a further softening of external demand, along with elevated prices for imported oil and gas, will continue to complicate growth prospects.

### 8. Central Asia

In the Central Asian region, UNCTAD expects growth of 3.6 per cent in 2022, as external demand will tend to weaken, but the rebuilding of European fossil energy stocks and elevated international oil prices will continue to benefit the region's energy exporters. A growth rate of 3.5 per cent is expected

for 2023, as fiscal support becomes more uncertain in a tight monetary environment and external demand weakens.

In Kazakhstan, growth returned and reached 4.0 per cent in 2021. Fossil energy exports contributed to narrowing the current account deficit, yet drought and higher global energy prices boosted inflation Although inflation and continued monetary tightening will weigh negatively on economic activity, high energy exports and revenues are expected to bring GDP growth up to 2.7 per cent in 2022. In 2023, GDP growth is projected at 3.5 per cent.

### 9. South Asia

UNCTAD expects the South Asia region to expand at a pace of 4.9 per cent in 2022, as inflation increases on the back of high energy prices, exacerbating balance of payment constraints and forcing several governments (Bangladesh, Sri Lanka,) to restrict energy consumption. Moreover, the limited and delayed progress in relaxing vaccine-related intellectual property (IP) rights continues to leave the region vulnerable to future outbreaks. For 2023, UNCTAD expects the region's growth rate to decelerate slightly to 4.1 per cent.

India experienced an expansion of 8.2 per cent in 2021, the strongest among G20 countries. As supply chain disruptions eased, rising domestic demand turned the current account surplus into a deficit, and growth decelerated. The Production-Linked Incentive Scheme introduced by the government is incentivizing corporate investment, but rising import bills for fossil energy are deepening the trade deficit and eroding the import coverage capacity of foreign exchange reserves. As economic activity is hampered by higher financing cost and weaker public expenditures, GDP growth is projected to decelerate to 5.7 per cent in 2022. Going forward, the government has announced plans to increase capital expenditure, especially in the rail and road sector, but in a weakening global economy, policymakers will be under pressure to reduce fiscal imbalances, and this may lead to falling expenditures elsewhere. Under these conditions, the economy is expected to decelerate to 4.7 per cent growth in 2023.

### 10. Oceania

In Oceania, UNCTAD expects growth of 3.6 per cent in 2022, followed by 2.1 per cent in 2023. The region's performance is determined to a large degree by that of its largest economy, Australia, which accounts for over 80 per cent of the region's GDP. After rebounding 4.8 per cent in 2021, partly on the back of recovering external demand, the Australian economy further benefitted from spiking commodity prices in the first half of 2022. Like in many developed countries, the labour market appears tight, but inequality is high, and poverty is on the rise. In 2022, Australia is expected to grow by 3.9 per cent. Yet as longer-term challenges and new headwinds jointly erode domestic demand, and external demand slows, growth will moderate to 2.3 per cent in 2023.

### 11. Africa

Africa's economic activity is expected to expand by a moderate 2.7 per cent in 2022, following a rebound of 5.1 per cent in 2021. This reflects several new challenges, including high international food and fuel prices, financial shocks owing to the stronger-than-anticipated tightening of monetary policy in advanced economies and acute risks of food insecurity in many parts of the region. As a result, an additional 58 million non-poor Africans will fall into extreme poverty in 2022, adding to the 55 million Africans already been pushed into extreme poverty because of the pandemic (UNECA, 2022). In the context of a severe weakening of European and other trade partners, growth on the continent will continue decelerating, down to 2.4 per cent in 2023.

In Nigeria, the economy grew 3.1 per cent, year on year, in the first quarter of 2022, compared with 4.0 per cent in the fourth quarter of 2021. This marks the sixth consecutive quarter of economic

expansion, partly on the back of oil export revenues absorbed by the non-oil sector, including services and agriculture. In 2022, Nigeria's economy is expected to grow 2.9 per cent, as result of weak oil output caused by technical and security hurdles in a context of underinvestment.

In Egypt, domestic economic activity continued to expand relatively quickly in early 2022, driven by activity in tourism, non-petroleum manufacturing and trade. Yet the country made a request to the IMF for a new program in March 2022 when it came under new financial pressure. For the rest of the year, economic activity is expected to soften owing to the negative spillover of the war in Ukraine, leading to an annual growth forecast of 4.0 per cent.

In South Africa, growth in the first quarter of 2022 surprised on the upside, although a severe slowdown is expected in the second quarter, with flooding in the southeast of the country. While private investment has strengthened on the back of the recovery, public sector investment remains weak. Household spending has continued to expand but is likely to soften in the second half of the year, with higher inflation, lower asset prices and rising interest rates. Meanwhile, tourism, hospitality and construction should see stronger recovery as the year progresses. Other headwinds include subdued investment and business sentiment, elevated prices for food and key imported inputs, high indebtedness of the middle class and increased volatility of capital flows, which compound longer-term challenges, such as the high unemployment and inequality. As a consequence, the economy will show weak growth rates of 1.4 and 1.3 per cent in 2022 and 2023, respectively.

Ghana and Tunisia are in talks with the IMF for emergency loans. In late May 2022, the IMF and World Bank considered 16 low-income African countries to be at high risk of debt distress, while 7 countries – Chad, Republic of the Congo, Mozambique, São Tomé and Príncipe, Somalia, Sudan and Zimbabwe – were already in debt distress. Bright spots, such as Côte d'Ivoire and Rwanda, are expected to exhibit rapid growth in 2022. However, 33 African countries need external assistance for food, and acute food insecurity is likely to worsen in the next months in 18 of these economies.

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# Chapter II

## Trends in International Markets

# A. INTRODUCTION

The extent to which the global economy is fragmenting and the consequences for its growth and stability are pressing questions for policymakers everywhere – and there are no clear answers. A discernible trend is the emergence of a rigid and fragile global economy after the global financial crisis (GFC). If this trend continues and becomes reinforcing, the damaging consequences for developing countries are likely to be significant.

The vulnerability of developing countries stems from the way the key international markets on which many depend have become both more concentrated and more volatile. This, as discussed in previous United Nations Conference on Trade and Development (UNCTAD) reports, is particularly true of financial markets, but the way innovative financial instruments, in the form of futures and options contracts, swaps, derivative instruments and so on, have allowed a handful of market speculators to influence the price of key commodities, such as food and energy, is clearly apparent in the current context. The vulnerability of developing countries is exacerbated by the lack of global safety nets to cushion the blow and repair the damage from unexpected shocks, such as the Covid-19 pandemic, and by the lack of policy coordination to ensure their vulnerabilities are taken into account when systemically important countries are pursuing their own policy agendas.

Given the unfavourable direction of the global economy outlined in the previous chapter, an immediate concern is the dangerous level of debt distress facing a growing number of developing countries. This is discussed in the next section. Section C explains how the breakdown of supply chains is raising wider concerns about the strength and direction of trade flows, whilst section D turns to the financialization of commodity markets.

# B. GLOBAL FINANCIAL CONDITIONS AND DEVELOPING COUNTRY VULNERABILITIES

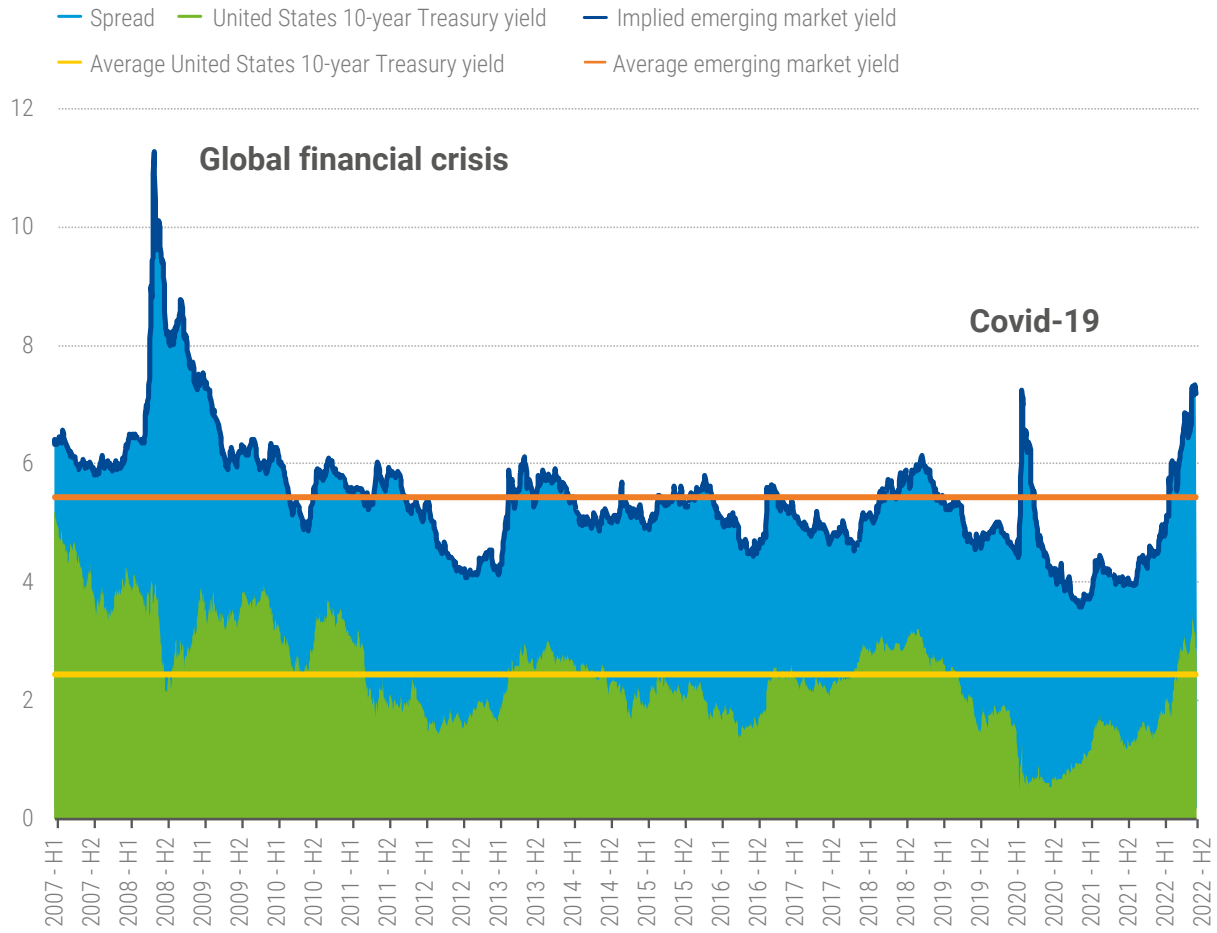
Over the decade and a half since the global financial crisis, many developing countries have seen their external financial positions deteriorate, first gradually and particularly since the Covid-19 shock more precipitously. As of mid-2022, the IMF assessed 55 per cent of Poverty Reduction and Growth (PRGT)-eligible countries[7] to be at high risk of or already in debt distress – compared to fewer than 30 per cent in 2015. Overall, the IMF has warned that around 6 out of 10 low-income countries and 3 out of 10 emerging market economies are at or near debt distress.

Three immediate factors have been critical in pushing these countries further towards the financial precipice. First and foremost, after many perfunctory announcements over the past ten years, United States monetary policy has now embarked on a decisive tightening cycle that has seen the United States 10-year Treasury yield increase almost six-fold between mid-2020 and mid-2022 (figure 2.1). Given the continued dominance of the United States dollar in the world economy, this, as discussed earlier, threatens to reverse the global economic recovery, not least through balance-of-payment crises in the developing world prompted by United States dollar appreciations against their currencies and, therefore, also an increase in the dollar-denominated values of their external debt obligations and higher borrowing costs.

[7] The 69 countries eligible to apply to the IMF Poverty Reduction Trust Fund (PRGT) include 25 low-income, 35 lower-middle income and 9 upper middle-income countries, based on World Bank income classifications. According to the IMF Debt Sustainability Framework, 30 of these 69 countries were deemed to be at high risk of debt distress and eight in debt distress, as of 31 May 2022.

Second, price hikes in some commodity markets add 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 as to the extent to which continuation of the war in Ukraine will affect commodity prices in the future. Third, the Covid-19 pandemic lingers on in many countries. This includes high debt burdens left by the pandemic in developing countries that remain unresolved.

**Figure 2.1** Emerging market yield decomposition, 2007–2022 *(percentage points)*




*Source:* UNCTAD secretariat calculations based on ICE Bank of America (BofA) Emerging Markets External Sovereign Index.
*Note:* The implied yield for external sovereign emerging market bonds equals the sum of the United States 10-year Treasury yield and the spread as measured by the ICE BofA. The average spread (of around 3 percentage points throughout the period) is measured by the difference between the two average yield lines.

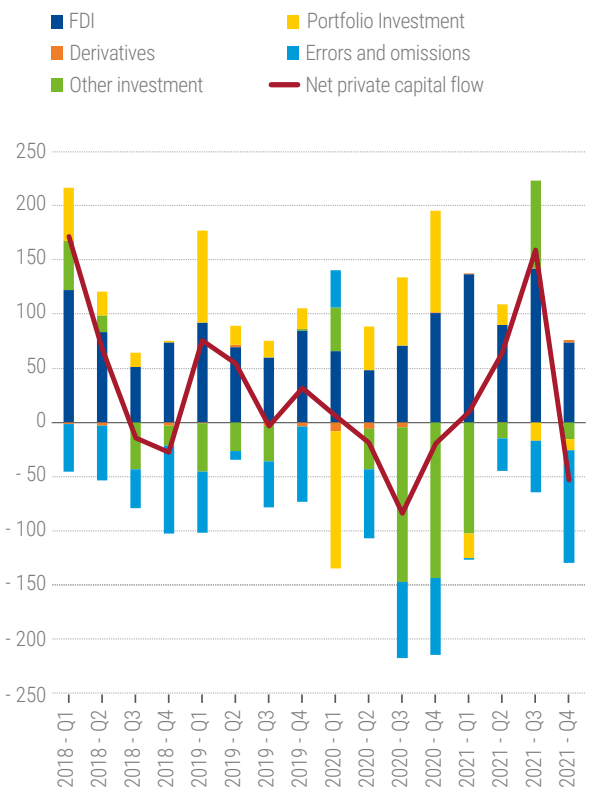
## 1. Net capital flows to developing countries: mounting headwinds

The combination of these factors has resulted in renewed net negative capital flows from developing countries since September 2021, bringing to a halt the rebound of net capital flows to developing countries observed since the last quarter of 2020 (figure 2.2.A).[8]

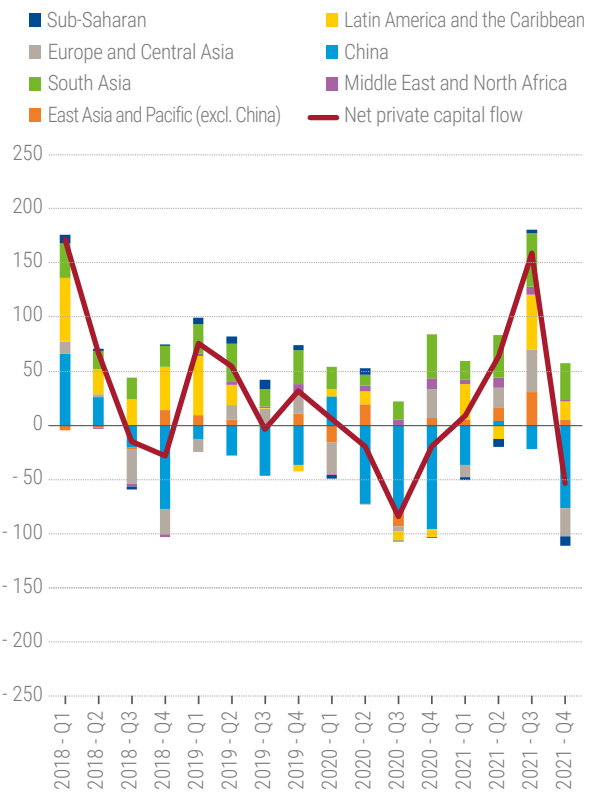
[8] Net capital flows refer to net non-resident inflows minus net resident outflows, including both private and official flows.

**Figure 2.2** Net capital flows to developing countries, 2018–2021 *(billions of dollars)*

**A. By type of capital flows**




**B. By country or country group**




*Source:* UNCTAD secretariat calculations based on national data.
*Note:* Developing countries are low- and middle-income countries according to the World Bank income group classification. By region, the following countries are included: East Asia and Pacific (excl. China): Cambodia, Fiji, Indonesia, the Lao People's Democratic Republic, Malaysia, Mongolia, the Philippines, Samoa, Thailand, Timor-Leste, Tonga, Vanuatu, Viet Nam. Europe and Central Asia: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Georgia, Kazakhstan, Kyrgyztan, Republic of Moldova, North Macedonia, Russian Federation, Serbia, Tajikistan, Republic of Türkiye, Ukraine, Uzbekistan. Latin America and the Caribbean: Argentina, Belize, Plurinational State of Bolivia, Brazil, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Suriname. Middle East and Northern Africa: Egypt, Iraq, Jordan, Morocco, State of Palestine. South Asia: Afghanistan, Bangladesh, Bhutan, India, Nepal, Pakistan, Sri Lanka. Sub-Saharan Africa: Angola, Cabo Verde, Eswatini, the Gambia, Guinea, Lesotho, Madagascar, Mauritius, Mozambique, Namibia, Nigeria, Rwanda, São Tomé and Príncipe, South Africa, United Republic of Tanzania, Zambia.

This initial rebound was driven by a confluence of developments. Increases in net inflows of foreign direct investment (FDI) to developing countries in the last quarter of 2020, and again in the first and third quarters of 2021, were a main feature of this recovery phase (*TDR*, 2021). By contrast, net portfolio investment that had led the deterioration of net capital flows in the early phase of the pandemic, remained subdued and volatile throughout 2021, after initial rebounds in the last three quarters of 2020 when global investors in search for yield triggered record net flows of $93 billion in the final quarter of 2020 alone (*TDR*, 2021). This pattern is driven mainly by non-resident portfolio flows to developing countries. However, portfolio diversification by residents in emerging-market economies has become an increasingly important component of net portfolio flow dynamics (JP Morgan, 2022). Finally, net official flows, recorded under "other investment"[9] played a significant role in the resurgence of capital

[9] Other investments include currency and deposits, trade credits and advances, private and official loans (including IMF loans and SDRs), guarantee schemes and other equities.

flows to developing countries in this period. Thus, the August 2021 allocation of special drawing rights (SDRs) as well as emergency lending by the IMF and the World Bank were the main driver behind this category's positive contribution in the third quarter of 2021.

However, with the deterioration of global financial conditions from September 2021, net capital flows to developing countries turned negative again in the last quarter of 2021, reaching $52.3 billion or around 60 per cent of the highest net negative flows in the period of observation at the peak of the Covid-19 pandemic (third quarter of 2020). The first quarter of 2022 saw a slight recovery from this trend, with FDI inflows largely compensating for near record portfolio outflows of $108.8 billion due to the sell-off of developing countries' bonds and equities, in part triggered by the war in Ukraine. This flight of portfolio capital was surpassed only in the first quarter of 2020 amidst the onset of the Covid-19 pandemic.

Both the initial rebound of capital flows to developing countries as well as the recent negative capital flow shock have affected developing country regions unevenly (figure 2.2.B). As previous reports have stressed, this reflects not only the dynamics of net foreign liabilities, but also the build-up of foreign assets by residents of large emerging market economies, led by China (*TDR*, 2019; 2021). Chinese "other investment" outflows (linked to overseas deposits, bank loans abroad and trade credit and advances) accounted for the bulk of "other investment" outflows from developing countries in the last quarter of 2020 and the first quarter of 2021.

From end-2020, when the Covid-19 crisis was seen by some to gradually come under control, through to the first quarter of 2022, South Asia was the recipient of the largest cumulative net capital inflows, equivalent to $179 billion and led by large inflows of other investments. East Asia and the Pacific (excluding China) recorded net inflows of $70.3 billion, linked mainly to high FDI inflows during this period. Net inflows to the Middle East and North Africa were smaller, amounting to $36.2 billion, mainly as a result of inflows in other investment.

The remaining regions witnessed more volatile net capital flows over this period, marked by differing patterns. These were positive in Latin America and the Caribbean, a region that benefited from net positive capital inflows of $121.5 billion since late 2020, with the bulk of these received since the third quarter of 2021. Thus, in the first quarter of 2022 alone, FDI to this region more than compensated for net portfolio outflows, resulting in net capital inflows of $40.7 billion. These amounted to only $9.9 billion in East Asia and the Pacific in the first three months of 2022, hovered around zero in other regions, and were strongly negative for China mainly due to portfolio outflows. Sub-Saharan Africa was the only region experiencing net capital outflows throughout the period from end-2020 and into 2022, totaling $10.9 billion, due to portfolio and other investment outflows overshadowing official and FDI inflows. This is especially concerning given the high degree of external vulnerabilities of the region.

The overall outlook for developing countries remains subdued for now. According to the most recent data available for (selected) developing countries, the flight-to-quality from developing economies continued unabated during the second quarter of 2022, reaching levels comparable to those following the onset of Covid-19 pandemic by end-June (IMF, 2022b; Wheatley, 2022). This is also borne out in the data on emerging market sovereign bond spreads. As figure 2.1 shows, these spreads – an important indicator of sovereign financial risk and distress – have risen sharply between September 2021 and July 2022, following the United States Federal Reserve'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 global financial crisis and at the height of the Covid-19 pandemic, when 10-year United States Treasury bond yields actually fell, the current episode is clearly driven by emerging market bond spreads moving in tandem with the 10-year United States Treasury yield curve – a clear indicator of the central role played by the tightening monetary policy cycle in the United States in mid-2022.

Worst hit by these deteriorating financial conditions are primarily frontier economies that already suffered from severe balance of payment constraints and high external vulnerabilities from well before

the onset of the Covid-19 pandemic. 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, Türkiye, Pakistan, Uganda and Zambia). By contrast, for emerging market economies with larger and more liquid markets and with investment grade ratings, sovereign bond spreads have been relatively contained (Curran, 2022). This now seems to be changing to an extent, with external sovereign bonds of other larger emerging economies, such as Brazil and Colombia, seeing their bond spreads on the increase, if not yet in distressed territory (table 2.1). Given growing expectations of a United States (European Union) recession in 2023, the most likely scenario will be one comparable to earlier crisis points, in which further rising sovereign bond spreads with falling yields on 10-year United States Treasury bills.

But this only captures debt and financial distress in those developing countries that issue foreign currency-denominated sovereign bonds above minimum thresholds required for inclusion in relevant indices. Other assessment criteria include the IMF debt sustainability reports for countries eligible to apply to its Poverty Reduction and Growth Fund and, of course, countries already in default or undergoing sovereign debt restructurings as of July 2022. Table 2.1 provides a summary overview of countries meeting one or several of these criteria, at the time of writing.

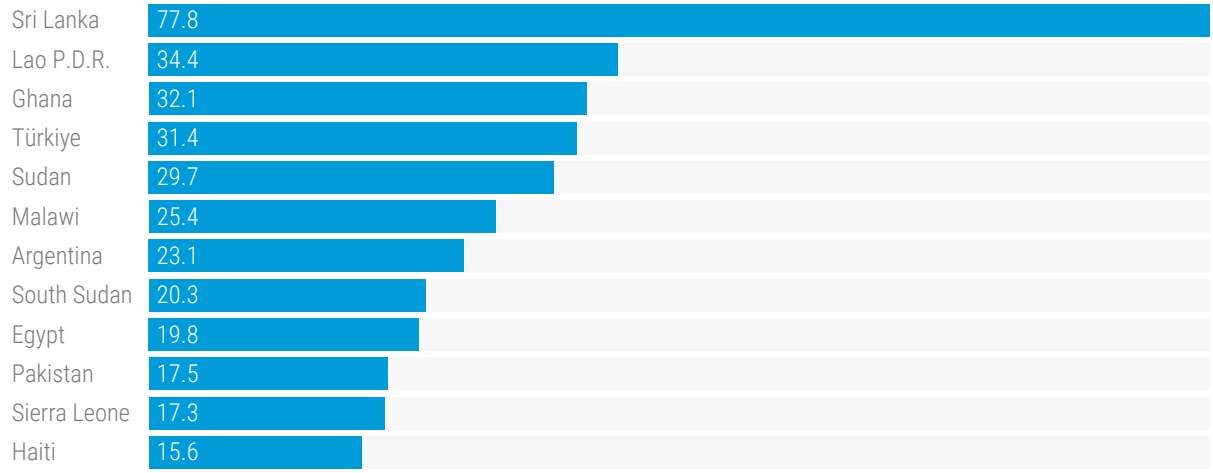
Predictably, these developments have also resulted in widespread currency depreciations across developing countries in the first half of 2022 (figure 2.3). In addition to widening spreads of developing countries' external sovereign bonds, domestic currency depreciations further increase the servicing costs of debt denominated in foreign exchange. In all, 90 developing countries recorded nominal depreciations of their currencies against the dollar, of which 34 exceed 10 per cent. Countries with major depreciations are either net food importers and/or those with long-standing high external vulnerabilities. Those with only small depreciations are net commodity exporters or countries that have embarked on a monetary tightening cycle ahead of advanced economies (box 2.1), since the increased interest rate differential created carry-trade opportunities.

**Table 2.1** Developing countries considered in or close to debt distress, mid-2022

| | In default as of 30 June 2022 | Undergoing sovereign debt restructuring as of 30 June 2022 | Bond yields close to or above 10 percentage pointsrelative to 10-year United States Treasury bills as of 30 June 2022 | IMF debt sustainability assessments (in debt distress or at high risk of debt distress) for PRGT-eligible countries as of 31 May 2022 |
|---|---|---|---|---|
| **Low-income countries (LICs)** | Zambia | Chad, Ethiopia, Mozambique | Uganda, Zambia | Afghanistan, Burundi, Central African Republic, Chad, Republic of Congo, Ethiopia, The Gambia, Guinea-Bissau, Malawi, Mozambique, Sierra Leone, Somalia, South Sudan, Sudan |
| **Lower middle-income countries (LMICs)** | Lebanon, Sri Lanka | | Egypt, Pakistan | Cameroon, Cabo Verde, Comoros, Djibouti, Ghana, Haiti, Kenya, Kiribati, Lao P.D.R, Mauritania, Micronesia, Papua New Guinea, Samoa, São Tomé and Príncipe, Tajikistan, Zambia, Zimbabwe |
| **Upper middle-income countries (UMICs)** | Suriname | | | Dominica, Grenada, Maldives, Marshall Islands, St. Vincent and the Grenadines, Tonga, Tuvalu |
| **Not classified** | Venezuela (Bolivarian Republic of) | | | |

*Source:* UNCTAD secretariat calculations based on IMF Debt Sustainability Framework (as of 31 May 2022), Refinitiv and World Bank income classification 2022–2023.
*Notes:* As of 30 June 2022, Brazilian sovereign bond (10-year maturity to keep comparison with 10-year United States Treasury bills) saw a spread of 9.9 per cent and Colombian bonds of 8.4 per cent (both up from previous year-on-year for date of 30 June).

**Figure 2.3** Nominal exchange rate depreciations against the United States dollar, selected developing countries, January–July 2022 *(percentage)*




*Source:* UNCTAD secretariat calculations based on Refinitiv.
*Note:* Estimated change in per cent of the nominal exchange rate against the United States dollar between 1 January 2022 and 8 July 2022.

### Box 2.1 Monetary tightening in developing countries

The combination of rising policy rates in advanced economies, higher domestic inflation rates and depreciating currencies is severely limiting the policy space available to monetary authorities in developing countries. This complex background explains the sharp contrast in terms of monetary policy responses in the early stages of the Covid-19 pandemic relative to the situation in 2022. Between June 2019 and May 2020, for a group of 72 developing countries, the median central bank policy rate declined from 5.0 to 4.5 per cent. At least 52 of these countries were able to cut rates during this period to support their response to the pandemic. By contrast, between June 2021 and May 2022, the median policy rate for this group increased from 4.0 to 4.9 per cent. At least 51 countries raised policy rates during this period (figure 2.B1.1A). This widespread tightening of monetary policy in developing countries is acting as a constraint on the efforts of authorities to sustain economic recovery in the aftermath of Covid-19.

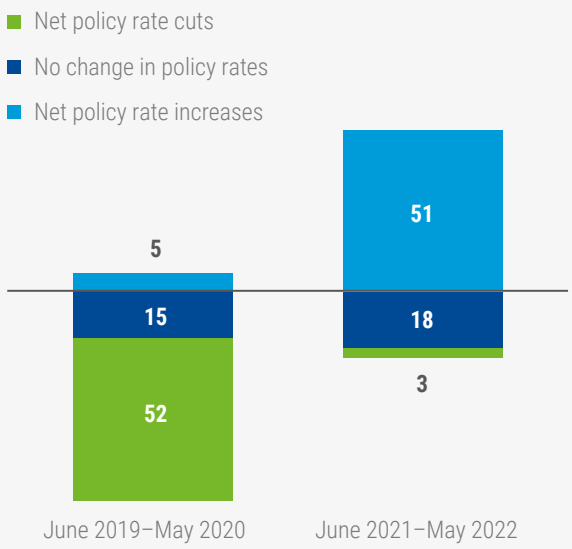
In the current context, one of the most important risks faced by developing country governments is an overshooting of domestic monetary policy tightening. Central banks in these countries have tried to preempt the expected increase of policy rates in the United States by raising their own rates from the second half of 2021 (*TDR*, 2022). However, with United States monetary tightening transmitting inflationary pressures to developing countries through balance of payment crises and currency depreciations, compounded (until recently) by price hikes in core international commodity markets, monetary authorities in these countries come under pressure to extend the ongoing cycle of tightening, both in terms of rate hikes and duration (World Bank, 2022a). High domestic inflation rates turn policy rates negative in real terms and, therefore, broadly accommodative in many countries. An analysis of the situation for 56 developing countries shows that in at least 35 cases, policy rates have turned negative despite the implementation of nominal rate increases over the last 12 months ending in May 2022 (figure 2.B1.1A). This then calls for further monetary tightening.

This thinking relies heavily on central banks' wariness of the perceived risks of unanchored inflation expectations and wage-price spirals (BIS, 2022). These risk preferences inform their inclination to pursue

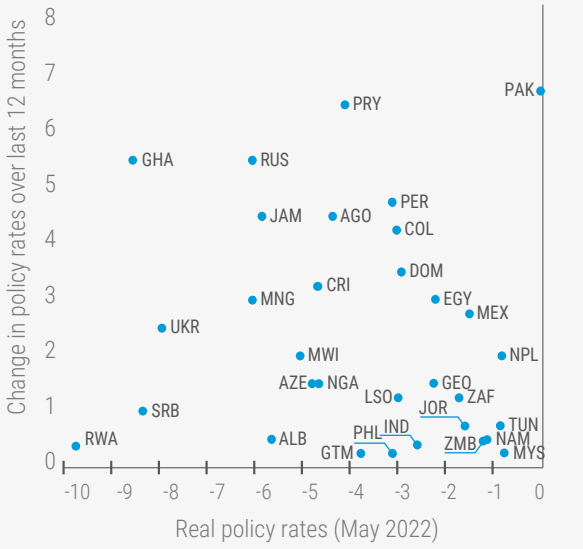
further rate hikes despite both the lack of evidence on systemic build-ups of wage-price spirals and the equally significant danger of triggering sharp domestic economic downturns (Storm, 2022). This dynamic highlights the blunt nature of the use of monetary policy tools to tackle the often divergent causes of domestic inflationary pressures (*TDR*, 2022).

**Figure 2.B1.1** Monetary policy in developing countries

**A. Changes in monetary policy, developing countries, 2020-2022** *(number of countries)*




**B. Real policy rates and changes in nominal policy rates, developing countries, 2021-2022** *(percentage)*




*Source:* UNCTAD secretariat calculations based on Refinitiv.
*Notes:* Panel A includes data for 72 countries with available data until May 2022. Panel B includes data for 56 countries with available data until May 2022. The real policy rate is estimated as the difference between the policy rate and national CPI figure for May 2022. Policy rates include reported central bank policy rates, discount rates or repurchase rates.

## 2. External debt sustainability in times of tapering

Clearly, these global financial conditions – and the United States monetary tightening cycle – put already fragile debt sustainability in many, though not all, developing countries in further and acute peril (UNCTAD, 2021). This is evident from the following brief analysis of the evolution of two core indicators of external debt sustainability in developing countries.

The first of these – the ratio of total external debt stocks to exports (of goods and services, including tourism revenues) – provides an indication of countries' external 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 (figure 2.4.A). By 2021, this figure had again 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 tightening financial conditions is precisely that this recent positive development will be reversed.

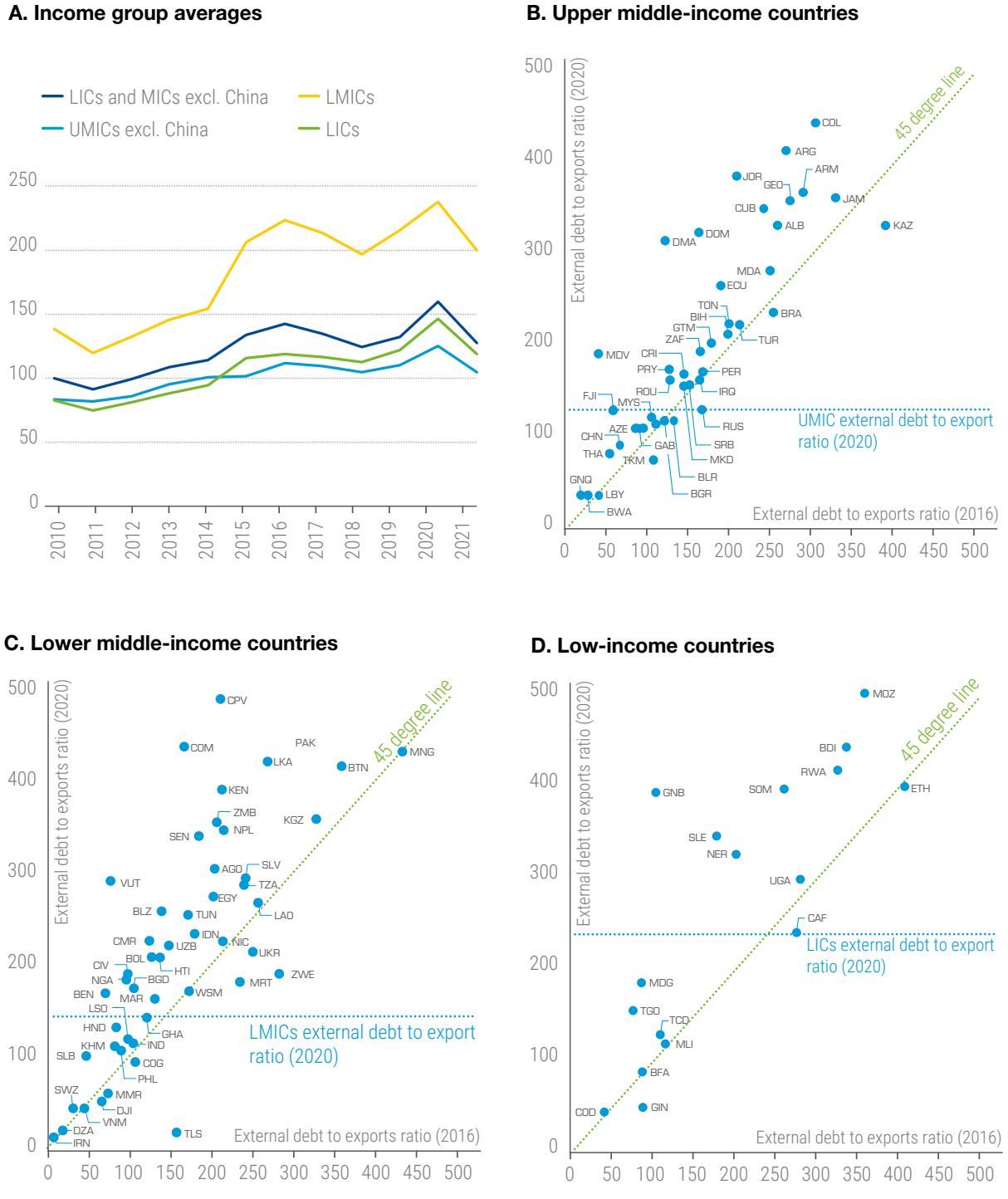
Disaggregating these data by income groups, low-income countries faced the most severe constraints throughout, with their external debt stocks still exceeding their export revenues by a factor of 2 in 2021. Lower middle-income countries saw their external debt sustainability eroded substantially as their ratio of total external debt-to-exports steeply from a relatively low value in 2013 (compared, for example to upper middle-income countries at this stage) to 118 per cent in 2021 (and a factor of 1.5 in 2020). Unsurprisingly, upper middle-income countries have fared better on average but have also seen their ability to service external foreign-currency denominated debt obligations through export revenues decline over the past decade.

Most importantly, however, such group averages hide the fact that, in each income group, there can be significant "outliers" – that is several often-smaller countries in much more dire straits than the average picture would suggest. This is relevant since assessing the severity of debt distress in the developing world needs to be informed by country experiences. Figure 2.4B-D therefore provides a more detailed picture, at country-level, of changes in their ratio of total external debt stocks to their export revenues between 2016 – when monetary tightening first set in – and 2020, the last available year for country-level data. This shows quite clearly that the number of countries in each income group – with often very different institutional histories, current policy frameworks and operating at different per-capita income levels – whose position deteriorated in regard to this indicator is substantial (i.e. all countries above the 45-degree line in figure 2.4B-D).

The second core indicator is the ratio of debt servicing costs on public and publicly guaranteed debt to government revenues. This approximates the ability of governments to continuously service public (rather than total) external debt obligations, reflecting not only governments' ability to marshal domestic resources for this purpose but also the changing costs of servicing such debt. As figure 2.5.A shows, a steeply increasing share of government revenues was needed to service external public sector debt obligations in the period 2010 to 2020. This is the case, on average, for all developing countries (low- and middle-income countries according to World Bank income classification), as well as for specific income groups, and is a clear reflection on the cost borne by many developing countries due to their integration into international financial markets. This has proved a double-edged sword for many and, especially, poorer and more vulnerable frontier developing countries: On the one hand, largely private financing provided much-needed immediate relief from external financing constraints, not readily available through multilateral channels. On the other, (re-) financing in international financial markets has arguably worsened external financial constraints in these economies in the longer-term due to their heightened exposure to market risks and associated high and highly volatile debt servicing costs.

While this situation saw some improvement in upper middle-income countries in 2021 – one that is vulnerable to being reversed soon if adverse global financial conditions persist – there has been little, if any, reprieve in low- and lower-middle income countries. By 2021, these countries' public sectors remained, on average, under high pressure to dedicate substantive and growing shares of their government revenues to servicing their external debt servicing obligations, compared, for example, to either the 2013 taper tantrum episode or the onset of monetary tightening in 2016. Here again, individual country experiences across income groups are telling and relevant, as depicted in figure 2.5.B for 2020 (the latest data available at country-levels). Clearly, a significant number of both low- and middle-income countries have seen their external public debt servicing costs rise to well above 20 per cent of their government revenue. This is not only not conducive to their own future growth prospects, let alone their ability to respond to higher benchmarks for inclusive and sustainable growth, but it is also destined to negatively rebound on global economic (inclusive and sustainable) growth prospects.

**Figure 2.4** Total external debt stocks to export revenues, developing countries, 2010–2021
*(percentage)*



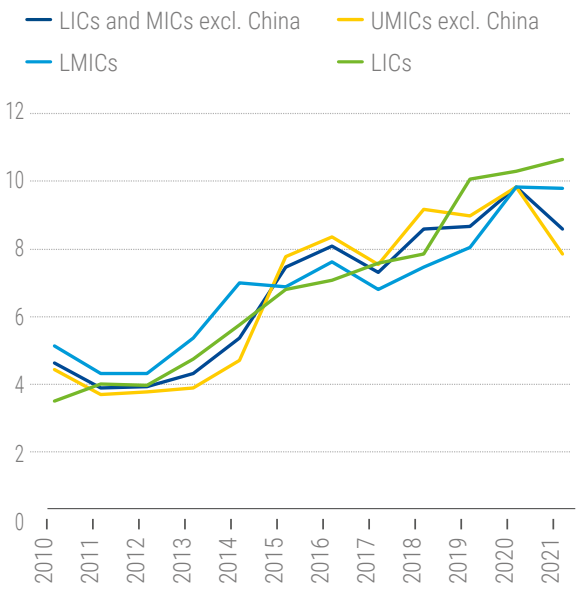

*Source:* UNCTAD secretariat calculations based on World Bank International Debt Statistics.

Such figures suggest that the deterioration of developing countries' external debt sustainability was more widespread across developing countries than indicated by the IMF LIC Debt Sustainability Framework. However, and has mentioned, the countries with a particularly perilous position in the three country groups are mainly economies which were already facing high pressures on their external debt positions before the Covid-19 pandemic. The pandemic, along with increasing climate-related shocks, the war in Ukraine and the current tightening of global financial conditions, has led them to the brink of debt distress or to default.

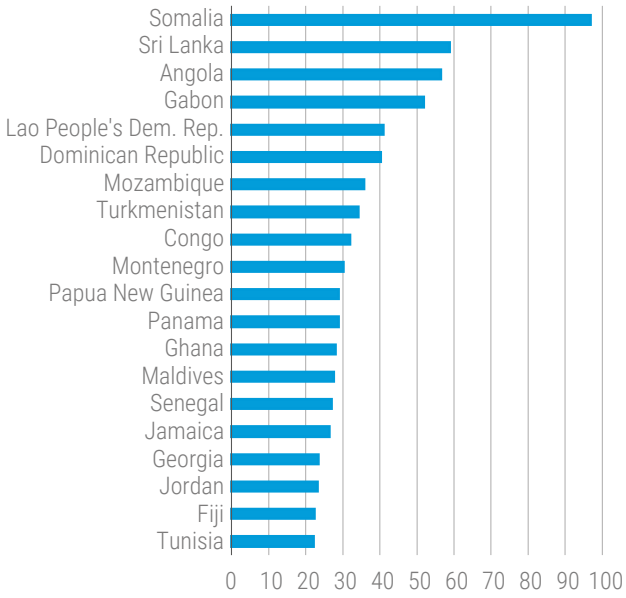
This means that the current situation, although very worrying, is different from the 1980s and 1990s when a few but very large developing countries faced acute financial and debt crises.

**Figure 2.5** Servicing costs on public and publicly guaranteed external debt to government revenues, developing countries and groups, 2010–2021 *(percentage)*

**A. Income group averages**




**B. Top 20 countries in 2020**




*Source:* UNCTAD secretariat calculations based on World Bank data.

## 3. Policy responses by the international community

This analysis reinforces the warnings raised recently by the United Nations Global Crisis Response Group on Food, Energy and Finance. 94 developing economies, home to 1.6 billion people, are severely exposed to at least one of the dimensions of the interlocked crises outline above. The Group has emphasized that there is no way to respond to this challenge, without first addressing the deterioration of financial conditions in developing countries. Unfortunately, policy and financial commitments made by the international community in recent months have fallen short of what is required (United Nations, 2022a).

There are three relevant areas of multilateral action which require the implementation of additional measures based on a renewed sense of urgency. These include the provision of official development assistance (ODA), the allocation and effective deployment of SDRs and policies to effectively address debt distress in developing countries.

First, there is an imperative need for developed countries to meet their ODA commitments while protecting levels of assistance in key areas, including Covid-19 vaccination efforts and climate commitments, and particularly to least developed countries (LDCs). In 2021, ODA reached $178.9 billion, equivalent to 0.33 per cent of GNI of the members of the Development Assistance Committee (DAC) (OECD, 2022). This figure is problematic for at least two reasons. First, it is less than half of the established commitment of 0.7 per cent of GNI. Over the last 50 years, the systemic failure of DAC members to meet their pledges means that developing countries have lost over $5.7 trillion in developing financing (OXFAM, 2020). Second, resources allocated to LDCs are under threat because of the declining share of grant financing as well as the expected increase of in-donor country refugee costs (Eurodad, 2022).

Second, developing countries have made active use of their share of resources received through the allocation of $650 billion in SDRs by the IMF in August 2021. At least 69 developing countries have included SDRs in government budgets or have deployed them for fiscal purposes for a total of $81 billion since this allocation (CEPR, 2022). Additional resources are required that could be deployed through different mechanisms. These include the operationalization of commitments to reallocate SDRs towards the IMF Poverty Reduction and Growth Trust (PRGT) and the new Resilience and Sustainability Trust (RST), a new emission of SDRs in 2022, and in addition, establishment of an SDR development link in SDR allocations as long advocated by UNCTAD (UNCTAD, 1965).

Third, 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, establishment a multilateral legal framework for sovereign debt restructuring to facilitate timely and orderly debt crisis resolution with the involvement of all official (bilateral and multilateral) and private creditors (*TDR*, 2015). The framework would facilitate the provision of debt relief linked to a debt sustainability assessment that incorporates long-term finance needs, including for the achievement of the 2030 Agenda and the Paris Climate Agreement (*TDR*, 2019). Second, establishing a publicly accessible registry of debt data for developing countries to address debt transparency challenges. Following the UNCTAD Principles for Responsible Sovereign Borrowing and Lending, this registry would allow the integration of debt data by 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 (UNCTAD, 2012; Rivetti, 2021; Eurodad, 2019).

### Box 2.2 Developing countries' sovereign defaults and restructurings in 2022

The deterioration in global financial conditions has not triggered a sharp increase in the number of countries that are either in sovereign default or undergoing a debt restructuring during the first half of 2022. In total, there are five countries classified in default – Lebanon, Sri Lanka, Suriname, Bolivarian Republic of Venezuela and Zambia – and a further three undergoing a debt restructuring as of July 2022 – Ethiopia, Chad and Mozambique. Except for Sri Lanka, all the ongoing cases of default and restructuring started in previous years. In the case of defaults, the duration of each open event remains below the average length of a default over the last 50 years, estimated at 58 months (figure 2.B2.1.A). In contrast, in the case of debt restructurings, the duration of each open event is already above the historical average, estimated at 11 months (figure 2.B2.1.B).

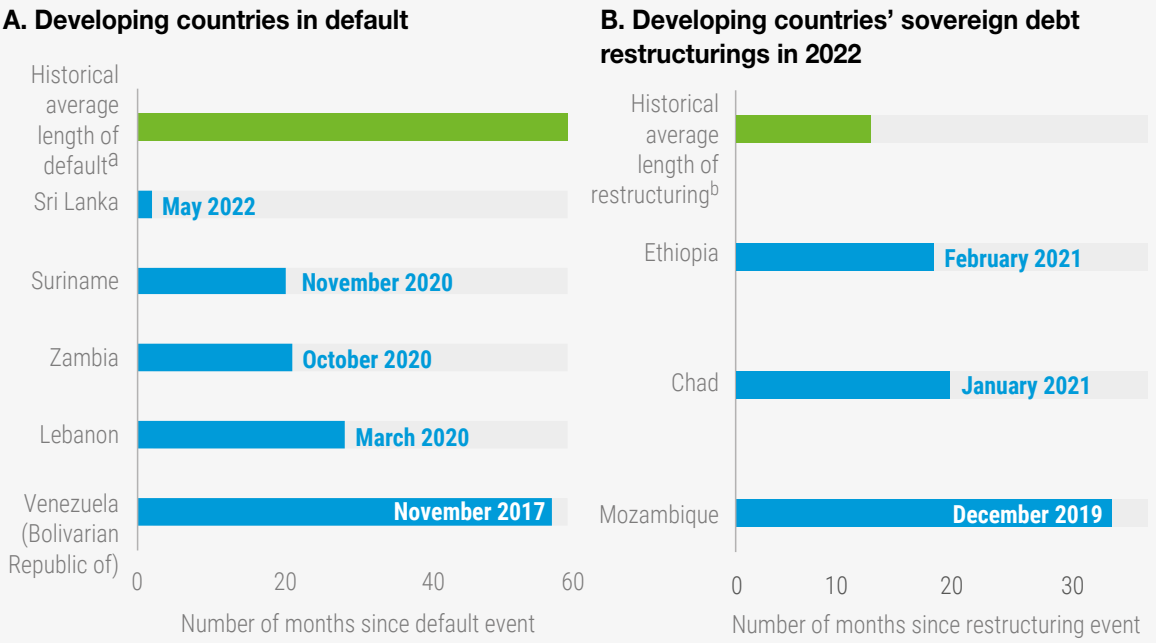
The situation faced by these countries raises three pressing concerns. First, debt distress has already caused a severe degree of economic and social disruption in these countries. Further delays in addressing their debt challenges places them at risk of steeper economic output losses (Asonuma et al., 2019). Second, the combination of elevated debt levels, higher interest rates and the growing likelihood of a global economic slowdown or recession raise the risks of a renewed series of debt crises, as last seen in the 1980s (World Bank, 2022a). As a result, a substantial number of countries might be effectively prevented from mobilizing resources towards achieving the SDGs as they spend most of the rest of the

decade grappling with the consequences of debt distress. Third, the existing "non-system" for sovereign debt resolution is not suited to address these problems (Ocampo, 2017). In the context of an increasingly diverse creditor base, developing countries in debt distress are trapped by strategic creditor choices which are more responsive to repeated inter-creditor disputes across countries than to the economic and developmental considerations of a specific debt restructuring negotiation.

Against this background, efforts to enhance the G20 Common Framework (CF) can be considered a step towards, but not a substitute, for a permanent and comprehensive debt restructuring mechanism (United Nations, 2022a). Of the eight countries that are either in default or undertaking a restructuring in 2022, four are eligible to join the Common Framework. This includes Chad, Ethiopia, Zambia and Mozambique. The first three have opted to participate in the initiative since early 2021. With the exception of Zambia, for which an Official Creditor Committee, including China, was eventually set up under the CF on 16 June 2022 and subsequently moved quickly to help unlock a $1.3 billion IMF loan to the country (Cotterill and Wheately, 2022), the CF has achieved little progress so far to accelerate the process of debt crisis resolution for participating countries.

Previous *TDR* reports have raised concerns over an approach to sovereign debt restructuring that focuses on official bilateral creditor preferences as an effective way to address the manifold external debt challenges faced by developing countries (*TDR*, 2015). Thus, for example, Zambia still will have to negotiate the exact terms of debt relief under the CF as well as find a way to bring on board private creditors on comparable terms.

**Figure 2.B2.1** Developing countries' ongoing sovereign defaults and restructurings in 2022



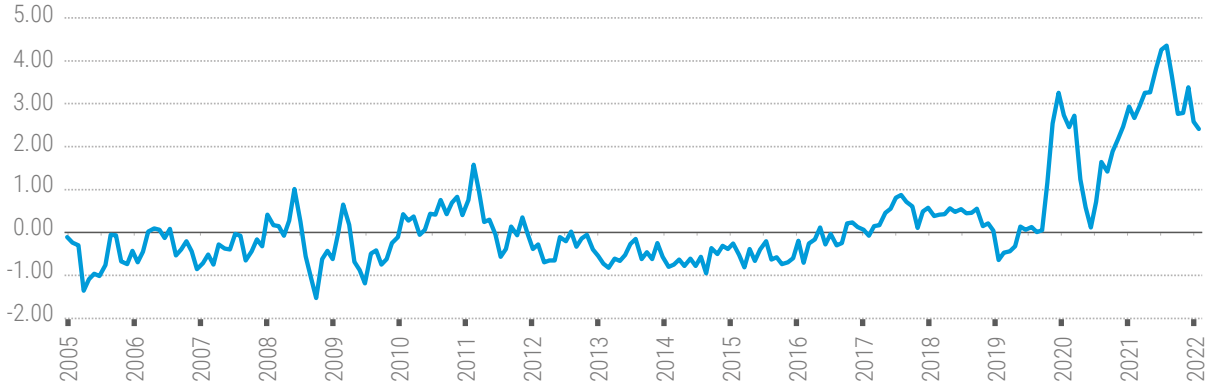

*Source:* S&P Global Ratings (2022); Asonuma and Trebesch (2016).
*Note:* Panel A includes countries classified in default by S&P Global Ratings as of July 2022. Default date as reported by S&P.
[a] Average length of post-default restructurings from default to debt exchange between 1978 and 2020, as defined by Asonuma and Trebesch (2016). Panel B includes countries undergoing a debt restructuring, including participation in the G20 Common Framework (Chad and Ethiopia) or facing ongoing litigation (Mozambique), but which are not classified in default by a rating agency. Restructuring date refers to application to the G20 Common Framework and start of litigation.
[b] Average length of strictly and weakly preemptive debt restructurings between 1978 and 2020 as defined by Asonuma and Tresbesch (2016).

# C. TRENDS IN INTERNATIONAL TRADE

Despite the outbreak of war in Ukraine and subsequent sanctions imposed against the Russian Federation, as well as continued lockdowns in China, affecting particularly Shanghai, world trade has shown resilience in the first half of 2022.

Before the emergence of these new headwinds, there was a sense that other difficulties that had hampered the movement of goods around the world since 2020 would gradually ease. Freight rates started to decline after the third quarter of 2021 while the disruptions in international supply chains and other logistical eased after it peaked in late 2021 (figure 2.6).

**Figure 2.6** Global supply chain pressure index (GSCPI), January 2005–June 2022
*(standard deviations from average value)*




*Source:* Benigno et al. (2022).
*Note:* The index is normalized such that a zero indicates the index is at its average value, with positive values representing how many standard deviations the index is above this average value (and negative values representing the opposite).

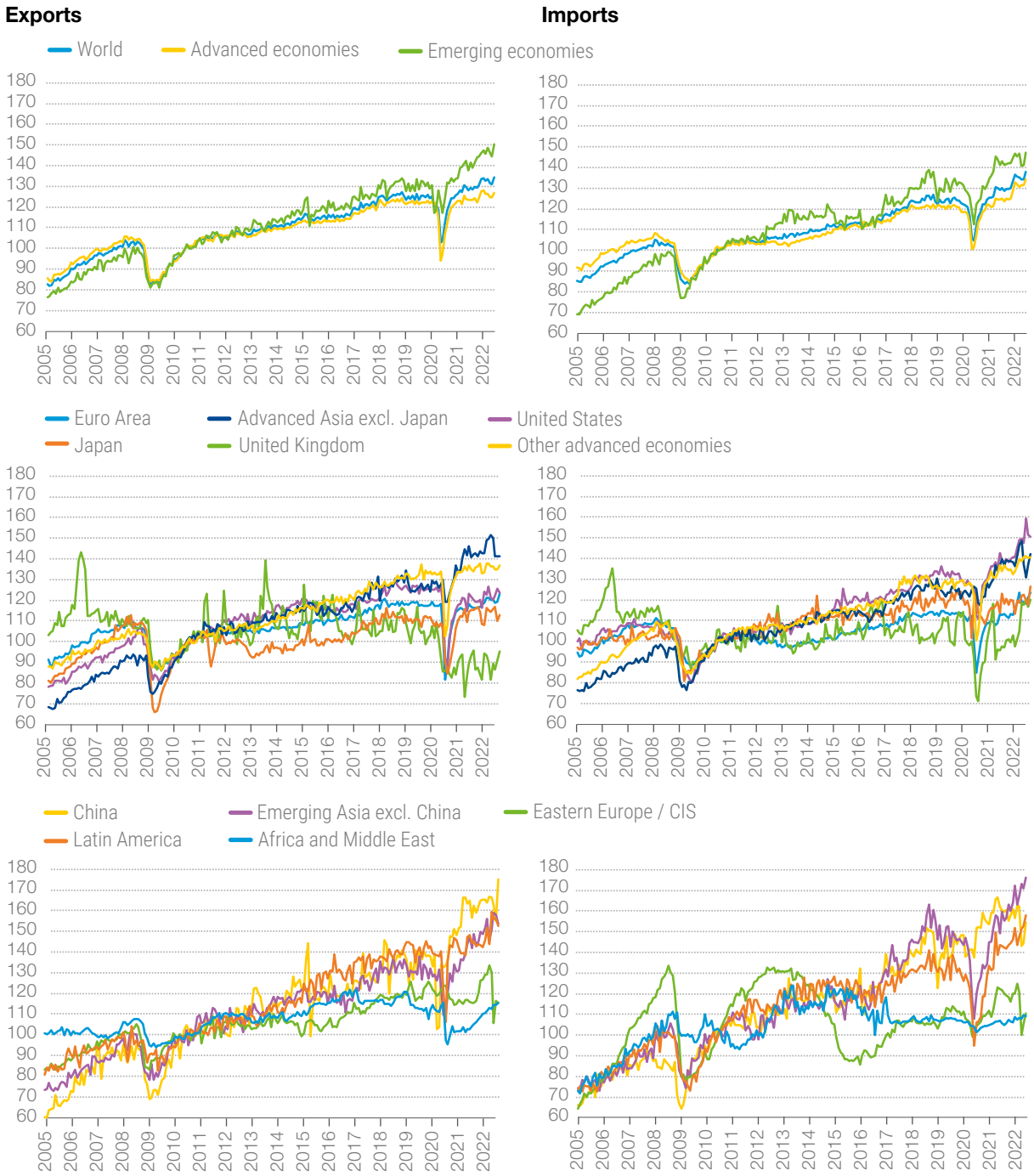
Robust merchandise imports – emanating primarily from Europe, the United States and parts of the developing world, like "Emerging Asia excl. China" and "Latin America" – supported the growth of merchandise trade in the first half of 2022 (figure 2.7). This partially reflected pent-up demand relating to the legacy of the pandemic-driven spending shift from services towards goods that could not be satisfied earlier because of the supply bottlenecks. It also resulted from other positive factors such as the appreciation of the dollar in the case of the United States, the relative dynamism of intra-regional trade in Europe, and favourable terms-of-trade effects in some large emerging economies due to elevated energy prices.

Elsewhere, demand for foreign goods has been more muted. One notable case is China, where monthly data show merchandise imports between January to May 2022 5.6 per cent below their average during the same period last year. Meanwhile, CPB estimates also pointed to a significant contraction in the imports of the "Eastern Europe / CIS" group, following the outbreak of the war in Ukraine.

In terms of exports, patterns since the Covid-19 outbreak have varied. Within advanced economies, by mid-2022, Asian exports stood way above their pre-Covid-19 levels. This contrasts with the United States and especially the United Kingdom, where exports remain significantly below their historical peaks. In between these two extremes stand Europe and the "other advanced economies", laying slightly above their pre-Covid-19 heights. Within the emerging economies, the picture is also mixed. In China, "other developing Asian economies" and Latin America, the V-shaped recovery was extremely

rapid, while exports continued to grow afterwards. This led to average levels for the first five months of 2022 that were between 6 and 14 per cent above their pre-Covid-19 maxima. Meanwhile, in "Africa and Middle East" and in "Eastern Europe / CIS", similar figures remained about 5 per cent lower than their pre-Covid-19 peaks.

**Figure 2.7** World merchandise trade, January 2005-May 2022 *(index numbers, average 2010=100)*




*Source:* CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor database.
*Note:* Country group classification relies on Ebregt (2020).

Altogether, these developments contributed to an averaged year-on-year growth of 4.3 per cent in real terms for world trade during the first five months of 2022, if one takes the simple average between the growth of exports (3.0 per cent) and imports (5.5 per cent).

Turning to the components of exports allows a better grasp of the underlying patterns behind these aggregates. For goods, estimates of world seaborne exports from Cerdeiro et al. (2020), which track maritime merchandise trade by their respective vessels in real time, show the following. For the three main types of vessels, containers, bulk and oil/chemicals,[10] data show a significant synchronized rebound taking place in the second quarter of 2022 (figure 2.8.A). Besides these three main vessel types, gas shipments and vehicles also registered an upturn during the first half of the year. This contrasts with foodstuff, the only vessel type that did not perform well during this period (figure 2.8.B). This results mostly from the blockaded grain exports in the Black Sea, which affected net food-importing countries in Africa and parts of Asia, since some of them are highly dependent on cereals coming from the two countries currently at war (United Nations, 2022a). In late July, however, grain shipments from Ukraine started again after an agreement with the Russian Federation was signed. At present, it is still unclear how long it will take for exports to normalize but prices of key grains, including wheat and corn, saw immediate falls and have already returned to pre-war levels.

Turning to trade in services, recent patterns from the subcomponents of this catch-all aggregate depict a rather favourable picture after many of these sectors were hard hit by the pandemic. Starting with tourism, the sector continues to recover at a strong pace. This is a boon for the largest component of trade in services, which accounted for one fourth of this aggregate in 2019 before dropping to one tenth in 2020 and 2021 during Covid-19. More precisely, international tourism saw a strong rebound in the first five months of 2022, with arrivals reaching almost half the levels of the same period of 2019. By regions, Europe and the Americas continued to lead the recovery. Europe welcomed more than four times as many international arrivals as in the first five months of 2021. In the Americas, arrivals more than doubled over the same period. Despite the strong rebound, arrivals remained 36 per cent and 40 per cent below 2019 levels in Europe and the Americas, respectively. The Middle East and Africa also saw strong growth of about 150 per cent in January-May 2022 over 2021 but remained about 50 per cent below 2019 levels. Asia and the Pacific saw arrivals almost double, though numbers were still 90 per cent below 2019, as some borders remained closed to non-essential travel (UNWTO, 2022a). In this context UNWTO has revised upwards its forecast for 2022 due to stronger-than-expected results in the first quarter of 2022. It expects international tourist arrivals to reach 55–70 per cent of 2019 levels in 2022 depending on the scenarios it considers for the rest of the year. In parallel, the percentage of experts seeing a potential return of international arrivals to 2019 levels in 2023 has increased from 32 per cent in January 2022 to 48 per cent in May, reflecting rising optimism among tourism experts worldwide, building on strong pent-up demand, in particular intra-European travel and travel from the United States to Europe (UNWTO, 2022b).

Turning to transport, which accounts for about one sixth of the total trade in services, the recovery has continued over the course of 2021 and in early 2022. For air passenger transport services, IATA data show that the seasonally-adjusted international revenue passenger kilometres (RPK) – an airline industry metric reflecting the number of kilometres travelled by paying passengers – had exceeded the 2019 levels for almost all main routes by the end of second quarter of 2022, after growing steadily since the beginning of 2022. Two key segments differ strongly from this encouraging development: “Asia-Europe” and “Asia-North America”. For these two routes, international RPKs were still severely depressed (May 2022) at about 65 per cent below the 2019 level, despite progressing since January 2022 when this figure stood at 80 per cent.[11] Meanwhile, trends in air cargo has shown an almost opposite evolution. This specific service declined almost 10 per cent year on year in late 2021, early

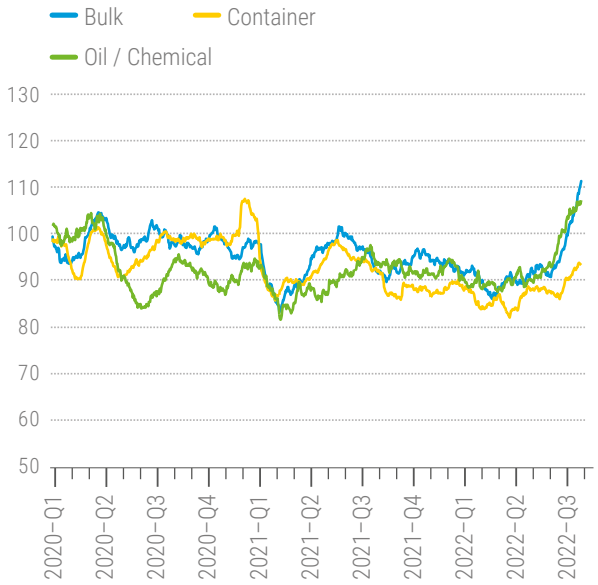
[10] Containers represent roughly half of the world maritime transport in terms of metric tons of cargo, while bulk and oil/chemicals account for slightly less than one fifth of the total each.

[11] IATA (2022). Air Passenger Market Analysis – May. 7 July. Available at https://www.iata.org/en/iata-repository/publications/economic-reports/air-passenger-monthly-analysis---may-2022/

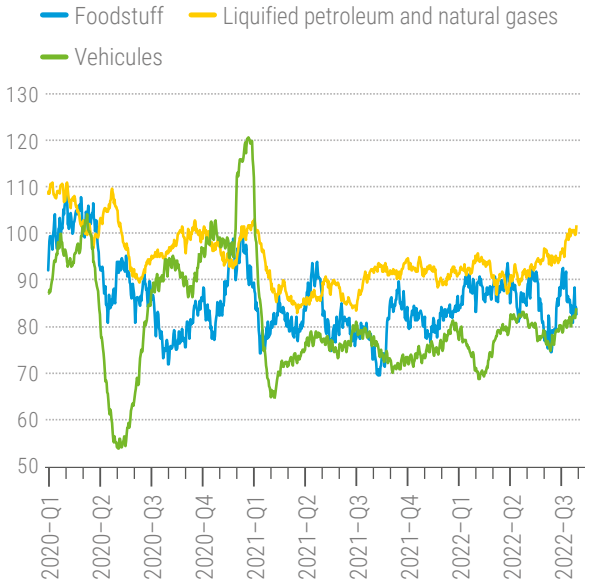
2022, after an intense activity during the first three quarters of 2021, which lay way above pre-pandemic trends. Overall, under the current conditions, the revenues of the commercial airlines for passengers are expected to reach $498 billion in 2022, compared to $607 billion in 2019, while for cargo, revenues are forecast to $191 billion in 2022 from $100 billion in 2019.[12]

**Figure 2.8** Metric tons of world exports by vessel type, 1 January 2020–7 June 2022
*(index numbers, average 2019=100; 31-day centred moving averages)*

**A. Three main types of vessels**




**B. Other selected types of vessels**




*Source:* UNCTAD secretariat calculations based on Cerdeiro et al. (2020) and AIS data collected by MarineTraffic (available at UN COMTRADE Monitor).
*Note:* Underlying data behind the 31-day centred moving average go until 22 June 2022.

In the other broad categories of trade in services, the recovery has continued across the board, with export revenues in 2021 exceeding the 2019 figures, except for construction which remained 8 per cent below its pre-pandemic level. Trade in "ICT" and "insurance and pensions services" registered the largest growth over these two years, about 30 per cent. During the same period, "financial services", "personal, cultural, and recreational services" and "other business services" grew between 12 and 18 per cent.

Despite such positive development in the first half of 2022, the outlook for international trade is rather grim as the global economy reached an important crossroad around midyear. In the second half of 2022, risks remain mostly tilted to the downside and trade growth is expected to weaken. This results from a combination of different factors including, inter alia, continued supply chain disruptions, weakened demand tapering demand for consumer durables, unduly aggressive monetary policy, and elevated freight charges. Such worries seem already visible in inventories and new export orders, both leading indicators for trade, which were subdued in July 2022. Except for China's new order figure, which has rebounded in the aftermath of the recent lockdown, those of other major economies have declined or stabilized below the 50-threshold, marking the difference between improvement and deterioration. As a result, and despite the broad uncertainties that lie ahead, it is expected that global

[12] IATA (2022). Industry Statistics Fact Sheet June 2022. 20 June. Available at https://www.iata.org/en/iata-repository/publications/economic-reports/airline-industry-economic-performance---june-2022---data-tables/

trade will grow almost at par with the global economy in 2022, namely in the range of 2 to 4 per cent. This would represent a sharp deceleration from the 2021 figure, whose current estimates point to a range of 7 to 10 per cent in constant prices, depending on whether one considers world exports or imports, given the challenges that trade statisticians are facing to get reliable price indices for these variables since many countries still have to provide their final numbers for 2021.

Beyond 2022, the prospects for trade remain relatively weak, mirroring the expected deceleration of economic growth discussed in the previous chapter and suggesting a return to the subdued long-term trend prior to Covid-19.

Certainly, the Declaration at the conclusion of the 12th Ministerial Conference (MC12) of World Trade Organization provided some positive elements and the reaching of an agreement suggested the multilateral trading system remains relevant in difficult, as well as in good, times. However, many of the elements were indecisive with the details still pending and it remains to be seen to what extent they can boost international trade in the near future. The outcomes of value to developing countries are mainly concerned with the emergency responses to food insecurity and the Covid-19 pandemic, notwitstanding the resitance of some advanced economies to agree to waiving the TRIPS legislation that could help developing countries combat the pandemic. Moreover, not being able to resolve the issues around fully and well-functioning dispute settlement system poses an ongoing challenge to multilateralism.

In this context, there is still a long way to achieve an inclusive, transparent, and development-friendly multilateral trading system that serves the three pillars of sustainable development and allows developing countries to have sufficient policy space to pursue pragmatic development policies adapted to local conditions. In the pursuit of this objective, chapter IV of this Report argues that, while a constructive and cooperative approach to multilateralism must remain paramount, open developmental regionalism could support this transition.

# D. COMMODITY MARKETS

While the market for commodities has been historically characterized by sharp movements in international prices, the fluctuations observed since the onset of the pandemic in early 2020 have been startling not only in terms of their magnitude but also in the sudden reversals in trajectories. It is important to bear in mind that the effects of these abrupt price movements are not limited to the returns to international investors, for whom commodities are just another form of financial asset. Rather these swings in international prices are having a heavy and real impact on economies and individuals, particularly in the developing world.

Not only are developing countries seeing an outsized impact of these price movements on their current account balances – complicated further by the fact that any deterioration in these balances necessitates financing precisely at a time of increasingly scarce and costly international financing conditions – they are also experiencing a disproportionately large knock-on effect on domestic inflationary pressures as these raw materials account for a far larger share of their consumer baskets than those of developed countries. Ultimately, these sudden price swings are having a direct impact on the welfare and livelihoods of some of the most vulnerable populations across the globe, both as small-scale producers and as consumers of these basic goods.

Even before the outbreak of Covid-19, the last decade had seen a period of elevated volatility in commodity markets, with multiple shocks causing both steep declines and rises in international prices. This is in stark contrast to the first decade of the twenty-first century, during which a turbocharged demand for commodities from a rapidly growing and industrializing Chinese economy produced a

considerable and sustained increase in commodity prices across the board. The heightened volatility in commodity markets since the global financial crisis in 2008 has only been exacerbated in the last two years by severe and largely unprecedented shocks on both the demand and supply side.

The outbreak of the Covid-19 pandemic in early 2020 precipitated an abrupt drop in commodity prices as lockdowns were imposed and economic activity slowed to a crawl across the globe. The aggregate commodity price index fell by 25 per cent from January to April (figure 2.9). While the fall in prices was broad-based, energy commodities registered the largest drop (54 per cent), followed by metals (16 per cent) and food (9 per cent). Thereafter, a rapid bounce-back in activity, particularly in China, coupled with severe disruptions to supply, transport and logistics produced a sharp recovery in commodity prices. The aggregate index rose by just over 50 per cent between April and December 2020, finishing the year over 10 per cent above the level observed at the end of 2019.

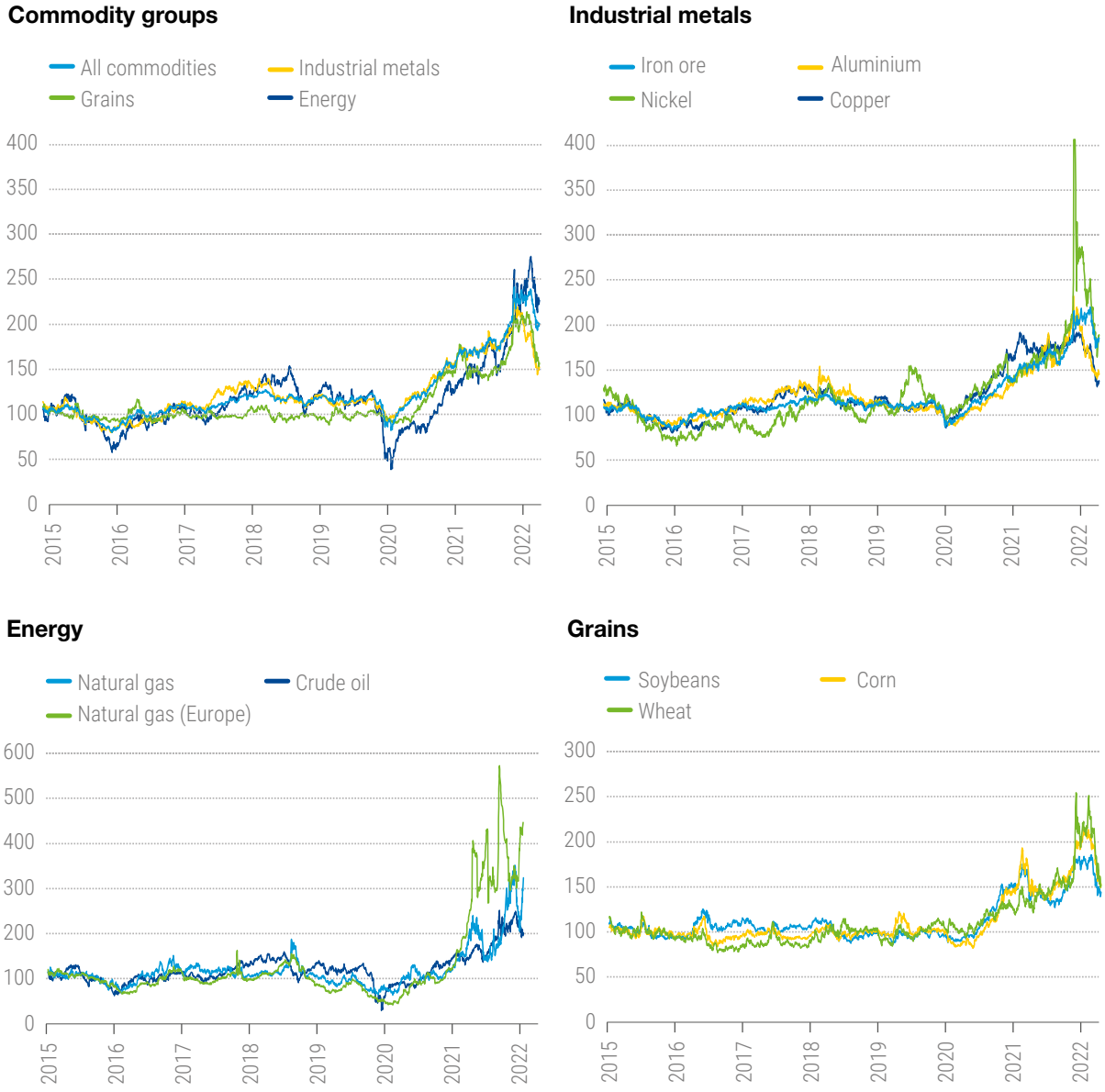
The same factors driving the upward movement in prices in the latter half of 2020 continued into 2021. The aggregate index posted an annual increase of 54.7 per cent over the course of 2021 (table 2.2), with energy commodities again registering the largest change (85.8 per cent), followed by food (29.9 per cent) and metals (20.7 per cent). These upward price pressures remained through the first two months of 2022, as all commodity groups registered further increases.

**Table 2.2** World primary commodity prices, 2008–2022 *(percentage change over previous year)*

| Commodity groups | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022[a] |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| All commodities[b] | 33.4 | -31.6 | 24.3 | 28.6 | -3.0 | -3.7 | -7.9 | -36.2 | -9.4 | 17.4 | 16.0 | -7.4 | -15.8 | 54.7 | 55.7 |
| Non fuel commodities[c] | 22.2 | -17.8 | 26.1 | 18.9 | -12.7 | -6.5 | -8.0 | -18.9 | 2.3 | 9.1 | -2.2 | 0.1 | 4.2 | 33.9 | 14.3 |
| Non fuel commodities (in SDRs)[c] | 18.3 | -15.6 | 26.9 | 15.1 | -9.8 | -5.9 | -8.0 | -11.9 | 3.0 | 9.1 | -4.2 | 3.0 | 3.5 | 31.1 | 19.2 |
| All food | 32.6 | -10.4 | 12.0 | 24.0 | -6.5 | -9.6 | -0.8 | -15.6 | 3.6 | -1.3 | -6.5 | -2.0 | 6.6 | 29.9 | 23.9 |
| Food and tropical beverages | 31.1 | -2.2 | 11.6 | 23.6 | -9.9 | -9.1 | 3.8 | -14.2 | 2.2 | -1.6 | -6.7 | 0.3 | 3.6 | 21,0 | 22.3 |
| Tropical beverages | 19.2 | 1.1 | 19.8 | 31.2 | -22.4 | -19.8 | 24.1 | -10.3 | -3.3 | -3.1 | -8.5 | -5.1 | 4.8 | 28.3 | 49.8 |
| Food | 34.9 | -3.2 | 9.1 | 21.1 | -5.6 | -6.0 | -1.2 | -15.4 | 4.0 | -1.2 | -6.1 | 1.9 | 3.3 | 19.0 | 15.1 |
| Vegetable oilseeds and oils | 35.2 | -24.1 | 13.0 | 24.8 | 0.7 | -10.5 | -9.6 | -18.8 | 7.0 | -0.5 | -6.2 | -6.9 | 13.7 | 49.0 | 26.5 |
| Agricultural raw materials | 8.4 | -16.4 | 37.0 | 24.5 | -19.2 | -8.8 | -11.8 | -13.3 | -0.4 | 5.3 | -1.8 | -3.9 | -2.1 | 13.5 | 5.5 |
| Minerals, ores and metals | 19.7 | -12.9 | 33.6 | 20.5 | -6.9 | -9.5 | -12.8 | -17.2 | 4.6 | 11.3 | 1.3 | 6.2 | 15.5 | 20.7 | 5.3 |
| Minerals, ores and non-precious metals | 17.5 | -25.4 | 39.0 | 12.2 | -16.8 | -2.0 | -14.6 | -24.8 | 1.4 | 25.7 | 2.6 | 3.4 | 3.7 | 43.6 | 7.9 |
| Precious metals | 23.4 | 7.5 | 27.5 | 30.8 | 3.4 | -15.8 | -11.0 | -9.9 | 7.1 | 0.4 | 0.0 | 8.9 | 26.3 | 3.6 | 2.5 |
| Fuel commodities | 37.9 | -38.6 | 23.1 | 32.0 | -0.5 | -1.2 | -7.5 | -44.4 | -17.5 | 25.9 | 27.5 | -12.6 | -32.0 | 85.8 | 91.2 |
| **Memo item:** | | | | | | | | | | | | | | | |
| Unit value of exports[d] | 10.9 | -9.4 | 4.4 | 11.9 | -2.3 | 0.8 | -1.2 | -11.9 | -4.0 | 5.1 | 6.7 | -2.6 | -0.5 | 15.0 | n.a |

*Source:* UNCTAD secretariat calculations, based on UNCTAD, Commodity Price Statistics Online; and UNCTADstat
*Note:* In current dollars unless otherwise specified.
[a] Percentage change between the average for the period January to May 2022 and January to May 2021.
[b] Including fuel commodities and precious metals. Average 2014–2016 weights are used for aggregation.
[c] Excluding fuel commodities and precious metals. SDRs = special drawing rights.
[d] Unit value of merchandise exports of developed countries (M49).

**Figure 2.9** Daily commodity price indices by commodity group and product, Jan. 2015–July 2022
*(index numbers, 2015=100)*




*Source:* UNCTAD secretariat calculations based on Refinitiv data.
*Note:* Price indices correspond to Dow Jones Commodity Index, except "Natural Gas (Europe)" which corresponds to Hamburg Institute of International Economics (HWWI) Natural Gas Europe price index and "Iron Ore" which corresponds to Credit Suisse Commodity Benchmark (CSCB) iron ore TR index.

The outbreak of war in Ukraine therefore came at a time of already historically high prices across the various commodity categories, and it only exacerbated these upward price pressures. Moreover, the war has had a truly global impact on commodity markets due to the key role played by the Russian Federation and Ukraine in international food, mineral and energy supplies. The Russian Federation is not only the world's largest natural gas exporter, but also the second largest oil exporter, as well as a leading supplier of aluminum and nickel. Likewise, both the Russian Federation and Ukraine are key

global suppliers of various grains. Between them, the two countries provide approximately 30 per cent of world exports of wheat, as well as 20 per cent of maize and over 50 per cent of sunflower oil (United Nations, 2022b). Perhaps even more crucially, the Russian Federation and neighboring Belarus account for approximately 20 per cent of global fertilizer exports. A combination of factors generated by the war, including production disruptions, interruptions to transportation links – particularly the shutting down of Ukraine's ports on the Black Sea – and the imposition of sanctions on Belarus (before the war) and on the Russian Federation, have put a severe constraint on the supply of these materials from these countries to the world. Though sanctions to the Russian Federation explicitly excluded food and fertilizers, exports of these suffered declines due to a 'chilling effect' in the private sector (foreign insurers, lenders, traders, and shippers) which, afraid of reputational risks, further retaliatory action, often over-complied and 'self-sanctioned'; a clear result of this was a noted increase in trade transaction costs, in the form of higher interest rates, insurance premiums, and shipping rates for goods coming from the Russian Federation, including grains and fertilizers. Speculation and financialization of the markets have also played an important role as explained before (see box 1.3). The result of which 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 the 2 months following the outbreak of the war (figure 2.9).

While the increase in prices has been broad-based, certain commodities have been more affected than others. As is customary, and consistent with the Russian Federation's key role in global energy supply, the most drastic spike in prices was observed in energy commodities, which rose by 25 per cent in the two months following the war in Ukraine. Initial sanctions against the country did not target the Russian Federation's oil and gas exports, precisely for fear of unsettling global energy markets. However, the potential for disruptions to Russian supply as well as avoidance of Russian crude by oil traders owing to concerns of possibly violating financial sanctions imposed on the Russian Federation economy alarmed oil markets, particularly as tight global oil supply – largely due to the very gradual relaxing of output restrictions introduced by OPEC+ members as per the agreement reached in April 2020 despite a faster than anticipated surge in global oil demand since then – was already applying significant upward pressure on prices. As a result, the price of the Brent crude oil benchmark rose rapidly from just under 100 dollars on the eve of the war to over 120 dollars only two weeks later.

Subsequent announcements by the United States banning oil imports from the Russian Federation, by the United Kingdom to phase out Russian oil imports by the end of the year, and by the European Union to ban seaborne oil imports from the Russian Federation by the end of 2022, as well as prohibiting shipping insurance for oil exports from the country, exerted further pressure on oil markets. However, the release of 180 million barrels from the United States' strategic petroleum reserves as well as the readiness of both China and India to receive Russian oil exports – and thus take advantage of the significant discount at which the country's Urals brand of crude oil trades compared to other benchmark prices – proved sufficient to ensure that global oil supplies did not tighten further.

For its part, the natural gas market has been particularly sensitive to the war 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. There still exist different types of gas pricing: fixed, regulated or cost-related mechanisms; prices linked to crude oil or oil products; market, spot or hub-based prices. In the United States and the United Kingdom, privatization and market-based pricing was already well underway by the end of the 1980s. In the European Union, the process started later: in 2005, nearly 80 per cent of its gas was sold on an oil-linked basis, by 2018 that figure had fallen to around 25 per cent with 75 per cent of gas sold at spot or hub prices (and regulated prices had virtually disappeared) (Stern and Imrisovic, 2020). Basically, even long-term contracts price the entire purchase based on the price of the last barrel exchanged on the spot market. On the contrary, Asian markets, which used to import 70–75 per cent of LNG before the war in Ukraine, remain largely dominated by oil-linked or fixed pricing (Stern and Imsirovic, 2020). Globally, spot prices dropped in 2019 due to large LNG supply. In the

European Union, that affected pricing of pipeline gas from Gazprom to the considerable advantage of member states. Then, ahead of winter 2021/22, Asian economies rushed for new long-term contracts securing greater volumes ahead of time and rely less on spot cargoes. So, what determined a good deal for Europe in 2019 turned bad in 2021/22, well before the war in Ukraine and despite gas supply based on long term contracts being fully guaranteed (Stern and Imsirovic, 2020; Sharples, 2021).

Hence, the liberalization of the gas market and the choice of market-based pricing rather than based on cost-based agreements with producers has proved problematic for Europe, a move which Asian countries have not yet made. As gas spot prices in Europe skyrocket, with the main beneficiaries the Russian Federation and the United States, the region just became the first world importer of United States LNG but still cannot avoid dependence on Gazprom supply (Celi et al., 2022). On the contrary, countries which have been able to establish fairer long-term relationship with producers are now enjoying lower energy prices and reliable delivery. Those who have maintained control of domestic energy companies and/or their retail price formation have also been able to keep the distributive implications of domestic inflation in check (Storm, 2022) as shown by the difference between the GDP and the private final consumption expenditure deflator in Indonesia and China. The decision by Germany to halt the Nord Stream-2 Baltic Sea gas pipeline project, as well as the European Union's pledge 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 the Authorities of the Russian Federation has provoked a surge in European natural gas prices, increasing by more than four-fold in April compared to levels a year earlier (figure 2.9). Moreover, since the European Union's commitment to reduce its reliance on Russian natural gas supplies depends on the bloc increasing its imports of Liquefied Natural Gas (LNG) from other countries, LNG prices have also registered increasing upward pressures since the outbreak of the war. LNG prices stood almost 30 per cent higher in June compared to January, and over double the level registered a year earlier in June of 2021 (UNCTAD secretariat calculations based on data from Japan Import Price Index for LNG). These price movements are further increasing the import bills of LNG-importing developing countries, and could even potentially price out some developing countries from the LNG supplies on which they depend to meet their energy needs.

Perhaps the area in which the impact of the war has been most damaging to developing nations has been in the precipitous rise in food prices. Even before the war broke out, however, food prices were already approaching historic highs, with the subsequent adverse consequences for the most vulnerable populations across the globe. Before the war, it was estimated that food insecurity touched the lives of an estimated 800 million people around the world (FAO, 2022).

Since the Russian Federation and Ukraine are, respectively, ranked the third and seventh largest producers of agricultural goods, the repercussions of the conflict on global food supplies and prices have been widespread and considerable. While some countries, particularly in the case of the European Union, have been able to make up for the shortfall on certain agricultural imports by tapping regional producers or alternative sources, this has not been the case for most developing nations who lack the regional partners and global presence to ensure the provision of additional agricultural stocks in times of global supply squeezes.

The outsized impact of the war in international food markets is reflected in the sharp jump in the aggregate price index of grains between February and April, at just over 16 per cent (figure 2.9). The two countries' key role in global wheat supplies translated into a surge of over 30 per cent in international wheat prices during this period. Moreover, the shortfall in wheat supplies coming from the Russian Federation and Ukraine has hit Africa and the Middle East particularly hard as these regions rely on these two countries for an outsized share of their wheat imports. For its part, maize prices also saw precipitous increases in the aftermath of the war, rising by more than 20 per cent in the following two months. Largely unrelated to the war, soybean prices have also remained at elevated levels since the beginning of the year due to adverse weather conditions in producing countries, namely Argentina, Brazil and the United States.

In reaction to growing domestic price pressures on staple food items, a number of countries instituted food export restrictions in an effort to bring down prices. While such measures may have provided some relief in the short-term domestically, they have exacerbated upward price pressures internationally.

An important additional factor weighing on current and future food prices has been the disruption to worldwide fertilizer supply from the war. As mentioned earlier, together the Russian Federation and neighbouring Belarus account for a substantial chunk of worldwide fertilizer exports. The 2021 sanctions on Belarus international sales of potash – a key ingredient in fertilizers – have intensified the already sharp upward trend in prices observed since mid-2020. According to data from the World Bank, while the aggregated price of food rose by almost 80 per cent from May 2020 to June 2022, that of fertilizers increased by just shy of 230 per cent over this same period (World Bank, 2022b).

Moreover, the introduction of a fertilizer export ban by China in an attempt to alleviate domestic price pressures has only added to the tight supply conditions internationally. The scarcity and steep price increases of fertilizers has important implications for food markets, as these factors will inevitably translate into a reduction in their usage by farmers, thereby lowering crop yields and provoking a further increase in food prices. The situation is even more dire for many small-scale producers in developing countries, for whom the lack of access to or prohibitively high prices of fertilizers will translate directly into increased hunger and poverty rates.

Like the developments in energy and food markets, industrial metals also registered sharp increases since the war broke out in late February. The industrial metals index rose by 9 per cent between April and February, with the price of aluminum and nickel (for both of which the Russian Federation is an important global supplier) registering substantial increases.

However, true to the sudden reversals observed in the last two years, talk of a sustained upward trend in commodity prices – with some analysts even prognosing another super-cycle similar to that seen in the first decade of this century – was quickly quashed as substantial declines were observed in the price of a range of commodities from April onwards. The aggregate commodity price index dipped by 12 per cent between April and July, with the prices of industrial metals and grains registering declines of 28 per cent and 21 per cent, respectively. Grain prices by mid-year had returned to the levels observed prior to the war, while in the case of industrial metals the downward movement in prices brought price levels close to those prevailing at the beginning of 2020, prior to the pandemic. With regards to energy commodities, the decline between April and July was more moderate, at just 1 per cent. However, comparing energy prices from their peak in early June to their value at the end of July, we observe a sharp decline of 18 per cent, with the notable exception of European natural gas prices which have remained near historical highs (figure 2.9).

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 expansion of the Chinese economy, partly explained by strict lockdowns in response to new Covid-19 outbreaks but also by more long-term challenges and weaknesses in certain key economic sectors (see section D, chapter I), 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, two United Nations-brokered agreements with the Russian Federation, Türkiye and Ukraine – the Black Sea Grain Initiative to get grains out of Ukrainian ports, and the *Memorandum of Understanding between the Russian Federation and the Secretariat of the United Nations on promoting Russian food products and fertilizers to the world markets*, managed to ease upward price pressures on these products, and led to a 5-month streak of declines in the FAO Food Price Index.

However, as important as these physical demand factors on recent price dynamics are the financial factors lying behind price movements. The recent drop in prices points to the ever more financialized nature of commodity markets. As commodities have increasingly become a financial asset, huge

quantities of money are traded daily on commodity futures throughout global markets, with investors' decisions having an outsized impact on prices. In fact, part of the recent downturn in prices is crucially linked to the impact of the tightening of monetary policy in the developed world on investors' decision calculus (see box 2.3). Successive rate hikes by the United States Federal Reserve between March and July, totaling 225 basis points, have precipitated a significant increase in real interest rates. As a result, in April real yields on United States Treasury securities moved back into positive territory for the first time since March of 2020 and continued their upward trajectory, motivating investors to shift financial investments away from commodities towards such positive yield-bearing assets. These financial developments have played an important role in the recent retreat observed in commodity prices.

Although the prices of various commodity groups had by mid-year returned to levels similar to those observed before the outbreak of the war, it is important to remember that such prices do still represent historically high levels. Moreover, the recent drop in dollar-denominated international commodity prices has not translated into a significant easing of domestic inflationary pressures on these products in many developing countries as rapidly depreciating local currencies – an inevitable consequence of the abrupt tightening of monetary policy in developed economies – have kept local prices of many energy and staple food products at exorbitantly, and often prohibitively, high levels. As a result, poorer households in the developing world continue to suffer difficulties in covering their basic needs, while governments in numerous developing countries see their already limited fiscal resources eaten into due to the substantial energy and food subsidies they provide.

Looking to the latter part of 2022 and into 2023, heightened uncertainty on both the demand and supply side will translate into continued volatility in commodity markets, further complicating the picture for developing economies who are particularly vulnerable to such price swings. Broadly speaking, commodity prices are expected to remain elevated through 2022 and 2023 due to a combination of slowing growth and dampening demand that will be offset by continued supply and transportation constraints, as disruptions resulting from the war are expected to have a long-term impact on the supply of raw materials from both the Russian Federation and Ukraine.

### Box 2.3 The war in Ukraine: a shock too far for global food systems?

The war in Ukraine has served as a powerful reminder that local disturbances can carry global consequences. Between them, the Russian Federation and Ukraine are major exporters of vital agricultural commodities, including wheat, maize and sunflower oil, as well as fertilizers (United Nations, 2022a). The disruption to these markets has increased the pressure on international food supply chains, with demand, purchasing power, distribution, and production already under stress even before the war began.

The war comes on the heels of over a decade of turbulence in global food markets. This period started with several episodes of high and volatile food prices between 2007 and 2013. After 2015, the incidence of hunger started to rise, despite remarkable progress in China (FAO, 2020). Then Covid-19 struck at livelihoods, disrupting global and local food systems, although food workers were quickly dubbed "essential" and some local systems could adapt quickly to the changed conditions and were able to continue supplying food. Many governments in the world also helped food distribution systems by providing pandemic relief to their citizens in the immediate aftermath of the economic lockdowns.

The war represented a distributional shock. Ukrainian grains, for example, were still there, ready to be exported, but the primary export route via the Black Sea was abruptly closed. Initial uncertainty over how long the war would last inevitably sent prices higher. Existing contracts lapsed and buyers and traders scrambled to find new suppliers. The immediate implications of the supply shock were especially severe for the Middle East and

North Africa, a region that imports most of its grain from the Russian Federation and Ukraine. Behind that abrupt change, longer-term threats to agricultural production and storage in the region loomed large. The war also sent energy prices soaring, affecting fertilizer production costs even as both Belarus (before the war) and the Russian Federation' fertilizer exports were cut off. High energy prices also make the whole value chain more expensive, including the costs of food storage, processing and distribution.

The importance of exports from the region and uncertainty of how long the war would drag on also fueled speculation. Excessive speculation on commodity markets likely amplified the price increases for grains that followed the start of the war in Ukraine (Russell, 2022). Changes in futures prices for wheat were even more extreme, increasing by 50 per cent in the globally price influential Chicago futures market in February 2022, subsequently falling by 18 per cent in March.

Futures and forward contracts are normal market instruments, improving liquidity conditions by helping participants involved in producing, trading or consuming those goods to arrange a set price at a determined point in the future. Speculators have different objectives, betting on the direction of price movements. When many speculators enter into trades on agricultural markets with the same assumptions around crop, climatic and political conditions, they can amplify price movements in ways that are delinked from actual and anticipated supply and demand.

The German research institute ZEF (2022) found that the share of non-commercial traders (speculators) holding long positions (buying) in hard wheat and corn rose sharply to 50 per cent in early 2022, a situation that often corresponds to price spikes. Lighthouse Reports, an investigative journalism NGO, reported that in April 2022, investors pumped $1.2 billion into two major agricultural Exchange Trade Funds (ETFs track market prices for a basket of commodities), compared to just $197 million for the whole of 2021. Agricultural price indices are often a small share of the total ETF price index, but when energy prices are weighted more heavily in the ETF index formula, agricultural prices follow energy price trends. The United States and the European Union instituted some controls on financial speculation in physical commodity futures contracts in the wake of the 2009 financial crisis, but the controls have been weakened since.

For people who live in low-income, import dependent countries, even short-lived exaggerated price swings can have long term effects on food prices, increasing the incidence of food insecurity. Price swings delinked from supplies, especially when amplified by investors' expectations, disrupt planning for future crops and food supplies. In addition, the opacity and high levels of concentration in supply chains create the real risk that consumer prices will continue at historically high levels, even as farmgate and export prices have started to fall. New approaches to diversifying risk, including the establishment of grain reserves and encouraging planting of a broader variety of cereals suited to local climate and cultural conditions, would increase the stability of food supplies and prices.

More comprehensive information about supply chains could aid that process. The Agricultural Markets Information System (AMIS) was set up by the G20 after the 2007—2008 food price crisis to increase transparency in markets. For the most part, countries utilize reserves to smooth out supplies to national markets, although there are some important experiences with regional grain reserves in Asia, under the auspices of ASEAN, and in West Africa. While exact information on food stocks is difficult to gather, AMIS reports that "[l]ed by traditional holders of large public reserves such as China and India, grain stocks in developing countries more than doubled between the mid-2000s and today (FAOSTAT, 2020)." Of course, the existence of food stocks is not enough. They must also be available to stabilize markets. IPES-Food reports that the greatest knowledge of how much grain is at any given place in the world at any given time is knowledge held by private companies, in particular the "ABCD" of grain traders: Archer-Daniels Midland, Bunge, Cargill and Louis Dreyfus (Farchy and Blas, 2021). With those firms accounting for 70-90 per cent of global grain trade, their reserves are likely to be sizable. And with commodity speculation mounting, they have a clear incentive to hold stocks back until prices are perceived to have peaked (IPES Food, 2022).

On the demand side, financial speculators rushed into wheat futures, commodity swaps and agriculture-linked exchange traded funds (ETFs), immediately following the start of the war in Ukraine. The share of speculators in buy-side wheat futures contracts has increased from 23 per cent of open interest in May 2018 to 72 per cent in April 2022 (Agarwal et al., 2022). By April 2022, seven in ten buyers of futures wheat contract were investment firms, investment funds, other financial institutions and commercial non-hedgers whose aim was to profit from the rise in prices; Agarwal et al. (2022) find that investment firms increased their presence in the buy side of the wheat futures market in Paris from 4 per cent of open interest in 2018 to 25 per cent in April 2022, and investment funds increased their presence from 1 per cent to 21 per cent of open interest. Data from the CFTC also show increased speculative activity in wheat in the Chicago Board of Trade (CBOT), as is clear from the strong growth in Exchange Traded Funds (ETFs) linked to agricultural commodities in 2022. Financial investors are cashing in on rising food prices.

Public food stocks could play a role to stabilize markets and offset the concentrated power of the big private traders. Debates on international food security and stockholding often pit arguments to use free trade and global markets as the ultimate reserve against the long history of national public stocks as a tried and trusted food security mechanism. In fact, stocks and trade can usefully be seen as complementary strategies. If under perfect free trade conditions, public stocks create a market distortion, under actual open trade conditions—a context rife with market failures and distortions, including highly concentrated market power—public stockholding can be seen to offer important benefits. Ideally, public stocks will be thoughtfully integrated into commercial markets, to limit the power of either government or the private sector creating a widespread price shock. Note that stocks occupy a difficult terrain in economic policy where commercial and public interests meet and to some extent collide. Neither a purely private sector nor a purely government-controlled response is likely to prove as effective as policies that recognize the need for co-existence. Public stocks can provide a form of collateral in open markets, protecting against supply shocks that may curtail imports unexpectedly by bridging the gap before imports resume.

Some progress along those lines was made when countries at the WTO agreed in 2013 to refrain from challenging the way India procured food for its public stocks program until the rules of the Agreement on Agriculture could be revised to the satisfaction of all WTO members. The eventual negotiation of such a solution is a necessary first step. Those rules should include safeguards to ensure that public stocks are not dumped on international markets, where they could undermine farmers and food production in other countries.

The Ukraine crisis also showed a new wave of export bans and restrictions on foodstuffs from exporting countries. Things have eased a little since the spring of 2022 but the WTO rules in this regard remain inadequate, deepening the qualms net food importers already experience in trusting their food security to international markets (Espitia et al., 2022).

Other factors deepening the effects of higher food and fuel prices include the deepening debt crisis, a problem that has never really gone away, but that has risen again sharply due to the pandemic and the continued failure to force creditors to do something about the crippling effects public indebtedness has across developing countries. An estimated 60 per cent of least developed and other low-income countries were at high risk of or already suffering in debt distress, spending an average of 16 per cent of their export earnings simply to service their external debt—and Small Island Developing States averaged more than 32 per cent (see section B above). In 2022, these countries have seen the cost of their food imports rise, while their ability to pay has been eroded by the cost of servicing their debt, which has risen with rising interest rates, a higher valuation of the dollar, and higher risk premiums due to increased volatility in commodity futures and bond markets.

The crisis sparked by the war in Ukraine and the subsequent shocks to global supplies of grains and fertilizers drives home the imperative for diversification in which countries grow critical food crops. The unfolding climate catastrophe illustrates the need to diversify which crops are grown, both to respond to an increasingly erratic climate and to improve nutritional diversity. Global cooperation on those issues, as well as enhanced coordination on the regulation of markets, trade and reserves, could help to build resilience against the future shocks that are certain to arise.

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# Chapter III

## South-Led Integration in a Fragile World

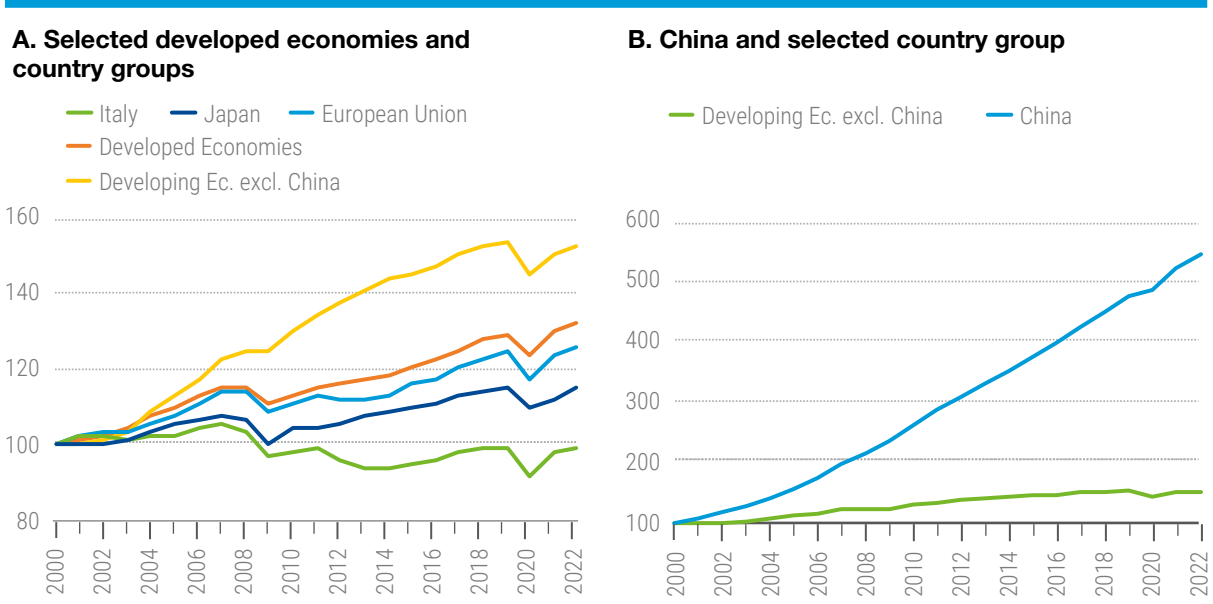
# A. THE LONG SHADOW OF PAST AND PRESENT MISTAKES

Chapter I has shown that 2022 and 2023 are set to be years of slowing economic growth, not just compared to the exceptional growth numbers of 2021, but to the already downbeat predictions of earlier this year. Whether or not this translates into a full-blown global recession, deteriorating macroeconomic and financial conditions will heighten the vulnerability of households, businesses and governments, particularly in the developing world, to any further shocks.

As argued in previous reports, a growth slowdown in any particular year may be triggered and aggravated by specific events, but their intensity and impact depend on underlying trends that shape the workings of the global economy and its responses to shocks. Key trigger factors this year have been the war in Ukraine, the interest rate hikes adopted by leading central banks to bring down inflation and the sharper than expected slowdown in China. These factors have ignited a highly combustible pile of problems in financial, commodity and labour markets that can be traced to underlying trends. In particular, financialization and corporate concentration have contributed to highly skewed patterns of income distribution, rising levels of indebtedness and constrained investment (both private and public) across the world, weakening global demand and growth prospects. In labour markets, fragmentation associated with global supply chains, along with the weakening of trade union power, particularly in developed economies, has contributed to subdued wage growth. Since the occurrence of rogue events – such as health, military or environmental crises – can be mitigated but never completely eliminated, leaving social and economic imbalances to fester bears a high risk.

For developed economies, the current slowdown of growth is concerning because it signals a return to the sputtering recovery that followed the 2009 recession (*TDR*, 2020). Developing countries have exhibited a more uneven picture, but even China, the strongest performer of the group for the last 20 years, is now growing at its lowest rate in decades. Everywhere, slower growth of GDP since the middle of the last decade means incomes that barely keep up with population growth (figure 3.1) and lower inducement to invest, including in industrialization and the green transition.

**Figure 3.1** Real GDP per capita, selected countries and country groups, 2000–2022
*(index numbers, 2000=100)*




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model and AMECO.
*Note:* Underlying data correspond to constant 2005 dollars. Aggregates were computed using market exchange rates as weights.

# B. THE ISSUES AT STAKE: COMPOUNDING THE INEQUALITY-ENVIRONMENT DOOM LOOP

## 1. The inequality-recession loop

A look at the composition of demand for goods and services underscores challenges in income distribution, investment, government spending on goods and services and in trade, confirming the analysis of previous reports (*TDR*, 2019; 2021).

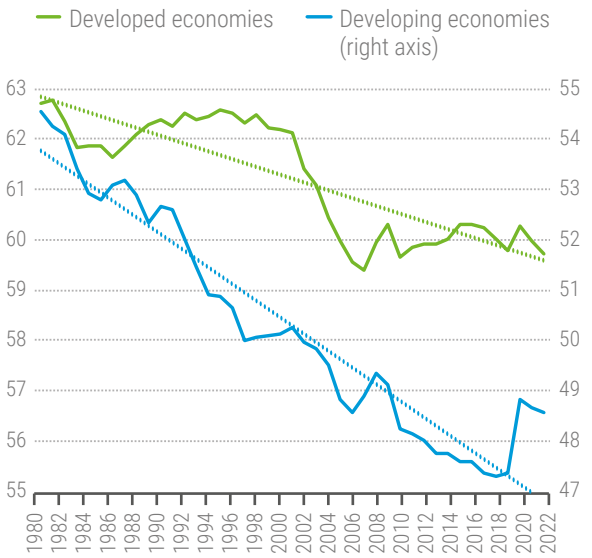
The share of total income accruing to wages is an important indicator of economic health, reflecting the cost of labour relative to total costs and the level of inequality generated by the labour market (before government transfers). As lockdowns suddenly reduced profits in 2020, labour shares across the world increased. But that process was quickly reversed as economic activity picked up again (*TDR*, 2020): record growth in 2021 was accompanied by a decrease of the labour share of income in both developed and developing countries. This is a common occurrence when economies come out of recessions: firms initially increase output by reducing idle capacity and underutilized work hours. But the extent to which the labour share decreases as a result depends on how quickly wages react to a tightening of the labour market. Strong labour representation can be expected to result in quicker compensation increases. In fact, over the past 50 years, wage growth has weakened in subsequent recoveries. This is particularly the case in developed countries, whilst in developing countries, wage responsiveness is clearly higher than in 1970 (as signalled by an upward 50-year trend). However, even in developing countries, wages' response has been more muted in the post-2009 and post-2020 recoveries than in previous recoveries. Overall, at least since 2009, labour markets have been delivering a more unequal distribution of income. Added to this, when wage data for 2022 are collected, they are likely to show a loss in purchasing power which will be reflected in a lower labour share, following higher inflation worldwide. Indeed, as seen in chapter I, wages are lagging price inflation in most parts of the world economy.

Falling labour shares have, in many countries, been linked to export-driven growth strategies and welcomed as signalling a country's gains in competitiveness. This interpretation is misleading (*TDR*, 2019; 2020). In fact, falling labour shares have also been the effect, not just a cause, of slowing global growth: with weak domestic demand for consumption and investment, pressure has increased on both developed and developing countries (whose investment and public spending have been constrained) to compete for higher shares of export markets. Slowing global demand and GDP growth have led to an ever-tighter race to the bottom. This phenomenon is hidden in years of upheaval, such as 2009 or 2020, but emerges clearly in subsequent recoveries. What is also clear is that for this process to be reversed and household demand to recover healthier growth rates, wage growth would have to accelerate and remain higher for many years (Taylor, 2020).

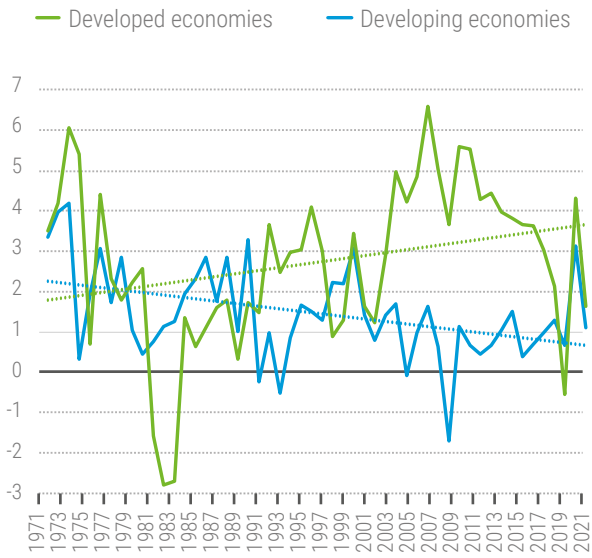
In the past decade, a growing protectionist rhetoric in developed countries has echoed the concerns of workers and smaller firms who have been on the losing side of the distributive struggle (Ferguson et al., 2020; 2021). But this has not been reflected in a clear or consistent policy shift. Developed countries have supported and protected specific domestic sectors, targeted key industries abroad, and prevented developing countries from doing the same, continuing their push for asymmetric rules in the World Trade Organization. However, these responses have not diminished the reach of the key players, such as large corporations (both national and transnational) and financial investors, whose dominant positions are protected by the rules (Baker, 2022), such as TRIPS. Thanks to their market power, these corporate players continue to advocate for a global race to the bottom in taxation, welfare and working conditions, influencing fiscal and policy space everywhere. In other words, protecting firms does not translate to protecting workers or other segments of society.

**Figure 3.2** Primary income distribution, developed and developing economies, 1971–2022
*(percentage)*

**A. Labour shares**




**B. Growth rate of average worker compensation**




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.
*Note:* Labour shares are total income from employment (as a share of GDP) Aggregates are computed using PPP weights.

## 2. Fiscal and monetary policies

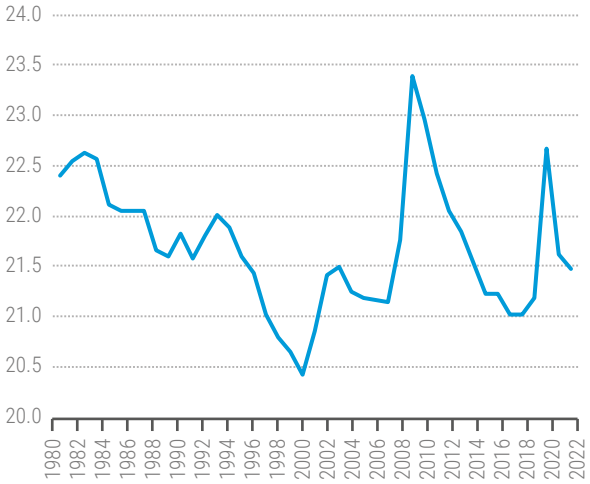
Government spending on goods and services, a key driver of the level of economic activity, has been decreasing as a share of national income for four decades. This has been the case in both developed and developing countries, with pressures to "rebuild fiscal buffers" increasing after each recession, based on the idea that discretionary but temporary fiscal expansions during economic shocks suffice to keep the economy close to its optimal equilibrium level (*TDR*, 2021).

However, it has been amply documented that such counter-cyclical expansions do not generally allow an increase in potential output, as this results from a stable growth of income, aggregate demand and technical progress (McCombie and Thirlwall, 2004; Ocampo et al., 2009; Storm and Naastepad, 2012). A purely countercyclical approach to fiscal policy not only appears insufficient to face the great challenges of reducing inequality and mitigating the impact of climate change, but also seems detrimental to its own declared objective of fiscal sustainability (as opposed to an approach that admits both countercyclical measures and enduring fiscal support to stimulate the creation of more capacity). Decades spent in pursuit of balanced budgets have intensified the cyclical fluctuations of income and employment, forcing governments and central banks to deploy large emergency disbursements in the downturns, often inefficiently (*TDR*, 2021).

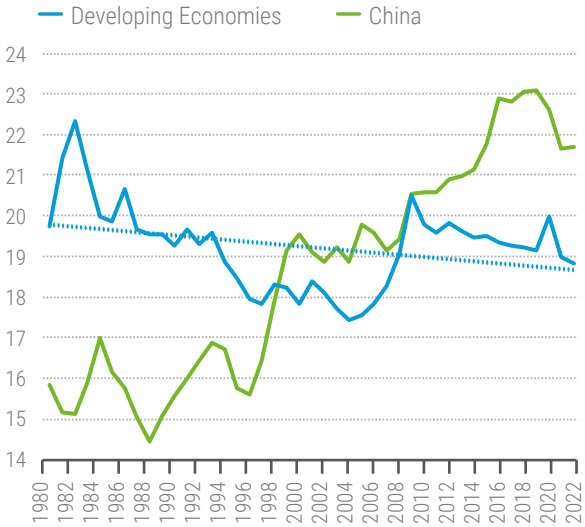
This endemic austerity, anchored to the dogma of expansionary fiscal contraction, has deprived the global economy of critical demand support, especially after 2010, slowing down overall growth and acting as a drag on consumption and investment. When growth rates are high, declining public spending as a share of GDP (figure 3.3) may indicate that government spending is efficient (positive multiplier) or that the economy is being driven by exports (which can support growth in a few countries but not in the whole world) and debt-fuelled private demand: both unstable sources of growth. But when growth rates are low, the declining trend is a clear sign that economies are deprived of sufficient public spending.

**Figure 3.3** Government spending on goods and services, developed and developing economies, 1980–2022 *(percentage)*

**A. Developed economies**




**B. Developing economies**




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

The reversion to austerity post-2020 is still ongoing, but data indicate that it may be even sharper than post-2009. Even in 2020, the year of massive fiscal packages, government spending slowed down globally compared to 2019. The fiscal expansion in the recession year of 2020 has been smaller globally than during the global financial crisis (GFC), a fact that can hardly be reconciled with the needs of today's global economy. Partly, this was because of the massive change in the composition of fiscal spending: during the lockdowns of 2020, transfers had priority over public works and other programmes that sustained labour demand. But in today's spiralling climate and energy crises call for massive state-led investment (both to increase energy efficiency and to develop supply of renewable energy). China stands out in this context, as the only large economy not exhibiting a contractionary "shark fin" pattern. Given its fast and steady progress in industrialization, growing living standards and energy efficiency, it is no surprise that a growing share of total income has been devoted to government spending on goods and services.

Underneath this global pattern, the differences between developed and developing countries are remarkable. Developed countries and China still had positive growth of government spending in 2020, although slower than in 2019. All other developing countries, on average, experienced a contraction of public spending in absolute terms, although the contraction of GDP was even more pronounced. This highlights the constraints developing countries are subject to in the global financial architecture.

The year 2021 saw a global acceleration of spending in absolute terms, for both developed and developing countries, while early data for 2022 point to another downswing. One component of public spending that has regained prominence this year is military spending. If military rivalry between major economies intensifies, this category of spending is bound to gain increasing importance in the medium term. But unlike the world war years, studies indicate that a military build-up today may prove a drag on the economy, cutting into aggregate demand, as the main items of military spending have little positive effect on the economy and tend to be financed with spending previously destined to more economically impactful uses (Becker and Dunne, 2021).

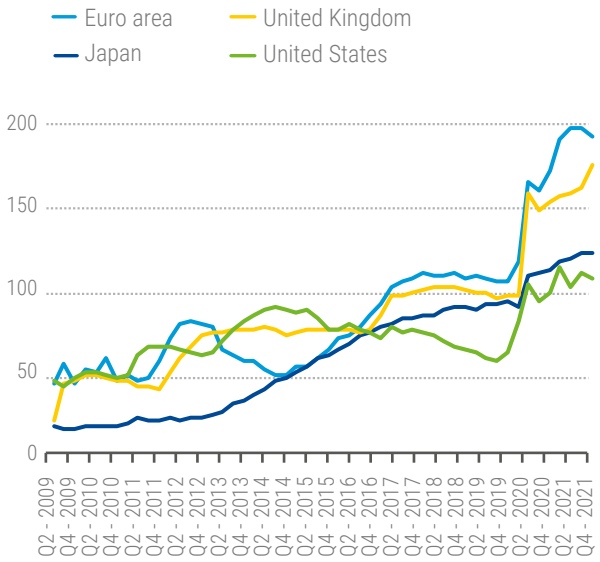
Monetary policy has been at the forefront of macroeconomic stabilization efforts since the beginning of the quantitative easing (QE) programs of the United States Federal Reserve (hereafter the Fed). When the fiscal channel dried up in 2010 (after a short-lived stimulus) but growth and inflation remained low, developed countries relied on large purchases of bonds and other securities by their central monetary authorities to support long-term in 2010 credit creation, while maintaining the smooth functioning of the money markets.

Within a few years, all major central banks developed their own QE programs, sometimes exceeding the Fed's both in value and as a share of GDP. Nonetheless, the role of the Fed has remained crucial since dollar-denominated liabilities held by entities outside the United States and the trades necessary to fund them have become even more prominent in the past decade: "US dollar funding remains below its peak of a decade ago relative to the size of the global economy, despite having grown in nominal terms. However, the share of international funding that is denominated in US dollars has risen compared with other major international currencies, reaching levels last seen in the early 2000s and making it the dominant international funding currency" (Committee on the Global Financial System, 2020).

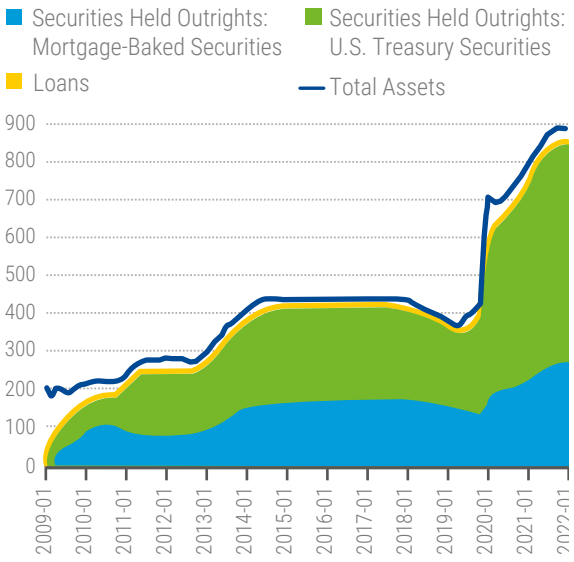
In particular, a greater share of US corporate bonds is held by non-US-residents (Lysandrou and Nesvetailova, 2022). Moreover, in a context of low interest rates, the search for higher yields made dollar denominated bonds issued by emerging economies particularly attractive: "EMEs as a whole, and China in particular, have become both larger borrowers and larger suppliers of US dollars, especially via the bond market" and including issuance from offshore financial centres (figure 3.5; Shin, 2013; Committee on the Global Financial System, 2020).

**Figure 3.4** Assets and liabilities of major central banks, developed economies, Jan. 2009–July 2022

**A. Monetary base** *(percentage of GDP)*



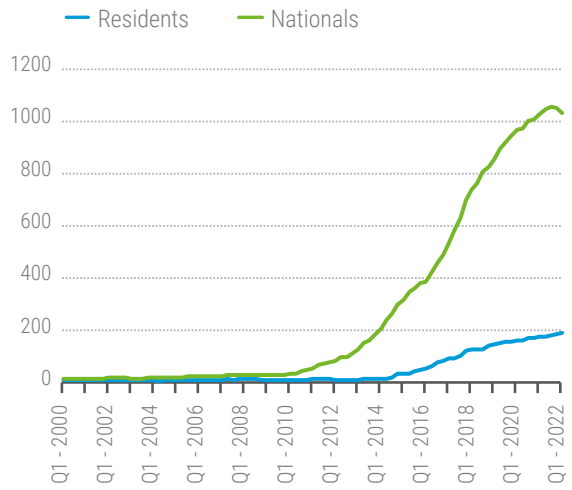

**B. Assets of the Federal Reserve** *(billions of dollars)*



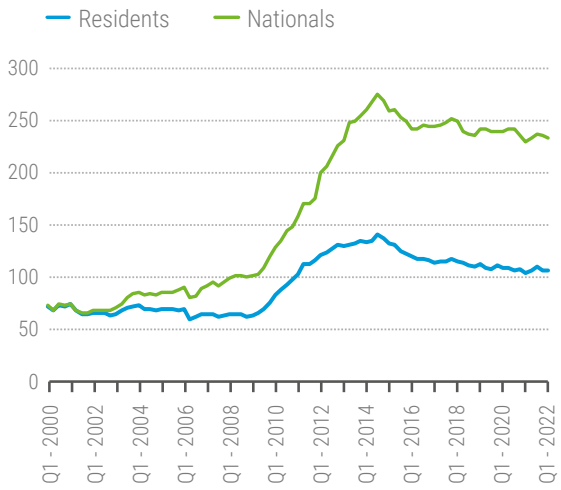

*Source:* IMF, International Financial Statistics, Monetary and Financial Accounts, Central Bank, Monetary Base, Domestic Currency and FRED, Federal Reserve Bank of St. Louis.

**Figure 3.5** International debt securities outstanding, selected countries, 1st quarter 2000–1st quarter 2022 *(billions of dollars)*

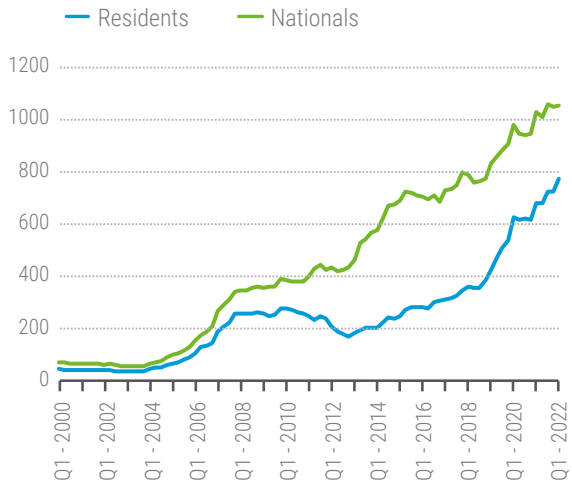
**A. China**



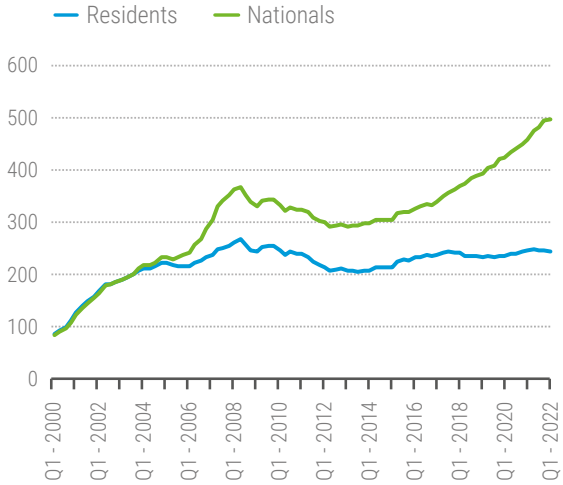

**B. Brazil**




**C. India**




**D. United States**

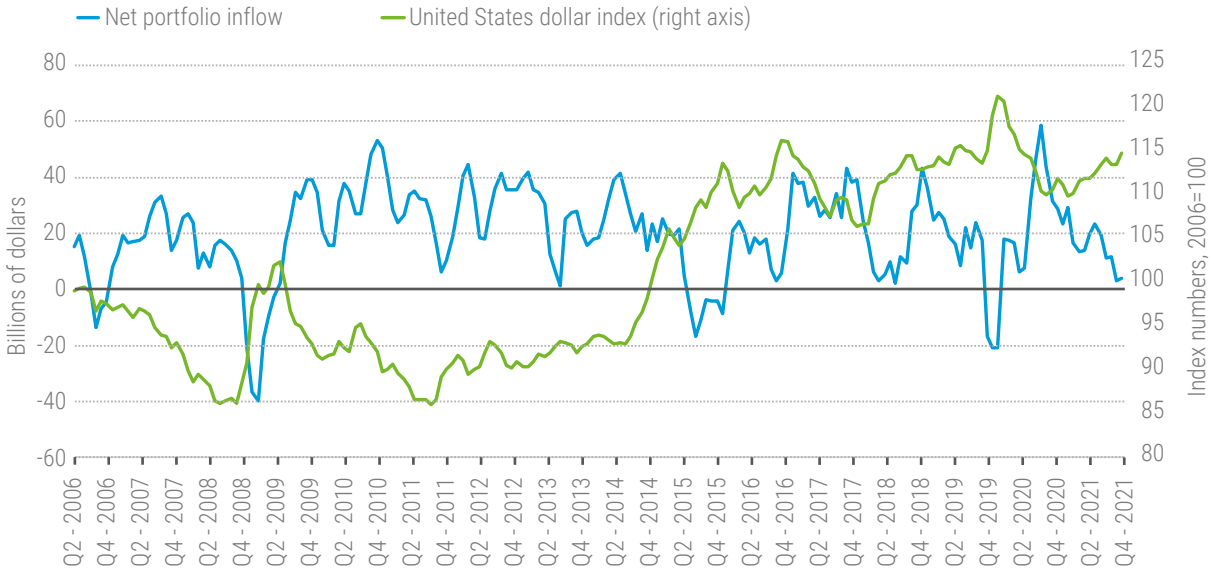



*Source:* Bank for International Settlements.

As a result, the Fed's decisions reverberate globally via at least three channels.

First, it is able to affect liquidity in key domestic and international markets. In particular through swaps and repurchase agreements (repos) of various collateral from private domestic and public foreign entities, it has repeatedly been able to prevent money market freezes, at least in the core of the global financial system. However, it has been far less efficient in disciplining cyclical expansions of global finance in a context of international capital mobility.

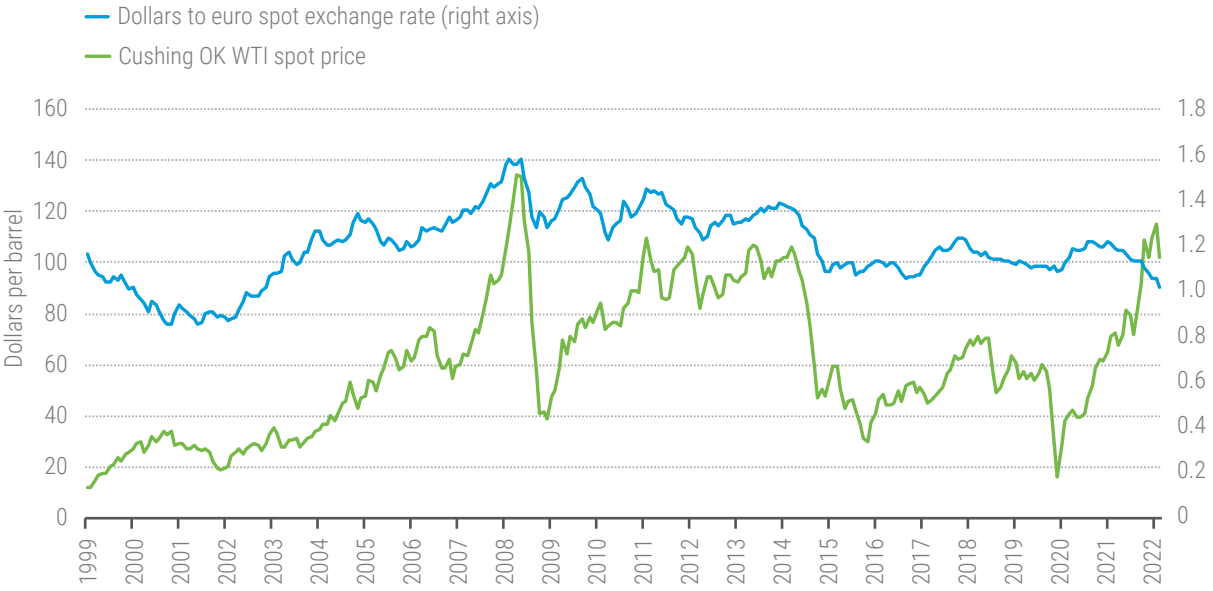
**Figure 3.6** Net portfolio flows to emerging economies and Nominal Broad Dollar Index, 2nd quarter 2006–4th quarter 2021




*Source:* IMF (2020) Global Financial Stability Report and Institute of International Finance Capital Flows Tracker.
*Note:* Net portfolio inflows are a three-months moving average (smoothed).

Second, it affects the value of the dollar and, thus, the price of imports and exports domestically and abroad. As a result, it also provides a floor for interest rates in other regions which cannot allow their currencies to depreciate too much against the dollar to avoid over-exposure of their balance sheets to dollar-denominated debt (figure 3.6). From the early 2000s until 2021, oil price movements provided a mitigating factor, thanks to their negative correlation with the dollar (figure 3.7).

**Figure 3.7** Dollar-euro exchange rate and crude oil price, January 1999–July 2022

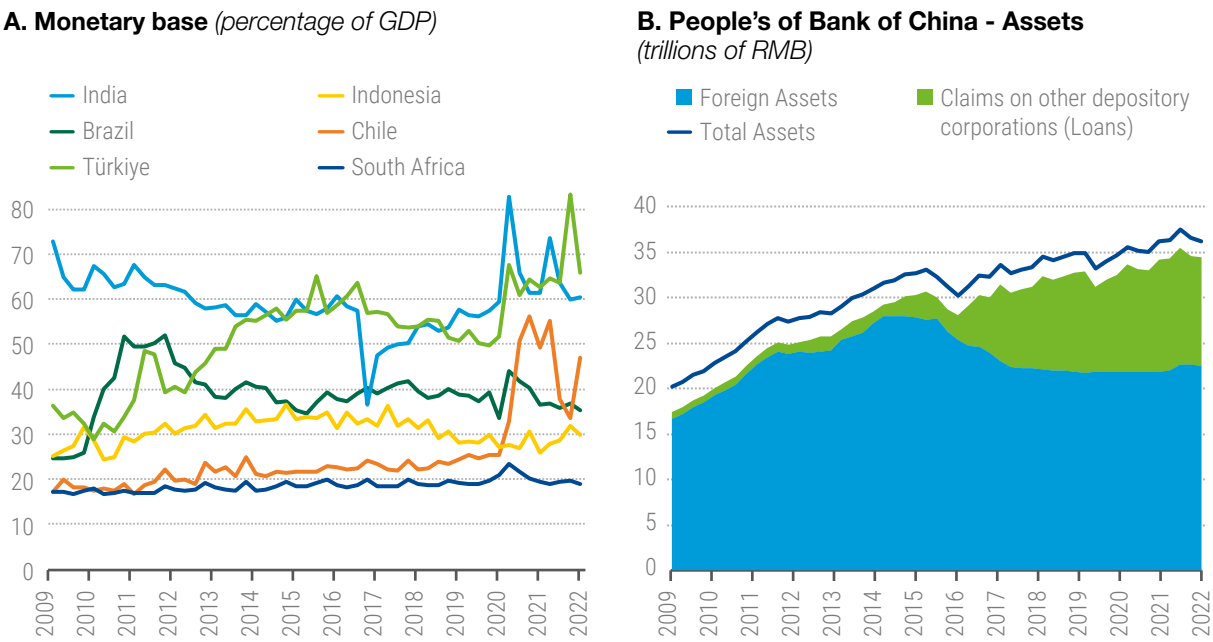



*Source:* United States Energy Information Administration; Federal Reserve Bank of St. Louis.
*Note:* Crude oil price is Free On Board.

Third, it affects growth and private demand in the United States including imports, thus affecting global growth.

During the Covid-19 crisis, the Fed's accommodative stance and its activity in the international repo markets avoided extreme stress in the global money markets and allowed central banks of developing countries to reduce interest rates quite significantly. Indeed, while in many cases they themselves engaged in asset purchases, it was mostly to control portfolio risk rather than to provide a stimulus, which was predominantly supplied in the form of loans, including to public banks (figure 3.8; Aguilar and Cantù, 2021).

**Figure 3.8** Assets and liabilities of major central banks, developing countries, January 2009–July 2022




*Source:* IMF, International Financial Statistics, Monetary and Financial Accounts, Central Bank, Monetary Base, Domestic Currency, and Surveys Based on Non-Standardized Report Forms (Non-SRFs), Monetary Authority.

However, as soon as the economy of the United States started emerging from the crisis and the Fed signalled its intention to raise interest rates in May 2021, those favourable conditions reversed, forcing premature interest rate increases in many developing countries, especially those most exposed to dollar-denominated debt.

The Fed's policy normalization aims at controlling the bubble in commodity prices and preventing higher import and energy costs from spreading into the domestic distributive structure. The announcement of May 2021 was followed by a crucial decision on the officialization of two standing repo facilities, which had been functioning in a temporary mode for some months: one dedicated to United States domestic primary dealers and soon to include additional depository institutions (Standing Repo Facility),[13] and one for foreign and international monetary authorities (FIMA repo facility).[14]

[13] Acceptable collateral are Treasury securities, agency debt securities, and agency mortgage-backed securities.

[14] "The FIMA Repo Facility allows FIMA account holders, which consist of central banks and other international monetary authorities with accounts at the Federal Reserve Bank of New York, to enter into repurchase agreements with the Federal Reserve. In these transactions, approved FIMA account holders temporarily exchange their U.S. Treasury securities held with the Federal Reserve for U.S. dollars, which can then be made available to institutions in their jurisdictions. This facility provides, at a backstop rate, an alternative temporary source of U.S. dollars for foreign official holders of Treasury securities other than sales of the securities in the open market. A temporary FIMA Repo Facility was established March 31, 2020, and the facility was made a standing facility on July 28, 2021" (Board of Governors of the Federal Reserve System, 2022)

The move showed that the Fed's commitment to global financial stability remains unchanged. That, together with the preparedness of the central banks of many emerging economies, has so far prevented a repeat of the 2013 taper tantrum.

But the impact on the real economy cannot be stopped. With fiscal policy invariably muted, with crude oil and gas still at elevated prices, the increased cost of credit is going to affect the most fragile sectors and regions of the world economy through reduced investment, wages and employment growth and liquidity stress, hitting hard the unemployed and low and medium wage earners everywhere, as well as firms and governments with elevated external debt in developing countries (see previous chapters).

The (already restricted) macroeconomic policy space for emerging economies to respond to the challenges of rising prices of food and fuels and increasing food insecurity will become more constrained as monetary policy is tightened in the United States. The timing for this tightening of the fiscal and monetary policy space could not be worse: many governments will be forced to withdraw essential public support schemes which were introduced during the pandemic, just when a fresh cost of living crisis undermines the livelihoods of millions of people across the world.

The appreciation of the dollar will move global demand away from United States goods and towards goods produced in other economies (assuming exchange rates are flexible). While the stronger dollar may lead to (export-led) expansion in some advanced economies (such as Germany and France), many emerging economies will experience net contractionary effects from the nominal depreciation of their currencies (Hirschman, 1949; Krugman and Taylor, 1978), mostly because the stronger dollar will make the essential imports of food, fertilizers and energy more expensive, raising their trade deficits and contributing to higher domestic inflation, which by crowding out demand for domestically produced (non-essential) goods and services will weaken domestic investment and economic growth (Storm, 2022). A stronger dollar has negative effects especially on real investment and real exports in the emerging economies, primarily because the stronger dollar weakens the balance sheets of dollar borrowers whose liabilities rise relative to assets. The result is a weaker credit position of and higher risk premia for (exporting) firms in those emerging economies with relatively large external (dollar-denominated) debts (Akinci and Queralto, 2021). These firms will suffer from a general tightening of global dollar credit supply, including for trade credit (Storm, 2022).

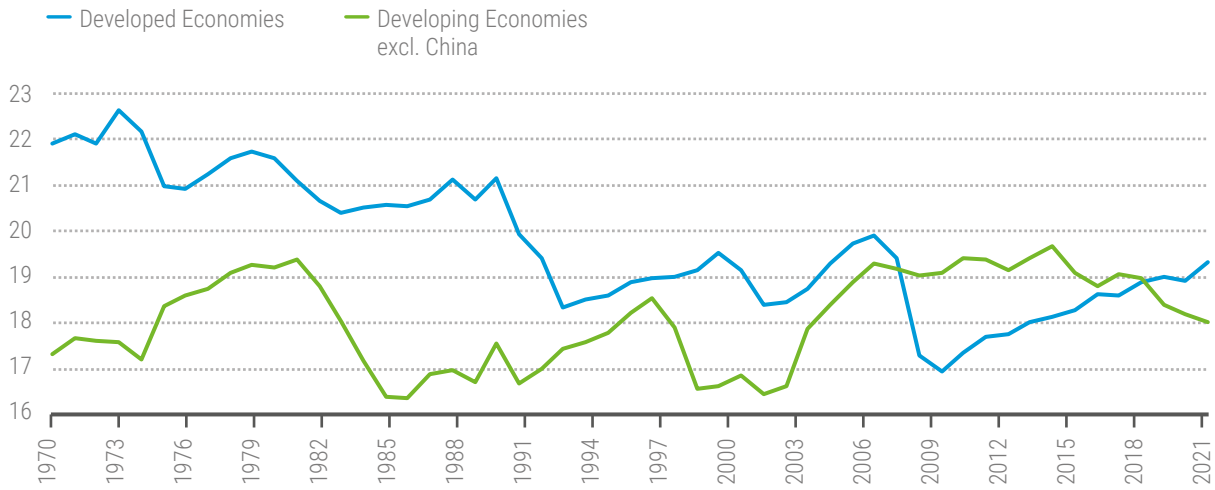
Hence, while central bankers in the core of the international system focus pragmatically on avoiding short term systemic instability, the real economy deteriorates, a fact that is increasingly overlooked by policymakers. Indeed, there are sound reasons to believe the damage done in the short run will spill over into permanent, long-run damage: monetary policy tightening will likely cause the growth rate of potential output to decline. Higher interest rates lower aggregate demand which, in turn, leads to reduced capital formation by firms. The decline in investment lowers the economy's capital stock and productive potential and depresses the rate of technological progress and productivity growth, because technological change is embodied in new capital goods (Storm and Naastepad, 2012; Girardi et al., 2020). In addition, lower demand leads to lower labour productivity growth, increasing the vulnerability to wage-led inflation. Yet most economists assume long-run potential growth is determined by the exogenous forces of demography (i.e. the growth of the effective labour force) and of technology (i.e. exogenous total-factor-productivity (TFP) growth), and most believe monetary policy does not influence these two exogenous supply-side drivers. It is no coincidence that the long-run "neutrality" of monetary policy is a cornerstone of the dynamic stochastic general equilibrium (DSGE) models commonly employed by central banks (Storm, 2021).

What is particularly worrisome is that the commodity price rally initially followed expectations of a global growth rebound, but when the Fed's moves, coupled with fiscal austerity and new international disruptions, changed the economic scenario, many financial markets remained buoyant. The economic recovery did not take place and speculators continued to profit.

## 3. The broken nexus between credit and capital formation

Despite the massive transformational challenge facing the global economy, investment rates across the world have been in long-term decline with sluggish growth even in the best of time (figure 3.9). This has resulted from two main factors: first, the general slowdown in growth, especially the relative reduction of labour incomes, which has slowed down the expansion of household consumption and investment; second, the accelerating process of financialization (*TDR*, 2018), which has led to the un-anchoring of asset creation from capital formation. Making matters worse, investment is in a well-known cause-and-effect relationship with growth, as it is strongly affected by expectations. If growth is expected to slow, investment declines, fulfilling the expectation.

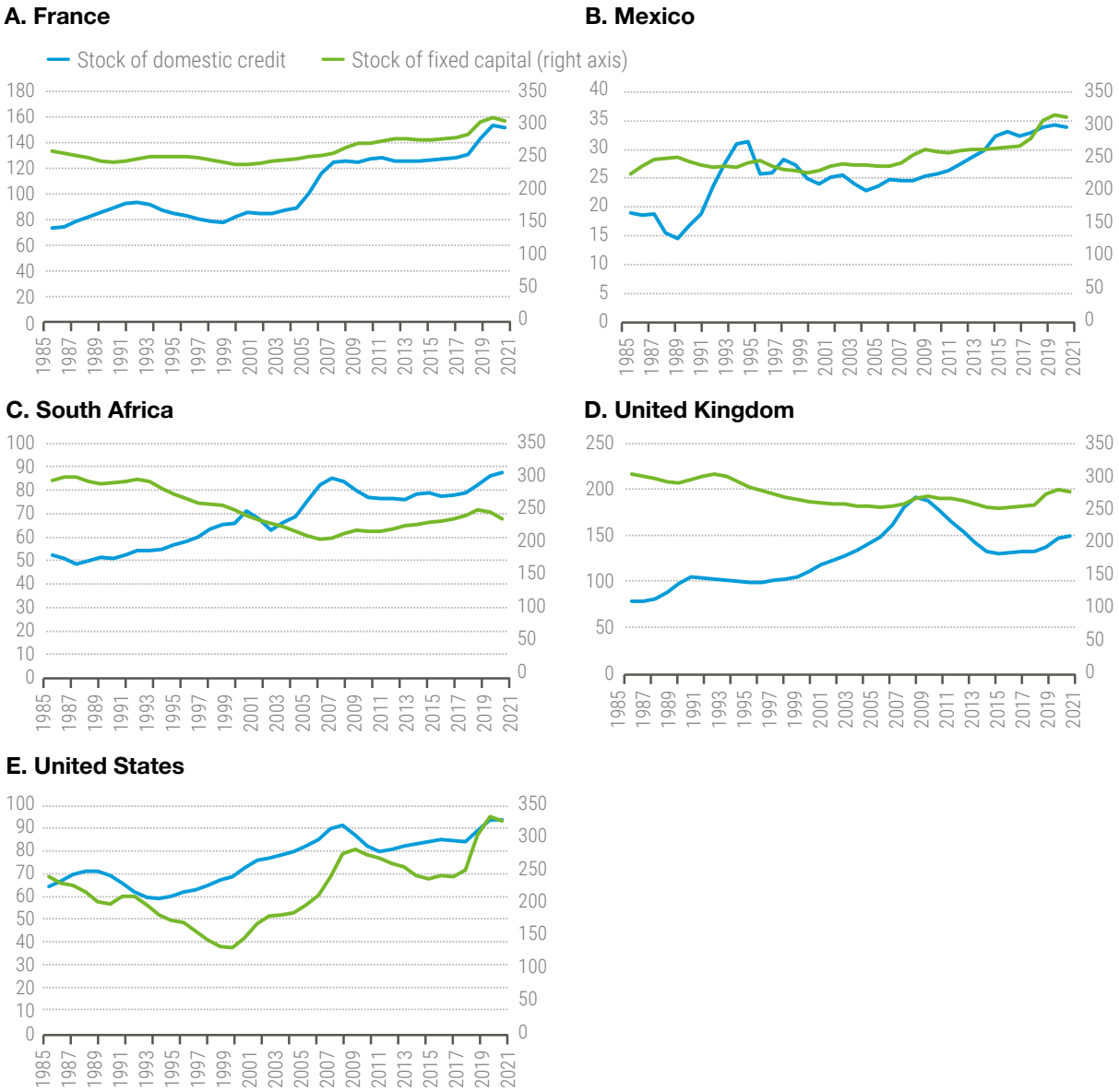
**Figure 3.9** Private investment, developed and developing economies, 1970–2022
*(percentage of GDP)*




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.
*Note:* Aggregates are computed using PPP weights.

Financialization has been fuelled by monetary and financial policies. For three decades, across developed and developing economies, credit creation has outpaced and in some cases far outpaced the creation of fixed capital, with the process continuing throughout the Covid-19 pandemic. While major economies have been awash in credit that did not find productive allocation, banking and financial regulation created many opportunities for financial speculation, including the fast-expanding non-banking financial sector (figure 3.10). In this way, short-term speculative uses of funds have outcompeted fixed investment and contributed to undermining confidence by increasing financial instability.

**Figure 3.10** Stock of domestic credit and of fixed capital, selected countries, 1985–2021
*(percentage of GDP)*




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

## 4. Balance of payments vulnerabilities[15]

The immediate policy challenges facing developing countries derive from two broad types of exogenous factors: global shocks that affect the world economy at large and major macroeconomic or trade policy changes in developed countries. These challenges are rooted in developing countries' own financial vulnerabilities and structural weaknesses linked to their role in the international trade and capital markets. In fact, in general, semi-industrialized economies face a binding external restriction on the long-term rate of expansion of their real GDP, reflected in the dynamism of their exports relative

[15] This section is based on Moreno-Brid et al., 2022.

to imports. The trade balance sets a long-term upper bound to the average annual rate at which real GDP can expand without sooner or later incurring a critical disequilibrium in the balance of payments. Of utmost social and economic importance is that this upper bound is lower than the rate of expansion of GDP required to, say, guarantee full employment and given the pattern of fixed capital accumulation.

The vulnerability of developing countries derives from their greater and more structural dependence on imports, a more unstable export basket, a more polarized economy with high levels of informality and a less reliable access to finance. Trade, in particular, is critical to development and potentially a powerful conduit of industrial upgrading and diversification but, for countries that have little influence on international prices and restricted access to large consumer markets, it is also a source of vulnerability (Capaldo and Omer, 2021). When any of those sources of fragility comes to the fore, and the financial outflows severely outpace the inflows, the foreign reserves might drain quickly, and the capacity to borrow and spend (the fiscal space) is often severely impaired, as foreign investors lose confidence and interest rates rise. At the extreme, when the solvency risk increases, the country might experience a serious credit crunch and a capital flight, driving towards default. For instance, in absence of appropriate policies that helped lowering import propensities, periods of expansion necessarily bring about a deterioration of the current account balance, higher inflation and internal indebtedness. If contextually, the government tries to run fiscal surpluses, it is the private sector that carries the burden, at least until the solvency risk transmits to the public sector. But a balance of payments crisis can emerge autonomously from the capital account, rather than from the current account: countries with smaller and less developed financial and banking systems can be quickly overwhelmed by incoming speculative capital flows and thus be driven to over indebtedness. Indeed, finance-driven boom-bust cycles have, as discussed at length in previous reports, been the prime driver of financial and currency crises in developing countries since the 1980s.

Among the challenges policymakers in emerging markets could face in this context, and to an important extent are already facing, we identify the following ones:

I - Sudden and drastic slowdown in the rate of growth of exports: This can happen if the world economy and trade lose impulse. The exports of a balance of payments constrained economy will be affected differently, depending on the specific basket of exports of goods and services and on the geographical composition of the main markets of destination. These two factors also condition the vulnerability of different countries to the introduction of environmental restrictions on certain products and commodities or of protectionist measures to favour the insourcing of selected intermediate inputs and final products due to industrial policies or geopolitical considerations (green-shoring, re-shoring, friend-shoring).

II - Sudden and drastic changes in the prices of exports or imports in international markets: The current global context of high inflation has a very heterogeneous impact between and within developing countries, benefitting or harming them depending on the effects on their terms-of-trade.

III - Rises in the benchmark interest rate in the developed world with the implementation of contractionary monetary policies and the termination of QE.

IV - Higher country risk premiums in developing countries, due to specific national/regional characteristics or to global shocks that detonate a “flight to quality” in short-term capital flows.

V - Excessive foreign debt repayment burden: A rise in the proportion of foreign debt that must be repaid in the period of analysis may push a country to an insolvency crisis, in conditions where its access to international credit becomes tightly rationed.

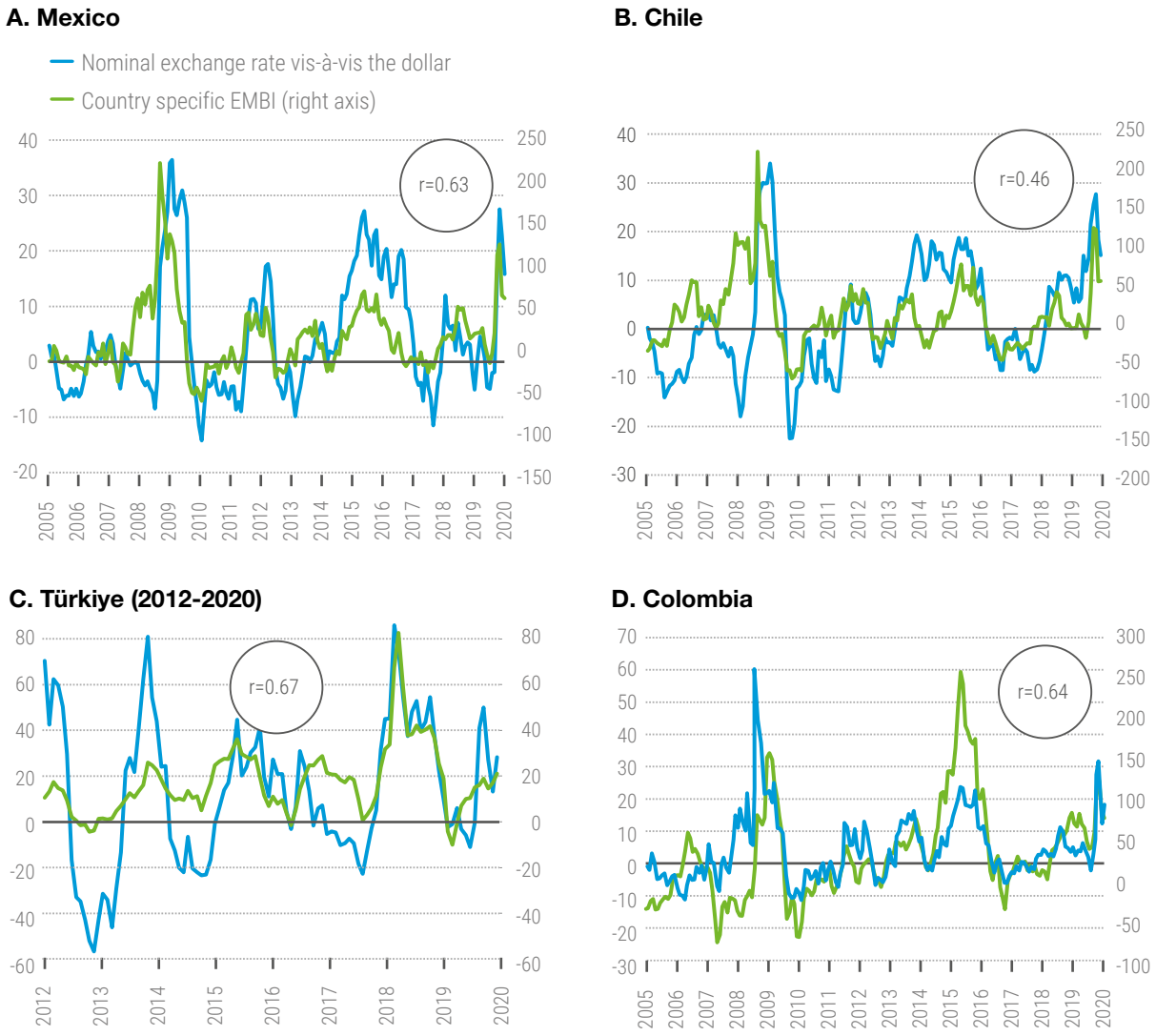
VI - A deterioration in the world financial markets´ perception of the developing economy´s macroeconomic strengths and external debt repayments may make the balance of payments constraint sudden and painfully binding, tightly rationing access to fresh financial resources. Recall that changes in this regard capture major modifications in the assessment of relevant actors in the

world´s capital and financial circles regarding what is a "reasonable" magnitude of the country´s current account deficit cum external debt repayments as a proportion of nominal GDP.

VII - Nominal exchange rate depreciations over and above the increase in domestic prices: Indeed, in cases where this happens, the total value of the current account deficit plus external debt repayments will increase as a share of nominal GDP measured in a common currency. If this increase is high enough, it may trigger a balance of payments crisis.

In addition, a crucial factor to pay attention to when evaluating the role of capital flows and the financial external restriction of the balance of payments is the cyclical behaviours of the nominal effective exchange rate and its close correlation with risk sentiment. For the countries analysed below, the correlation between these variables ranges from 0.4 to 0.6, indicating that when risk perception deteriorates, a sharp correction in the exchange rate follows (figure 3.11).

**Figure 3.11** Annual variations of the nominal exchange rate and Emerging Market Bond Index (EMBI), selected countries, 2004–2020 *(percentage)*




*Source:* Abeles et al., 2020.
*Note:* For the nominal exchange rate, an increase corresponds to a depreciation of the domestic currency vis-à-vis the dollar. The correlation between the two series under the considered period is reported within the circle.

## 5. Losing ground in the fight against climate change

The pandemic has shown that breaking the link between economic activity and emissions is necessary to stabilize the climate. As growth picked up again in 2021, emissions soared to a new high.

If the world is to overcome its multiple imbalances – not just climate change but development and inequalities too – massive investment in transitioning the economy out of its dependence on fossil fuel is necessary.

However, this will inevitably require an initial intensification of emissions (*TDR*, 2019), as the capital goods required for a new energy and productive infrastructure are built. Developing countries, which, in absolute but not per capita terms, became the leading group of emitters early this century, have made tremendous progress in reducing the carbon content of their economic output. However, data indicate that progress in the developed countries in "greening" their GDP has stalled, despite their massive outsourcing of manufacturing to the global South.

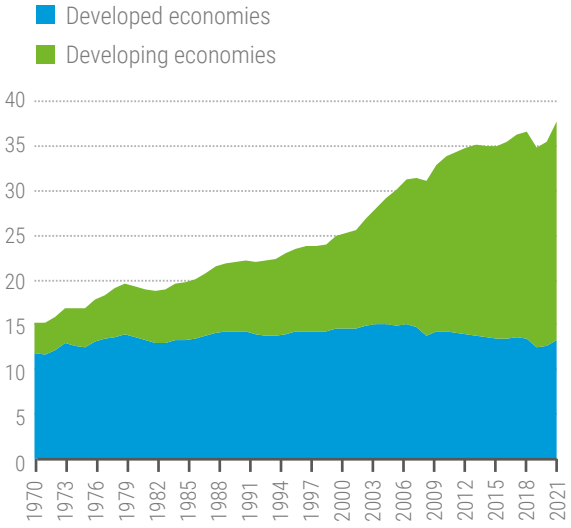
Multilateral discussions on a global climate policy have continued but they have not yet generated a workable compromise on the key issues of emission targets and financing. After the 2021 United Nations Global Climate Change Conference (COP26), discussions on economic commitments, including a New Collective Quantified Goal, doubling adaptation support, new financial instruments and other national and global targets are intensifying. However, the distance between the ambitions of developed countries and their willingness to lend commensurate support to developing countries remains large.

Furthermore, the energy crisis and the geopolitical stresses of this year have generated a strong appetite for cheap fuels and energy independence, both of which have already interfered with climate policies. The immediate response to turmoil in oil and gas markets in many countries has been to demand that energy companies produce more of both (Jenkins, 2022). Meanwhile, some companies have claimed that more exploration and extraction are not financially viable in their structure of corporate governance if prices dip below the high levels of early 2022 (Worland, 2022). This subjects the government to opposing forces: on the one hand, the need to curb consumption of fossil fuels to stop climate change; on the other, the incentive to slow down the energy transition to ensure the energy sector ramps up production of fuels and reduces its costs.

With energy costs at record highs and investment weakening, enforcement of stricter emission standards and other environmental regulation that can drive up production costs has fallen down the priority list for many major economies (Bennhold and Tankersley, 2022; Eddy, 2022; Maclean and Searcey, 2022). Many new rules that have been announced are set to enter into force in a decade or further into the future. In contrast, international trade is one area where emission standards have so far remained current, with items such as the Carbon Border Adjustment Tax discussed in several treaty negotiations (Council of the European Union, 2022).

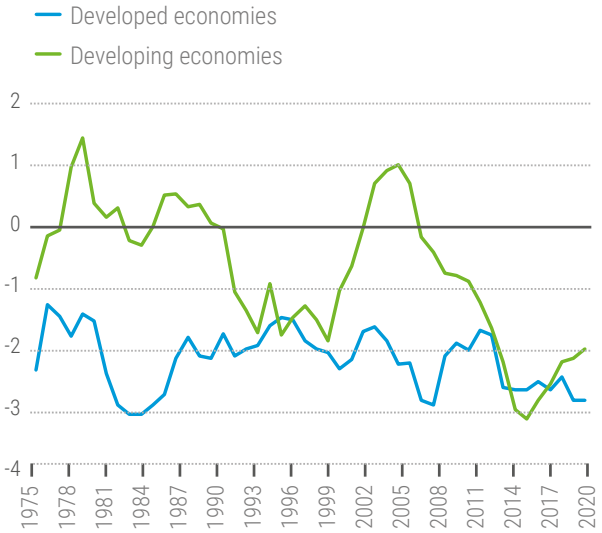
Proposals of trade restrictions based on embedded emissions echo a real concern about the large contribution of merchandise trade to climate change, which occurs both by providing an incentive to consumerism and by generating transport-related emissions. But these proposals pose two problems that do not really make them effective as policy tools. First, they assume reliable data on emissions embedded in international trade exist, while in fact, they are not yet available and given the complexity of value chains, they may never be available with the necessary detail. Second, and more important for development, the proposals would inevitably tighten the foreign exchange constraint that bedevils international trade flows for all developing countries (*TDR*, 2021). While such proposals are formally intended to work as incentives to decarbonize developing economies, in practice they paper over the reality of economies that are structurally at a disadvantage in international exchange and struggle to pay for imports, including costly productive inputs such as capital goods and energy. For most developing countries, this is a compelling incentive to use domestic sources of energy as much as possible, as the foreign exchange constraints pit development and climate goals against each other.

**Figure 3.12** Carbon dioxide emissions, developed and developing economies, 1970–2022 *(billion tons)*




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

**Figure 3.13** Variation of carbon intensity of GDP, developed and developing economies, 1975–2022 *(percentage change)*




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.
*Note:* 5-year moving average.

As a result, proposals to tax embedded emissions have little hope of helping to win the climate fight and are more likely to have two undesirable effects: further constraining industrialization in developing countries in favour of primary sector activities, as explicitly discussed in recent trade negotiations (Capaldo and Ömer, 2021), and pushing many developing countries into a sub-area of trade that makes them dependent on other developing countries with smaller markets and looser environmental requirements (Ömer and Capaldo, 2022).

### Box 3.1 Global value chains and the wage share: what lessons from global and regional trends?[16]

A stable labour share, i.e. the share of labour compensation in gross value added, was a stylized fact of advanced capitalist development, based on the premise that productivity increases would accrue to labour through commensurate real wage increases, keeping (tendentially) constant the share of wages in net output (Kaldor, 1961). However, the labour share has experienced a steady decline in advanced economies at least since the early 1980s. The process did not unfold within each country in isolation. In fact, the early 1980s coincided with the start of an extensive deregulation of product, financial and currency markets (hyper-globalization), a key component of which was the building of inter-country supply schemes. Under such schemes, outsourcing and offshoring practices became prominent, to the point of configuring global value chains (GVCs).

For developing countries, which became the suppliers to leading firms in industrial economies, the process started in the midst of structural adjustment policies in response to debt crises; this implied the dismantling of decades of import-substitution industrialization (ISI) efforts and a shift towards an export-oriented strategy based on import liberalization (*TDR*, 2018). These trends accelerated in the 1990s and

[16] This box is based on Wirkierman, 2022.

early 2000s, changing the nature of international specialization – with a focus on tasks of production, rather than integrated final products – with an ensuing change in the international division of labour. During the latest phase of hyper-globalization (1995 to 2007), the steep trend decline in the wage share was mirrored by a notorious increase in trade integration in value-added terms, but from 2008–2009 onwards, the path became more erratic, reflecting the "great trade collapse" during the GFC, with a speedy recovery which was again subject to a sharp contraction between 2014 and 2016. Yet the global wage share maintained a declining trend (with a temporary increase between 2010 and 2015). Hence, we now live in a world of declining global wage share with faltering globalization.

In short, the relationship between trade integration and wage inequality is complex and ambiguous. Understanding and quantifying it is extremely important, however, as regressive functional income distribution represents an obstacle for socially inclusive trade schemes.

A useful way to study the connection between GVC participation and the wage share is to compute the wage share activated by alternative sources of foreign final demand. The intuition behind this approach runs as follows. The wage share of a country is a linear combination of the wage shares of its industries. Industries produce to satisfy final demand requirements at home as well as abroad. Hence, when a foreign country demands final products which are either directly supplied by the domestic economy or require domestic inputs to be produced, it is activating output at home, which generates incomes, wages and, therefore, an associated wage share. But this domestic output activation across industries occurs in different proportions according to the products composing each specific foreign final demand basket. For instance, when a country in Latin America satisfies Chinese final demand, output from primary industries will be activated in a greater proportion than if the final demand came from another Latin American country, in which case mid-to-high-tech manufacturing products are produced (and traded) in a higher proportion. Thus, if primary commodities and mid-to-high-tech manufacturing products are produced by industries with different wage shares, there are distributive implications of deepening trade integration with certain regions with respect to others. Moreover, given that the home country is often only an upstream producer of certain inputs in a GVC, it is far from apparent what are the ultimate distributive implications of final demand from certain foreign countries, especially when the domestic economy does not have relevant direct trade linkages in final products with those economies, but rather mostly indirect links by exporting inputs through others. Hence, given the different commodity composition of each final demand basket associated to a foreign source of final demand, the wage share activated at home by each foreign country will be different. This is crucial to understand the distributive profile of domestic vis-à-vis international specialization.

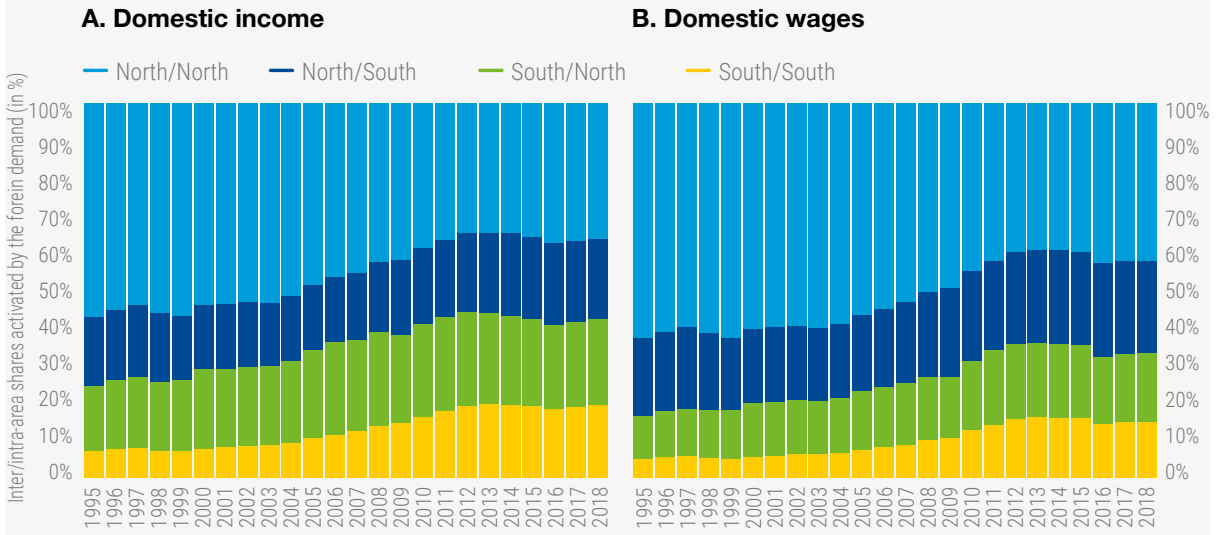
Based on this methodology, it is possible to obtain several important results (Wirkierman 2022).

1 - Sectoral trends across countries: Between 1995 and 2018, there was a generalized decline in the wage share across the high-tech manufacturing core of the economy, accompanied by mild increases in the median wage share for diffused intermediate inputs. Moreover, there were considerable wage share increases in agriculture, logistics, food and accommodation services and business services. That the high-tech manufacturing core of the economy experienced sharp wage share declines alerts us to the potential limits of technological upgrading: it has traditionally been argued that industrial transformation towards high-tech manufacturing is a crucial pathway to inclusive economic upgrading. Indeed, looking at the relationship between the technological content of a country's final export basket and the wage share activated by foreign final demand, i.e. the extent to which technological upgrading in GVCs is more inclusive in distributive terms, we find counter-intuitive results, suggesting the potential for technological upgrading in GVC participation to increase the activated wage share has diminished through time, especially for the global North. Broadly speaking, however, the wage share distribution across countries for each industry has become more "equally unequal" between 1995 and 2018. That is, compared to 1995, data points in 2018 seem to be more concentrated around a lower median wage share for the majority of industries.

2 - Activation and appropriation of global income and wage shares in the global North and global South: Over the same period, the global South caught up in terms of appropriated income shares for both domestic and foreign sources of activating demand. Interestingly, the increasing share of global income (i.e. relative growth) went hand-in-hand with an increasing wage share and vice-versa for the global North. Importantly, in the global South, this growth-distribution nexus has mostly been for the income share activated by domestic — rather than foreign — demand; in the global North losses have been sharper for the wage share activated by foreign final demand, pointing to a cost-cutting mode of international competition.

The global South has also been catching up in terms of the share of global income it activates: specifically, it went from 25 per cent to over 40 per cent of appropriated income activated by foreign final demand. But while in 1995, the global North activated almost 20 per cent (of the total 25 per cent), in 2018, the share activated by the global South almost equalled that activated by the global North, hinting to an important South-South trade integration through GVCs. Moreover, the global South increased the share of income it activates in the North. This supports the argument that the "decline [in share of world exports for advanced economies] was almost entirely due to the relative decline of North–North trade" (*TDR*, 2018: 41). However, the right panel of figure 3B.1 suggests the catch-up of the global South in terms of appropriated wages has been considerably slower than that in terms of income.

**Figure 3B.1** Domestic income and wages activated by foreign final demand




*Source:* Wirkierman, 2022.
*Note:* Activated/Activating area.

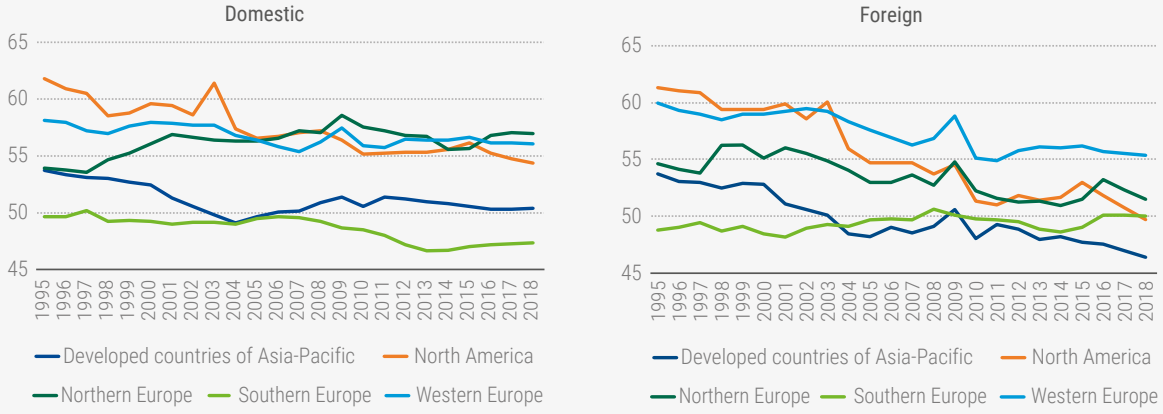
3 - Aggregating countries into regional groups[17] provides further insights into how the two different sources of final demand (domestic vs. foreign) impact functional income distribution. Figure 3B.2 allows to identify cross-regional differences in wage share trajectories. Moreover, by building a bilateral matrix of

[17] Regions are: Regions are: NAM (North America), LAC (Latin America and Caribbean), WEUR (Western Europe), NEUR (Northern Europe), SEUR (Southern Europe), EEUR (Eastern Europe), ZAF (South Africa), MENAT (Middle East, North Africa, and Türkiye), IND (India), China (CHN), Developed Asia-Pacific (DASP), ASEAN (Association of Southeast Nations), ROW (rest of the world). For details on the composition see Wirkierman, 2022.

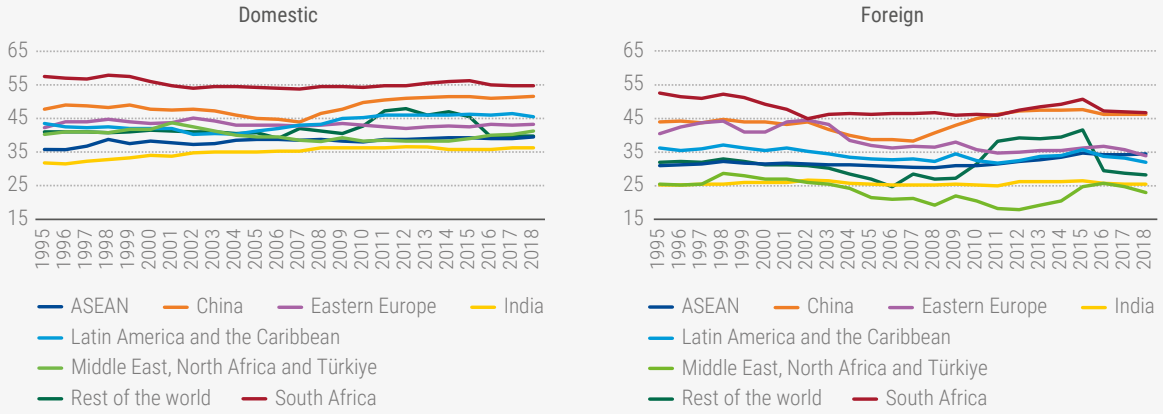
wage shares activated by each foreign source of final demand, it is possible — for a given source region — to identify the final output destinations activating the highest/lowest wage share and, at the same time, identify those activating regions inducing relatively higher/lower wage shares on others. Results evince the key regions in the global North (North-America and Developed Asia-Pacific) exert a downward pressure on wage shares of other source regions. This may be reflecting power asymmetries between lead firms and input providers along a GVC. At any rate, it is noticeable how regions in the global South that have increasingly appropriated shares of foreign-activated global income – such as China (CHN) and India (IND) – are also exerting a downward effect on wage shares of some of their trade partners. In contrast, for some regions of the world economy, intra-regional integration exerts a positive effect on foreign-activated wage shares. This is the case for Latin America and Southern Europe. This last finding should lead to a serious consideration of the potential of such regional integration strategies to foster inclusive growth.

**Figure 3B.2** Wage share trajectories according to activating sources of final demand, domestic and foreign, 1995–2018 *(percentage of gross value added)*

**A. Developed regions**




**B. Developing regions and countries**




*Source:* Wirkierman, 2022.
*Note:* See footnote 18 for the list of regions.

# C. LESSONS FOR AN ALTERNATIVE HORIZON

The Covid-19 economic crisis arguably made the Fed the commander-in-chief of the global financial and monetary system. In fact, the market for global dollar funding is a complex and geographically dispersed network of financial relationships, which the Fed has transformed into the building block of "a tiered system of international liquidity provision: the first tier including those whose credit is sufficient for a swap line, the second tier including those who can offer acceptable collateral, and the third tier including everyone else. It is a global dollar system, with the Fed operating as the de facto global central bank providing international lender of last resort support to the system" (Mehrling, 2022: 2).

A main concern is financial stability, and activity focuses pragmatically on those markets that appear to be systemically relevant. As a result, liquidity is not guaranteed everywhere, and pockets of gluts and scarcity persist (Eren et al., 2020). This is particularly true during a monetary tightening, but periods of financial expansion are not free from peril, especially for emerging markets that can attract disruptively large speculative inflows of capital.

This dollar system has recently proven resilient to extreme and unexpected shocks, but it has also failed to promote sustainable growth and prosperity. The pragmatism of the central bankers, who are forced to safeguard the financial stability of an unequal and stagnant economy, is not free from worrying consequences. Its success can buy the world some time, but it also inevitably intensifies the unsound separation of the financial and real economy and of liquidity and solvency concerns. This inconsistency became especially evident in 2021 when speculative increases in the prices of assets and commodities appeared as economies were still far from recovering, triggering the premature tightening. For all the pragmatism of its managers, the inadequacy of its underlying vision makes the global dollar system vulnerable to shocks.

However, the current crisis is signalling a clear alternative direction which requires some degree of de-linking from the global financial cycle, while relying on more patient capital funding that reconnects credit with development (*TDR*, 2005; section III.B.3). Similarly, economic models that assign control of price formation to speculative markets have proven particularly vulnerable and incapable of inducing sound investment strategies. That is quite evidently the case for energy markets.

The oil market, for instance, has become very financialized since the end of the 1990s (Gkanoutas-Leventis and Nesvetailova, 2015; *TDR*, 2011). It also remained a very concentrated market, with few producers, who sometimes are also refiners and distributors, as in the case of vertically integrated giants, such as Shell, ExxonMobil, Total, Chevron, BP, Eni and the like. Financial investors, as well as oil companies, act speculatively. Producers sometimes reach common agreements to influence global price, but these typically do not last very long. Oil pricing follows complex mechanisms based on the determination of benchmarks and differentials (a discount or a premium to marker), where most physical trade conditions remain private and undisclosed (Fattouh, 2011; Roncaglia, 2015; *TDR*, 2011).

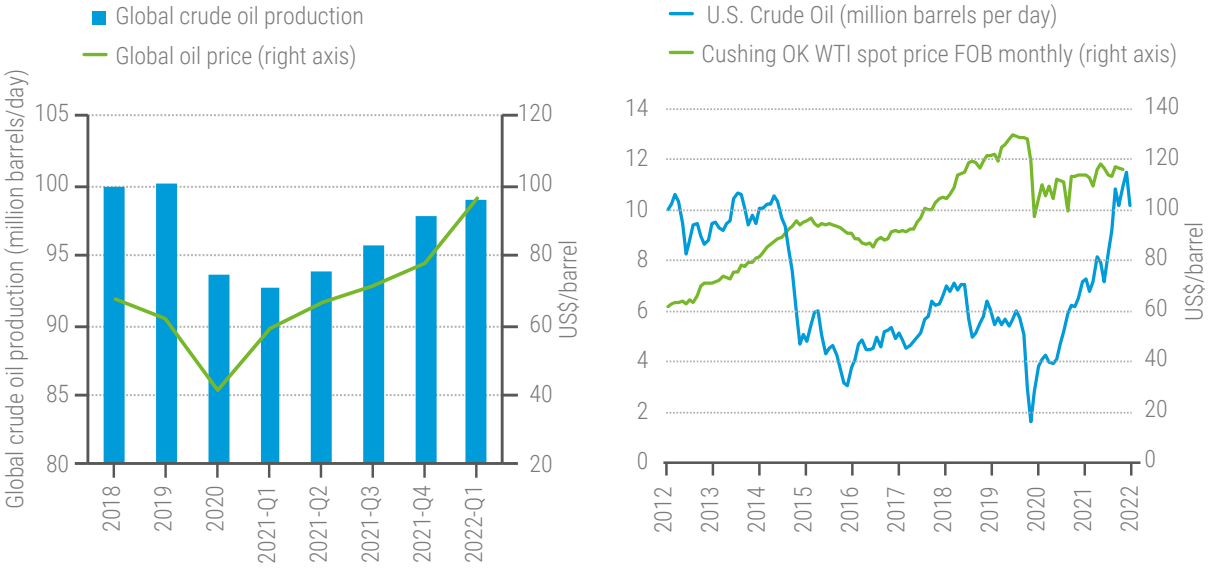
In this context, the identification of market fundamentals is particularly tricky, as all the players, including producers and refiners, act based on expectations, while accurate data about storage are impossible to gather. The most important benchmark price, the Dated Brent, is determined by two main companies, Platts and Argus, who record the deals for spot physical trade of Brent oil made in a specific time window. When deals in that window are too few to offer an accurate picture, the benchmark is determined by looking at the futures market. But whenever physical traders intend to fix a price based on that benchmark, they will intervene in the needed time window and influence its formation. Hence, high volatility in futures prices, which are observable in real time, does not always influence physical trade but their price trend does, offering a market convention on fundamentals based on which negotiations occur. To be clear, the market convention does not have to have any relation with actual fundamentals, whatever they are defined to be (Keynes, 1930; Greenberger, 2018).

In other words, this system joins the worst of two models: the shadiness of price negotiations in concentrated markets is coupled with of the risk of boom-bust dynamics, due to sudden shifts in the prevailing conventions and expectations. Indeed, this system, to which we should add the privatization and liberalization of national distribution networks in all developed countries, has produced times of very low and very high prices (*TDR*, 2011). This instability is not favourable for most producers, especially smaller ones and those based in developing countries, or for consumers, especially as the energy sector has a pivotal role in climate change mitigation planning (section III.B.5). It is, instead, highly profitable for speculative trading companies and vertically integrated giants.

The end of the commodity super-cycle in 2014, for instance, marked the beginning of a period of extremely low prices. A game changer was the lifting of the ban on United States oil export in 2015 and the normalization of the relations between the United States and Saudi Arabia. The price recovered for a few years until 2020, when it dropped dramatically, partly because of a fall in demand and partly because of the failure of producers to agree on a cut in production. Production actually increased, and prices of some crudes even went below zero, with the market in deep contango (i.e. future prices were much higher than spot prices) and companies running out of storage space and resorting to floating storage (Fattouh, 2021). This period was financially debilitating for many producers – and this explains their reluctance to engage in further production as prices started their climb in 2021.

Large state producers, such as Saudi Arabia, Qatar and the Russian Federation, are often accused of strategically holding onto reserves or production. However, the de-centralized shale oil sector in the United States appears to be equally hesitant to increase production when prices increase, citing Wall Street investors' pressure as the main reason (McCormick, 2022). The story of gas is very similar and perhaps even more telling (chapter II).

**Figure 3.14** Global crude oil production, 2018–2021, and prices, 2012–2021




*Sources:* OPEC, World Bank, United States Energy Information Administration.

## 1. Regional financial arrangements

As argued in previous Reports, overcoming the challenges discussed above – related to distribution, on a global scale. In the current system, international payments arising from trade are made in common currencies, used for domestic payments and financial transactions alike. This allows countries to retain a surplus or deficit indefinitely and makes some currencies (especially the dollar) scarce, establishing a foreign exchange constraint and making currency markets critical for the global economy. A solution is to establish a closed system for trade and investment payments in which any trade surplus has to be spent on imports or foreign investment, as Keynes advocated as early as the 1940s (Kaldor, 1964; Kregel, 2016).

A short-lived example was the European Payments Union (1950 to 1958), abandoned as European trade became more global. Short of a global clearing union, multilateral institutions can establish provisions to prevent imbalances from becoming unsustainable, as the Bretton Woods institutions were meant to ensure.

Unfortunately, existing multilateral institutions have not been able to deliver the needed support, especially for developing countries. This is why these countries have long sought regional cooperation agreements that may help ease their constraints. These can be categorized as follows (Fritz and Mühlich, 2019; *TDR*, 2015):

I - Regional funds for short-term balance of payments shortfalls: In practice, all these funds have proven throughout three decades to be too small to significantly withstand balance of payments crises.

II - Regional payment systems to reduce exposure to exchange rate fluctuations and promote inter-regional trade: These are mostly customs unions and payment systems that target transaction costs. They mainly exist in Latin America, although initiatives to introduce payment systems in Africa have been discussed for a long time.

III - Coordinated exchange rate policies aimed at stopping large exchange rate fluctuations and beggar-thy-neighbour macroeconomic policies.

Several agreements exist for planned monetary integration. With differing timelines, these mechanisms are all aimed at establishing a common currency and common exchange rate policies among member countries, mainly in Africa. However, they have remained largely at a pre-implementation stage, as members have not met the timelines agreed-upon in terms of economic convergence. The decade after the GFC has left most countries participating in these agreements hesitant to cede sovereignty and embark on the requested macroeconomic convergence programs.

Since the mid-1990s, financial cooperation among developing countries has increased, especially involving China, India, Brazil, Republic of Korea, Saudi Arabia and the Bolivarian Republic of Venezuela (chapter VI). This type of cooperation includes grants and concessional loans (either interest-free or at rates well below market) but sometimes also transfer of commodities, as the Bolivarian Republic of Venezuela has done with several Caribbean countries (*TDR*, 2007). In China's case, significant activity has been performed by the ExIm bank.

## 2. Steering the world economy onto a sustainable path

The above points to a clear outlook for the medium term: the world economy will remain fragile unless macroeconomic policies change course. This section explores medium-term economic prospects under two different policy scenarios. The scenarios are constructed using the UN Global Policy Model (GPM), an empirical framework of analysis of macro-financial dynamics, trade, fiscal, monetary, employment policies, demography and carbon emissions. It is based on a database that is consistent with principles of national accounting, global aggregation and stock-flow generation. It is estimated econometrically in panel-time series data.[18]

[18] See https://unctad.org/system/files/official-document/tdr2014_bp_GPM_en.pdf and https://mobilizingdevfinance.org/tool/unctad-global-policy-model-gpm.

### A "hands-off" scenario: comfort in conformity?

In one scenario, the policy stances of the past several years (decades, in some cases) are assumed to continue. Here, policymakers accommodate but do not actively interfere with market forces, based on an established playbook. According to that playbook, inflationary pressures are contained by rising interest rates; supply bottlenecks are alleviated by free trade and interventions that prop up profits (e.g., striking down a windfall tax on gasoline producers); income inequalities are mitigated by access to education and deregulation of labour markets, encouraging competition while enlarging the labour force; financial instability can be reduced when insolvent operators are not bailed out by states but held accountable for any wrongdoing; and government debt problems are corrected by cutting government outlays and by privatizing its assets.

Pressure to enter this "hands-off" scenario is strong in the real world. Most policymakers are wary of deviating from the orthodox playbook, afraid this may scare away investors who wield more power in financial markets than the government itself. The smaller the economy, the greater the disparity of power between the state and the well-coordinated network of domestic and international conglomerates. Even in large economies, corporations have considerable leverage over policy choices (Sciorilli Borrelli, 2022). Following the status quo seems prudent.

In this scenario, developing economies cannot preserve sufficient policy space to support development, unless they happen to be on the right side of a commodity boom or a geopolitical fault line, nor do they coordinate to respond to the policies adopted by the geopolitical blocs of major economies on trade, finance and climate. Developing economies are severely affected by the weakening of global demand, financial pressures, trade restrictions and any additional burden implied by climate policies (in the North).

### "South-led way"

The hands-off scenario is tied into a vicious circle. Increasing disparities of power, wealth and income lead to repeated crises and eventually consume policy space. But this is only true to the extent that those disparities are considered inevitable. In fact, three factors point to an alternative policy paradigm.

First, our projections indicate that continuing with the status quo leads to worsening macroeconomic performance. The empirical analysis in this section highlights the mechanisms and outcomes that are triggered by continuing the current policies in an already weak global economy. Medium-term prospects are gloomy.

Second, widespread financial and climate instability is bound to hit both developing and developed economies. The remedies offered in the orthodox playbook do not match the scale of these crises. No major economy, and certainly not a developed economy, can avoid the difficult decision (i.e. unpopular in the markets) of abandoning the hands-off approach.

Contrary to a common tenet of the financial press, debt and balance of payments crises in the South are not simply the result of government dysfunction. They are more likely a side effect of the policies adopted by the major central banks to avoid financial meltdown in times of market turmoil, especially after the GFC, when quantitative easing and other forms of liquidity expansion found ready financial traders, corporations and governments under pressure to roll over crushing debt (Ghosh, 2022; Green, 2022; Roubini, 2022). The unstable evolution of today's debts has been set off by this policy approach.

The evolving climate crisis adds a daunting dimension to this outlook, because of its irreversibility: the IPCC indicates that once a critical threshold of global warming is crossed, no realistic mitigation policies can prevent a vicious cycle of ecological self-destruction. The scientific guidance is that such a critical turning point is only a few years away (IPCC, 2022).

None of these crises are explored in the scenarios, as their timing and consequences cannot be predicted. But the urgency they create for a shift in policy approaches cannot be emphasized enough.

Third, policymakers in the South share critical common ground to be capable to question the asymmetries and biases in international trade and finance that favour large corporations from advanced countries (*TDR*, 2018). Leveraging this shared interest opens a space for a South-led way to counter the status quo.

Global economic forces and the orthodox policy playbook incentivize policymakers to compete with other countries rather than cooperate. In a typical "fallacy of composition", economies are often pushed to compensate for diminishing trade gains by cutting costs and trying to increase their share in export markets. For decades, especially for economies with relatively low degrees of specialization, potential partners in international cooperation have also been fierce competitors in the global markets.

Since the 1990s, coordination between governments has increasingly taken place within multilateral institutions, but with little actual coordination occurring beyond developed countries. This process has not served developing countries. On the one hand, international institutions overseeing financial arrangements (such as the IMF, the World Bank or the BIS) do not ensure fair representation to developing countries (either on executive boards or in membership), and the direction given to them, to a large extent, reflects the policy priorities of developed countries. On the other hand, the WTO, despite its more representative governance structure, has so far failed to conclude a development agenda, and the few agreements made have been heavily influenced by asymmetric power relations. Meanwhile, North-South cooperation has increasingly taken the form of bilateral or more recently, mega-regional trade and investment treaties, which have reinforced trade dynamics historically dominated by the North. The critiques of such agreements are known (chapter IV; Capaldo and Izurieta, 2018).

This experience provides fresh motivation to find different arrangements, with a stronger focus on the interests of the global South. Sections III.A to III.B highlight the common challenges faced by developing countries and show how international coordination is informed by the interests of developed economies. Increasing awareness of this reality is fertile ground for new forms of South-led arrangements, and these, in turn, may be stepping stones towards a more ambitious multilateral agenda.

Hence, a South-led way must take a South-South perspective as its point of departure, building on the observed patterns of cooperation in trade, of industrial diversification, finance and exchange rate management among economies of the South. The scenario identifies the conditions for more successful and sustained achievements in a coordinated policy strategy guided by a development perspective.

This type of coordination, even if with explicit South-South bias, implies the involvement and cooperation of Northern economies. After all, trade, finance, technology and climate require global coordination. But developing economies should reach global goals starting from their specific conditions and operating under specific constraints. Seen from this perspective, the empirical scenario offered below implies a concrete policy shift which acknowledges current institutional and macro-financial constraints and accordingly leaves room for involvement of more advanced economies (which could be much greater if they adopted measures to contain the tendencies towards market concentration and financialization). The difference from earlier North-South agreements in this simulation exercise is the core assumption of a well-defined Southern agenda as the benchmark for agreed policy decisions. Finally, the scenario incorporates the fact that the period of analysis (from the present to 2030) is too short to expect full achievement of desired goals. It should thus be regarded as a template to begin steering the global economy in a more sustainable direction.

Four distinctive features[19] of this scenario help explain the empirical outcomes presented below.

The first feature is that it is centred on policies to advance a coordinated industrialization. Partially cut-off from intellectual property (IP)-dominated technologies of the advanced economies and with limited access to international reserve currencies to pay for imports of capital equipment, developing economies manage their structural transformation by developing their industrial sectors at a pace consistent with their potential and that of their partners within the same fora. This has two implications. For one thing, industrialization will only move away from employment-intensive technologies gradually and partially. This will facilitate the de-informalization of large sections of their labour force, consistent with the development of social, education, health and caring services (Cimoli et al., 2009). For another, it requires a proactive government with a clear developmental agenda which will also contribute to alleviate inequalities of income (*TDR*, 2012).

The second characteristic of the scenario is the cooperation on finance and technology to sustain the path of trade integration and industrialization, repairing the broken link between credit and development (see section III.B.3). The emphasis is on recognizing that in the current global institutional set up, finance and technology are dominated by advanced economies. As they are at a disadvantage in these two aspects, economies in the South need alternative levers. As the experiences detailed in Chapter VI of this Report show, such levers range from a "managed" framework for trade, as opposed to "free-trade", to innovative forms of finance and exchange payments that can eventually be oriented towards formal "South-South clearing unions" (Kregel, 2016). Accordingly, if trade among Southern economies grows quickly, a significant portion of their total trade flows will be paid in either their own domestic currencies or through regional currency mechanisms. Considering that the instability of payment flows results not only from exchange rates but also from international prices, the financial institutions set up at a regional level can be geared to accommodate the underlying principles of "commodity reserve currencies" (Kaldor, 1964; Ussher, 2011). Part of the regional funding available can be increasingly allocated to regional buffer stocks that can help stabilize prices without totally disrupting the prices' responses to productivity, technology advances and demand. Based on these mechanisms, which are assumed to evolve only over time, the growth of commerce will be tied to a reduction of external imbalances, as well as the reduction of dependency on global finance. Regional financing and currency mechanisms are assumed to help negotiate workout paths for debts owed by developing economies to Northern financial centres and to provide financial insurance at the regional level.

A third characteristic is a coordinated effort to maintain a pace of agrarian transition that is consistent with industrialization, employment generation, food security and the need to avert environmental degradation (linked to the fourth characteristic). There is sufficient evidence of employment-intensive and traditional agriculture based on small and medium-size units providing food and agricultural inputs and commodities for industrialization. In short, the simulation assumes a coordinated agricultural transformation proceeding as an "agro-ecological model of industrialization à la Lewis", where the rise of productivity of agrarian labourers would be such as to avoid displacement that cannot be absorbed in the growing industries and services, even if the scenario also envisages an expansion of social and caring provision by the state (IPES-Food and ETC Group, 2021; Wise, 2020).

A fourth characteristic is the attention to strategies for climate change mitigation and adaptation. The technologies and financing to which Southern economies have access do not warrant a self-sustained transformation of their productive matrices. Only in so far as decisive and affordable cooperation by the most advanced economies is ensured, can developing economies embark on such transformation at a pace that can meaningfully contribute to global climate change mitigation. But movements in this direction cannot happen overnight, even if advances in low-cost and effective environmentally friendly technologies are currently available (Drahos, 2021). Thus, most developing economies will continue to rely on relatively more carbon-intensive industries than their Northern

[19] To be clear, such "features" are not changes in the model assumptions that were tested econometrically and eventually drive the model behaviour. Rather, they represent "what if" policy changes that are imputed into the existing model structure (see footnote 19).

counterparts, and in this scenario are assumed to set their environmental targets pre-conditioned on the primary strategy of building the productive and urban infrastructure to facilitate social and economic development. In addition, it is contemplated that an increasing amount of resources will be required for climate adaptation. Considering that joining a global mitigation strategy is favourable for all economies, the model simulation assumes a moderate increase of support from the most industrialized partners, in the form of transfers of technology and aid. Knowing that the experience of "technology transfers" is so far disappointing (apparent during the Covid-19 pandemic), this support is assumed to be marginal but increasing over time. Thus, most of the contribution of the global South to a greener development will result from the ecological-agrarian transformation and the avoidance or minimal use of fossil fuel machinery and fertilizers, together with the emphasis on local production for the satisfaction of basic needs.

## 3. Scenarios compared: climate catastrophe or climate change?

The hands-off scenario extrapolates from the structural patterns of production, demand, efficiency and degrees of diversification in global energy and primary commodities. Projections are based on a historical analysis of a reference database (UNSD, 2021) coupled with parameters of fossil-fuel content.[20]

We use the observed historical patterns (1970 to 2020) to estimate the relations among the main environmental variables, the economic, technological and financial conditions and the policies. Coherently with the discussion in section III.B.5, despite several decades of debates, commitments and pronouncements, the data show little progress.

Thus, assuming no meaningful change of policy direction through 2030, the outcomes of the hands-off scenario show that instead of decreasing, annual global carbon production is set to increase 16.5 per cent by the end of the decade, from about 17 billion (of "ton-equivalent") at present to about 20 billion. The carbon mix is such that the annual flow of CO2 emissions will easily surpass 41 billion tons (from about 35 billion at present). An estimated increase of non-carbon energy production from the current 2.5 billion (of ton-equivalent) to 3.2 billion is not going to have a meaningful mitigation effect.

Figure 3.15 compares the main environmental variables in the two scenarios. Let us be clear: the outcomes of the South-led way imply extraordinary policy measures that ought to be undertaken, with due differences, by all countries and sustained over time. But extraordinary as they seem for the world as a whole, our simulation is based on actual, albeit exceptional, experience: observed periods of time, sufficiently long, when there were noticeable advances in our key indicators. In practice, developed economies will show annual improvements of 6 per cent per year by reducing energy content (and especially carbon) for any increase in unit of output (GDP), while developing economies (in the aggregate) are expected to gain efficiency by 4 per cent per year.

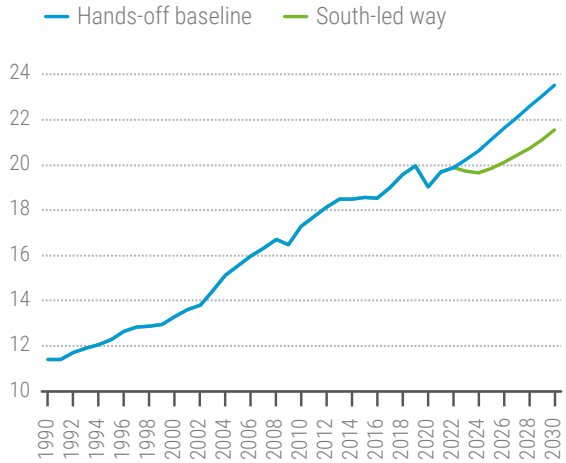
As discussed in more detail below, these energy efficiency gains are still compatible with moderately faster growth of GDP than in the baseline hands-off scenario and with sustained rates of employment. However, to ensure a significant stabilization of energy production as economies in the South progress, developed economies will experience a degree of growth moderation (Galbraith, 2014).

Efforts in terms of energy diversification include two aspects. On the one hand, all economies invest to diversify production and use. The effort of industrialized nations is larger, but everywhere the extent is comparable to a war-time military build-up. Inevitably, this implies a large involvement of the public sector, as prices, subsidies and tax incentives alone have proven inadequate to generate the needed private investment. In the design of the scenario, carbon taxes and other similar measures are fully re-cycled in the public budget to support climate mitigation and adaptation policies, so that the ultimate fiscal balance effect is neutral.

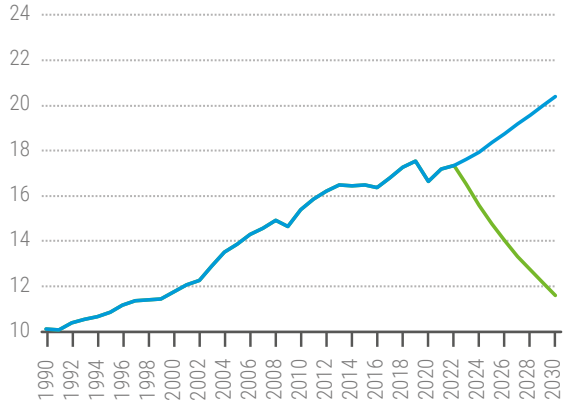
[20] Offering a comparable analysis of primary commodity extractions, environmental degradation, atmospheric pollution (directly or indirectly through technology) and so on would require a significantly more ambitious global model; therefore, the scenario design does not include sector-specific assumptions about primary commodities in one scenario or the other.

**Figure 3.15** Global environmental outcomes in two simulated scenarios, 1990–2030 *(billion tons)*

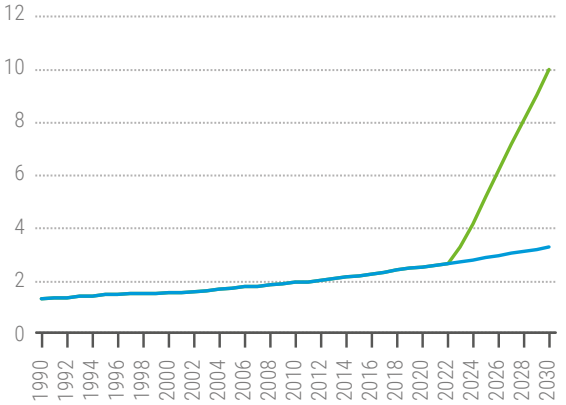
**A. Total energy production**



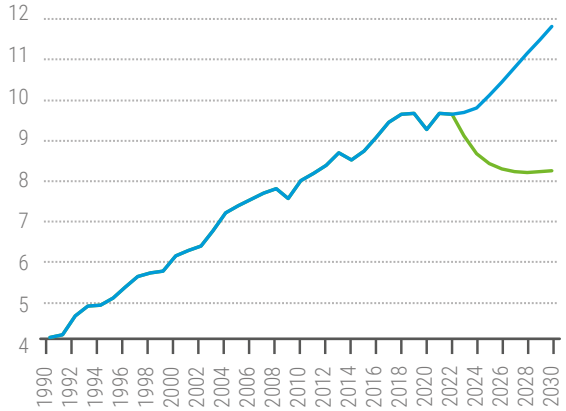

**B. Carbon energy production**



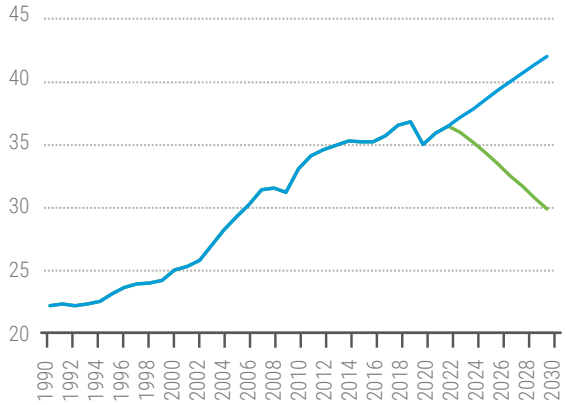

**C. Non-carbon energy production**



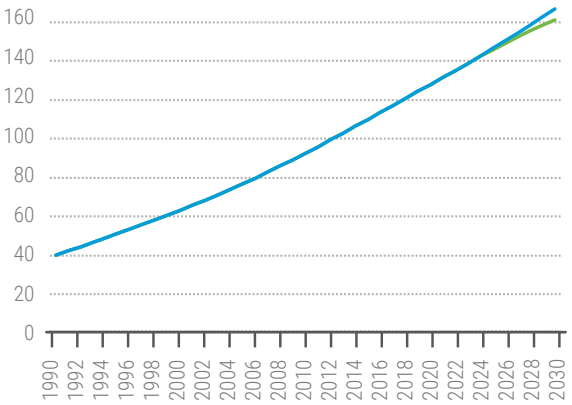

**D. Exports of energy**




**E. CO2 emissions**




**F. Cumulative CO2 emissions**




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

On the other hand, international coordination is required to support development strategies in the global South. In fact, for all the reasons given above, developing economies can only commit to a slower pace of diversification. Notably, as the global economic structure of production will still rely on carbon for some time, fossil-fuel exporting economies on the lower-income scale are granted greater quotas to supply global markets than the wealthier exporters. Moreover, financial and technology transfers from industrialized economies to the South, even if moderate initially, need to be part of the policy mix. These coordinated measures are deemed to be more effective mechanisms than unilateral green-shoring or "friend-shoring" measures, in so far as they include clear and transparent conditionalities, such as measures for a slow decline in global prices (topped by carbon-taxes imposed by each economy to help sustain environmental policies) and diversification away from their most polluting sources.

With a coordinated push of this kind, we estimate the flow of CO2 emissions to decline to about 30 billion tons by the end of the decade, enough to escape from catastrophic IPCC scenarios.

## 4. Scenarios compared: trade, finance and macroeconomic stability

Section III.B.3 highlights the combination of threats to macroeconomic and financial stability faced by developing economies, subject to structural balance of payments constraints.

As noted earlier, our modelling strategy was to rule out the case of a full-blown financial crisis, whose specific triggers and spillovers cannot be reliably anticipated. That implies assuming away any systemic shock to debt roll-over risk. On that assumption, the policy set up of the hands-off scenario delivers slow GDP growth (as explained in more detail below) and even slower fiscal revenues growth. At the same time, governments will face increasing spending claims for climate adaptation, development and debt repayment. Global trade growth will continue to be inadequate; therefore, net export revenues, especially of economies with low degrees of diversification, will be insufficient to maintain exchange rate stability. Volatile currencies tend to be the main factor driving inflationary pressures and food crises. The usual policy recommendation of cutting domestic wages and demand will, under these conditions, make matters worse.

Thus, government debt ratios will likely increase by about 30 per cent in Africa and 60 per cent in Latin America and the Caribbean (regional aggregates). Increases in debt-to-GDP ratios of nearly 30 per cent can be estimated for Western and Central Asia (taken as a whole) and for South and East Asia (as a whole, excluding China), though parting from lower levels. Needless to say, if we remove the assumption about roll-over risk, and place these debt overhangs back into the real world of finance, the situation could become unsustainable more quickly and if not addressed appropriately would eventually solve itself in the most disruptive way. But, under the current scenario, an appropriate and sustainable domestic and external debt restructuring is not conceivable. In fact, it would require abandoning the very policy set-up that defines it: unfettered liberalization of global capital and trade flows in the South, coupled with selective protectionism in the North.

In contrast, the South-led way assumes a series of new macro-financial and trade deals, following the map of existing regional and subregional agreements (detailed in chapter IV of this Report). Hence, the main accords are established by developing countries within their geographical regions. They are designed to sustain a pace of industrialization compatible with the development of their agrarian sector. Therefore, they are consistent with: (I) the provision of wage-goods (especially food and energy), (II) the achievement of overall productivity gains and (III) overall increases of employment. This is an important point, as unchecked development processes can trigger destabilizing influences between the two sectors with ultimately self-defeating consequences.

In this scenario, economies grow sufficiently to increase the imports from the regional partners, especially in the manufacturing and agricultural sectors but without reducing imports from elsewhere (to avoid protectionist retaliations from other partners). The ensuing global increase of imports implies that, domestically, import growth matches the growth of exports.

These are all dynamics that have been empirically observed through time. But the historical assessment of regional South-South agreements also indicates that such processes are often derailed when economies encounter external shocks due to movements of prices, exchange rates, international interest rates and capital flows. Hence, the importance of the financial part of the agreements in this scenario.

For the regional accords to succeed, they have to include mechanisms that facilitate transactions in domestic currencies or in financial vehicles that can be supported on stable exchange rates. More specifically, in a context of increasing South-South trade, establishing clearing unions between the signatories of a trade deal can reduce exchange rate instability and external imbalances to the extent that economies with a trade surplus can only use it to import goods in the currency of the deficit partner. We also envisage implementation of some degree of capital controls to reduce dependency on external finance, as this tends to increase the vulnerabilities of developing economies with no palpable benefit for economic development.

Finally, next to cooperation on trade and finance between developing economies, the scenario contemplates some involvement, even if more moderate, by the more industrialized economies. Again, this element of the scenario is extrapolated from observed, if ephemeral, examples of cooperation. Thus, depending on the strength of the pre-existing links, some developing countries will seek agreements with the more industrialized economies of North America, Europe, China or Japan. The qualitative difference from the past lies in the character of trade, which here aims at promoting industrialization, food security, financial stability, employment and the achievement of climate targets in the South, but brings benefits to the industrialized economies as well, such as improved financial stability and a predictable path of growth of imports.

The main results of the regional accords are captured in figures 3.16, 3.17, and 3.18.

Figure 3.16 shows trade shares in manufacturing exports of developing economies within the regional agreements, comparing the South-led way scenario with the hands-off baseline. Panels A and B shows the shares of exports of developing economies in each region relative to the total imports of the same group. Panel C shows the same measurement (exports on total imports of partner), but where the trading partner is the aggregate of the more industrial economies involved in the regional accord. In all these cases, the scenario yields tangible gains in terms of the trade of developing economies, as well as moderate improvements in their access to the markets of industrialized partners. Worthy of notice is the fact that the degree of the advances in regional trade is partially related to the strength of the point of departure. Performance improvements in the manufacturing industries take time (investment, capacity, development of networks etc.) and tend to proceed along with improvements in external financial conditions and exchange rate stability.

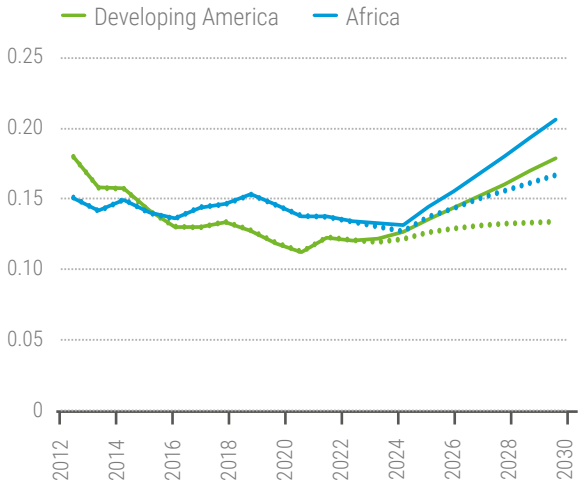
The model scenario incorporates the existence of regional stabilization funds which the economies use to target regional improvements in the net external asset position. The regional scope of the objectives frees single countries of the need to maintain an aggregate equilibrium in their balance of payments, which too often results in pressure to reduce the cost of labour and internal demand, to reduce imports.

As long as the targets are consistent with the position of the group in the global context, this mechanism should facilitate adjustments of intra-regional imbalances that avoid a mutually defeating race to the bottom and help maintain inter-regional buffers. It combines a series of actions, conducted in a collective and coordinated way: export promotion (which increases the flow of external revenues); import moderation (which does not imply restrictions on initial conditions, as exports tend to increase thanks to regional market access); exchange rate stability (thanks to the clearing unions); negotiations conducted by the region to reduce debt services (regions tend to enjoy greater leverage than individual economies); and capital control management to limit excessive financialization.

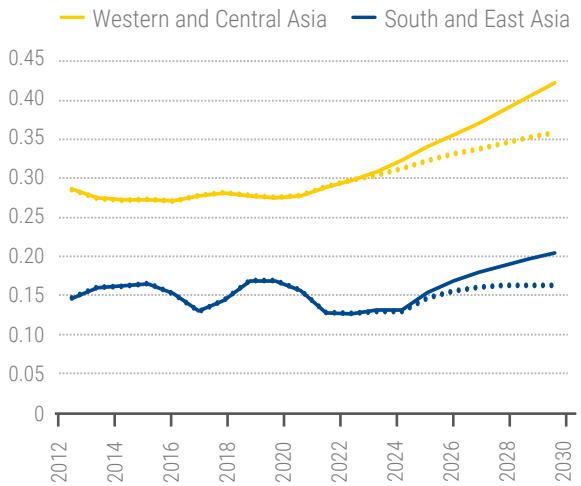
**Figure 3.16** Shares or manufacturing exports by developing economies linked with trade accords

**Developing countries' share of developing countries' intra-regional imports**

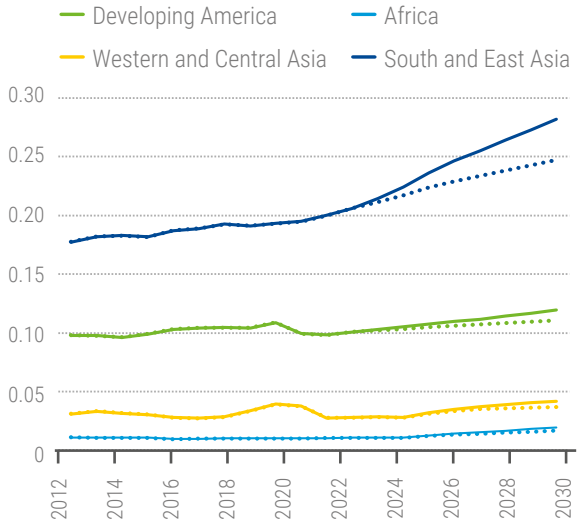
**A. Between developing economies**




**B. Between developing economies**



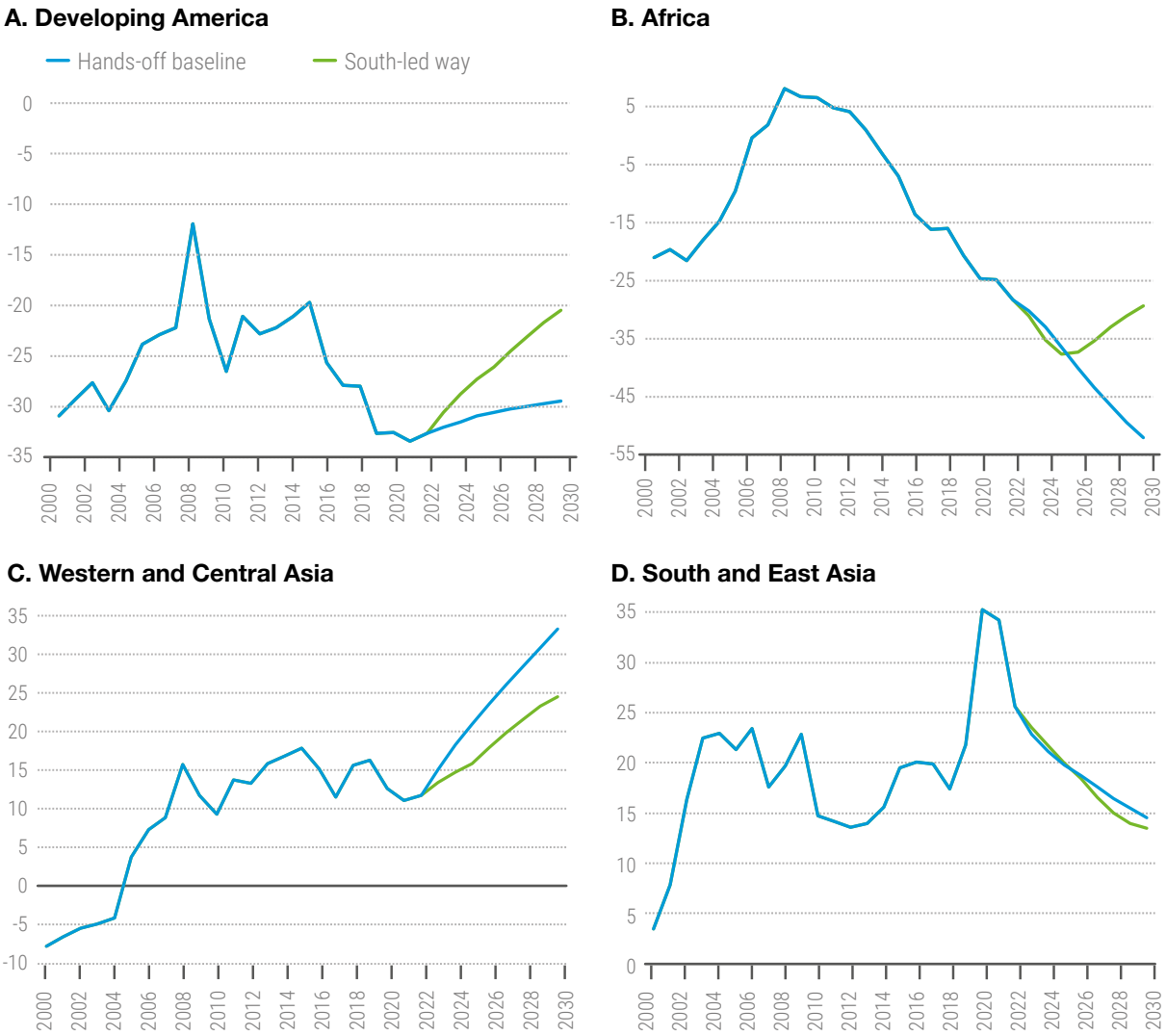

**C. Developing countries' share of industrialized partners' imports**




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

Results are presented for the aggregates of the four groups of developing economies in figure 3.17. As the figure shows, debtor groups slowly reduce the weight of their net liability positions, while net creditor groups reduce the relatively high accumulation of external assets. More granular data show that in all cases (reductions of net liability or of net assets), de-financialization (decreases of both external assets and liabilities) is the norm.

**Figure 3.17** Net External position, developing regions, 2000–2030 *(percentage of GDP)*




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

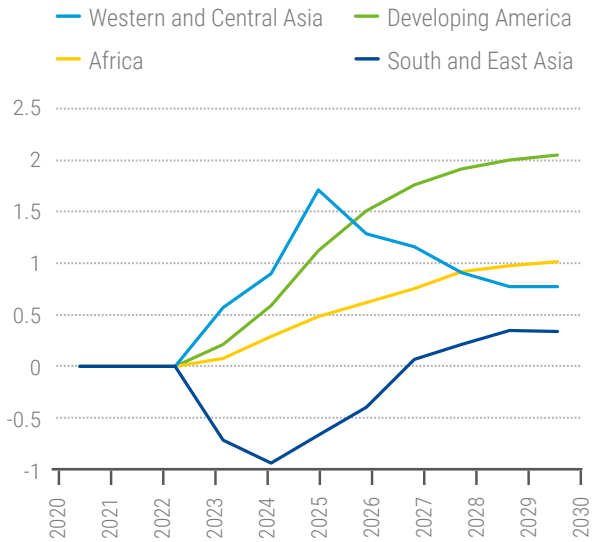
The management of exchange rates is modelled in a way similar to the modelling of external positions. Regional, not country-level, targets are proposed, and these are achieved subject to the constraints derived from trade, as well as the pressures on the balance of payments derived from accumulation of assets and liabilities. The results are presented in figure 3.18.

Panel A measures the "gain" of the aggregate exchange rate of the developing economies of each region relative to the hands-off baseline. The gain is calculated by measuring for each scenario the gap between the nominal dollar exchange rate appreciation of the group of developing countries of each region and the exchange rate appreciation of the group of industrialized economies partners in the same region. Developing countries tend to experience considerable depreciations of their currencies, as is the case for the 'hands-off' scenario, because of unrelenting balance of payments constraints. The mechanisms set out in the South-led way scenario reverse that tendency and therefore the gap with the exchange rate of industrialized partners is less negative. Hence, this yields a positive gain (in some cases, the currency still depreciates, but it is still less than in the baseline).

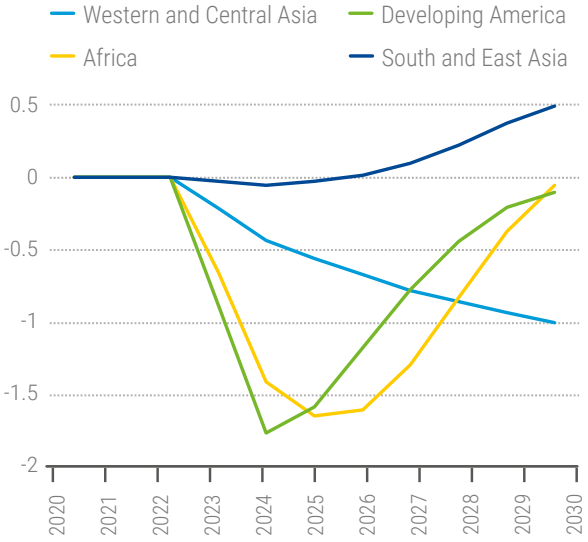
The model results confirm initial intuitions: groups of developing economies in net liability positions (Africa and Latin America) tend to be initially more vulnerable to global finance and therefore more prone to exchange rate devaluations. Policies to reduce net liability positions of the region (discussed around figure 3.17) and to stabilize exchange rates are generally more dramatic in order to achieve desired targets; thus, their improvements over the baseline (gains) are stronger. The case of developing countries in the Western and Central Asia region is likely influenced by the process of climate change mitigation, discussed around figure 3.15. Exchange rate improvements in this case respond to oil and commodity prices and the commitment to offer greater advances in the transformation of the productive structure away from fossil-fuels, which tends to be more import-reliant and could not be afforded at the required pace in the absence of exchange management measures.[21] Meanwhile, the pattern of exchange rates in developing economies of South and East Asia seems to be stable over the mid-term.

**Figure 3.18** Exchange rate and inflation gains, developing regions, 2020–2030

**A. Developing economies' exchange rates, relative to industrialized regional partners**




**B. Inflation gains (negative values reflect improvements)**




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

Panel B shows the same concept of gains for inflation rates, but in this case, improvements are shown as negative values. The gaps calculated in both scenarios measure the difference between the estimated inflation rate of the group of developing economies in each region and the estimated inflation rate of the group of industrialized partners in the same region. If the inflation rate of developing countries in the South-led scenario falls faster than in the hands-off baseline relative to the fall experienced by the industrialized partners, the gain shows as a negative number. The scenario yields, for all groups of developing countries, significant improvements in this sense (more "negative" gains), except for South and East Asia, as this region is broadly stable over the simulation period.

This is a very relevant result, confirming the observations made in the previous sections of this chapter about the transmission from exchange rates to inflation rates for most developing economies. Along with improvements in exchange rates (panel A), there are concomitant improvements in lowering inflation rates (panel B).

[21] Note that Saudi Arabia, part of this group, pegs its currency to the dollar.

## 5. Scenarios compared: economic growth and correction of global imbalances

In the hands-off scenario, structural problems are assumed to continue unresolved through the mid-term. Developed economies, driven by a fiscal austerity bias, excessive reliance on monetary policy, growing inequalities, weak investment and an unviable climate agenda, will show weak growth performance and low rates of employment and will also be subject to instances of financial stress in the wake of unsustainable processes. Developing economies in this scenario will be affected by a similar combination of shortcomings, amplified by the transmission effects to which "balance of payments constrained" economies are subject: trade imbalances, de-industrialization, financial instability and debt overhang. In some instances, these economies will maintain respectable growth numbers for some time, but pre-conditioned on rising indebtedness, excessive reliance on commodity extraction, low productivity and poor employment conditions.

Fossil-fuel and mineral extracting developing economies, as well as some developed economies that have outperformed the rest through combinations of export capabilities and domestic saving biases, will attempt to maintain growth by relying on external demand. Unlike the episodes of global imbalances in the past, this time around. the risks will be higher because the rest of the world, including some major advanced economies, faces balance sheet stresses in both public and private sectors, and asset valuations are dangerously high. Overall, economic growth will disappoint.

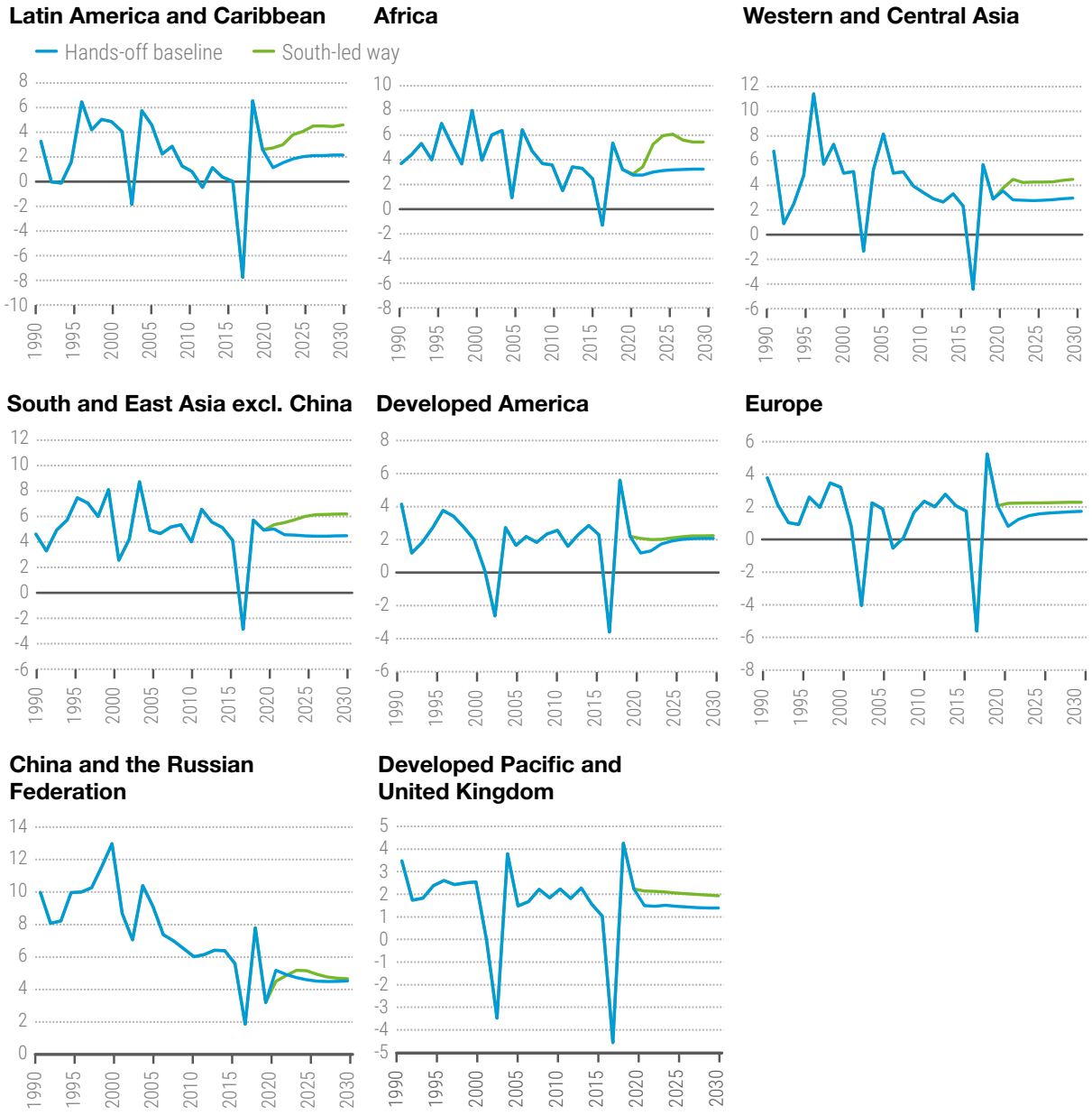
Alternatively, a South-led growth strategy focused on decent employment, investment for industrialization and a sufficient provision of social and infrastructure support by the state thus seems more compelling. But constraints from both environmental threats and financial vulnerabilities that have been tightening over time cannot be ignored. The simulation strategy for this scenario is that of proposing stimuli to growth that are known to be effective, like the promotion of income and employment measures that help reverse the declining trends of wage shares, public spending in social provision and infrastructure consistent with the promotion of investment, especially in shifting away from environmental degradation, and credit provision directly linked to employment and technological advances. At the same time, financial and natural resource constraints are incorporated into the estimation of the growth possibilities. What also enters into the calculations is the need to correct current account imbalances and repair the asymmetries of economic development between nations.

The growth performance of the two scenarios is shown in figure 3.19. Four graphs capture the patterns of the Southern regional groups in the aggregate (as weighted average of the economies involved). To (merely) approach the SDGs by 2030 and escape from vicious circles of insufficient income, sluggish demand, financial vulnerability, de-industrialization and poverty, their growth rates will be tangibly higher in the South-led way than in the hands-off baseline.

Meanwhile, counterpart industrialized economies grouped in the remaining four sets will achieve more moderate increases in their growth rates.[22] In the GPM estimations, stronger growth of these economies will trigger greater risks of heightened financial vulnerabilities. The South-led scenario does not contemplate a full rewinding of the highly leveraged global financial system or a full curtailment of global monopolies, while the patterns in the historical data suggest faster growth in the developed economies tends to be accompanied by, if not premised on, a deeper and more hazardous degree of financialization. Likewise, given the targets of de-carbonization, the timescales required to revamp the global production matrix and the achievements that are feasible on energy efficiency per unit of output, it is clear that a faster rate of global growth will not be compatible with the parameters of sustainability deemed by the scientific community. Thus, growth performance will be satisfactorily higher than in the baseline but will be tempered by the forces of nature and by the macro-financial limits inherited after decades of neoliberal policies.

[22] In the GPM exercise a few industrialized economies (such as China and Europe) are part of more than one regional accord with developing economies. But for global consistency, in figure 3.19 and ff. they are included only once.

**Figure 3.19** GDP growth scenarios, selected country groups, 1990–2030 *(annual percentage change)*



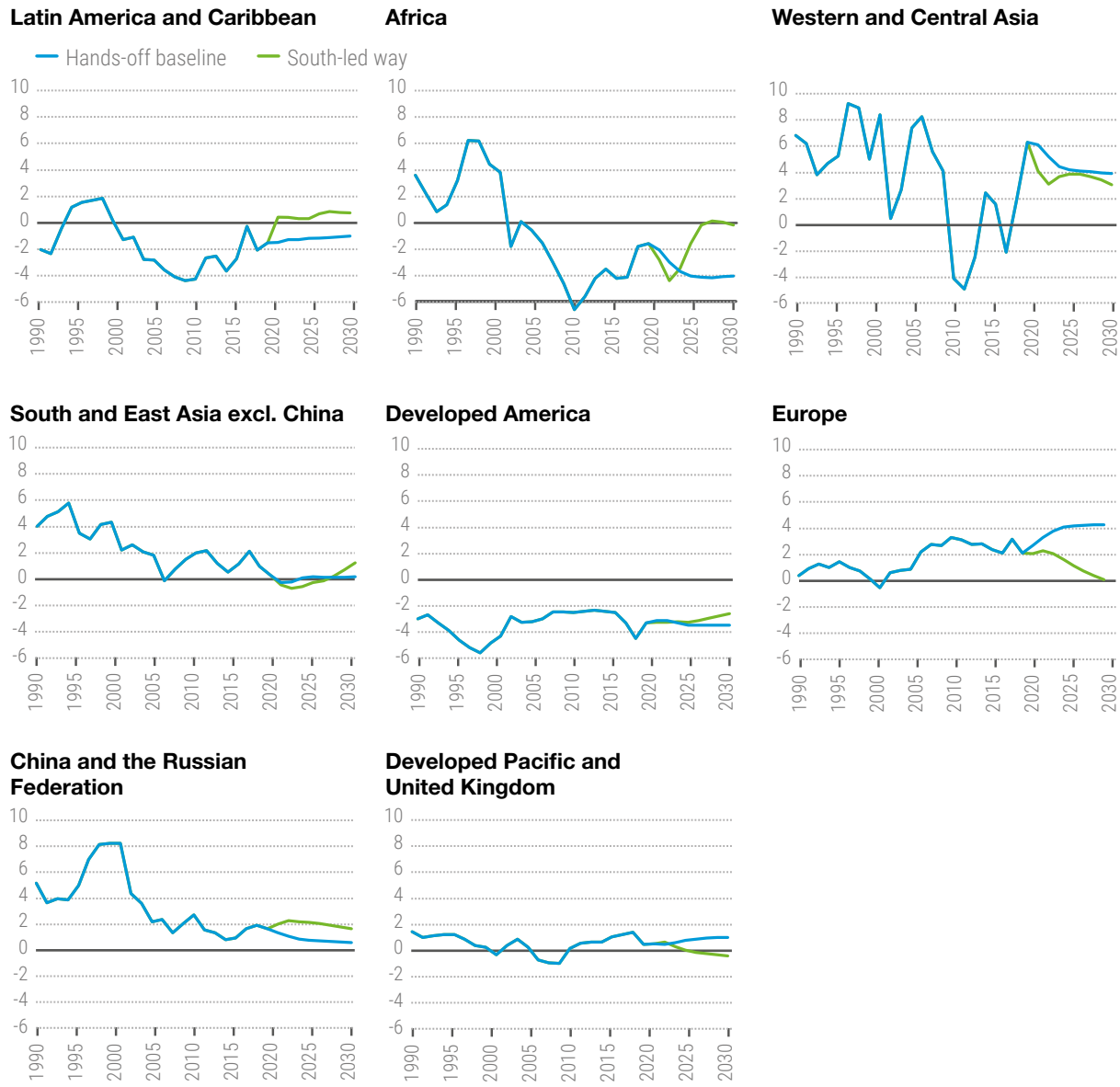

*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

The layout of current account balances for the two scenarios is shown in figure 3.20, according to the same groupings. The chosen aggregations do not highlight the most extreme country-specific cases, like the large surpluses of Germany (merged in the European Union group), of Japan and the Republic of Korea (in the Developed Pacific and United Kingdom group), or the case of India (a large deficit case), which is merged with economies of East Asia that have historically exhibited large surpluses. Yet the presentation is sufficiently illustrative to draw two lessons. First, due to growing financial vulnerabilities of a still highly leveraged global economy, macro-financial imbalances at present are generally more contained than they were in the past two decades. Exceptions include the case of Europe, which as a whole is tending to become a large surplus area (in the past, large surpluses in Germany were

combined with deficits in the other European Union economies). Another exception is Africa, which was in structural deficit for several decades; it shifted to high surpluses during the commodity super-cycle of the early 2000s but again showed very large deficits post-GFC.

The second observation is the contrast between the hands-off baseline and the South-led scenario, as in the latter, imbalances will be contained or significantly reduced relative to the baseline. Europe will likely reach surpluses of about 5 per cent of GDP by the end of the simulation period in the baseline, but the surplus will shrink in the South-led scenario. Other cases of relevant surplus correction include Japan (from 5 per cent of GDP in the baseline to 1.2 per cent of GDP in the alternative scenario) and the Republic of Korea (from 4.3 per cent to 0.8 per cent of GDP).

**Figure 3.20** Current account balance scenarios, selected country groups, 1990–2030
*(percentage of GDP)*




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

In the South-led scenario, Africa as a whole will manage to revert to external balance, in contrast to the otherwise large structural deficits of nearly 5 per cent of GDP in the baseline. The South-led scenario will also yield meaningful reductions of external deficits in North America (the United States alone will reduce the deficit from 4 per cent of the baseline to 2.7 per cent in the alternative scenario) and in India (the deficit will be reduced from about 4 per cent in the baseline to 1.2 per cent in the South-led scenario).

As indicated above, the South-led scenario sets three mechanisms in motion to correct global imbalances. First, trade regionalization with a focus on industrialization in the South, accompanied by the mentioned regional currency mechanisms, has a direct effect on deficit reduction in developing economies. Second, the measures towards de-financialization, regulation and capital controls work in the same direction, especially helping developing economies. Third, the policy principle applied along the simulation is that imbalances can be corrected more effectively by setting spending targets for surplus economies than by making deflationary adjustments in deficit economies.

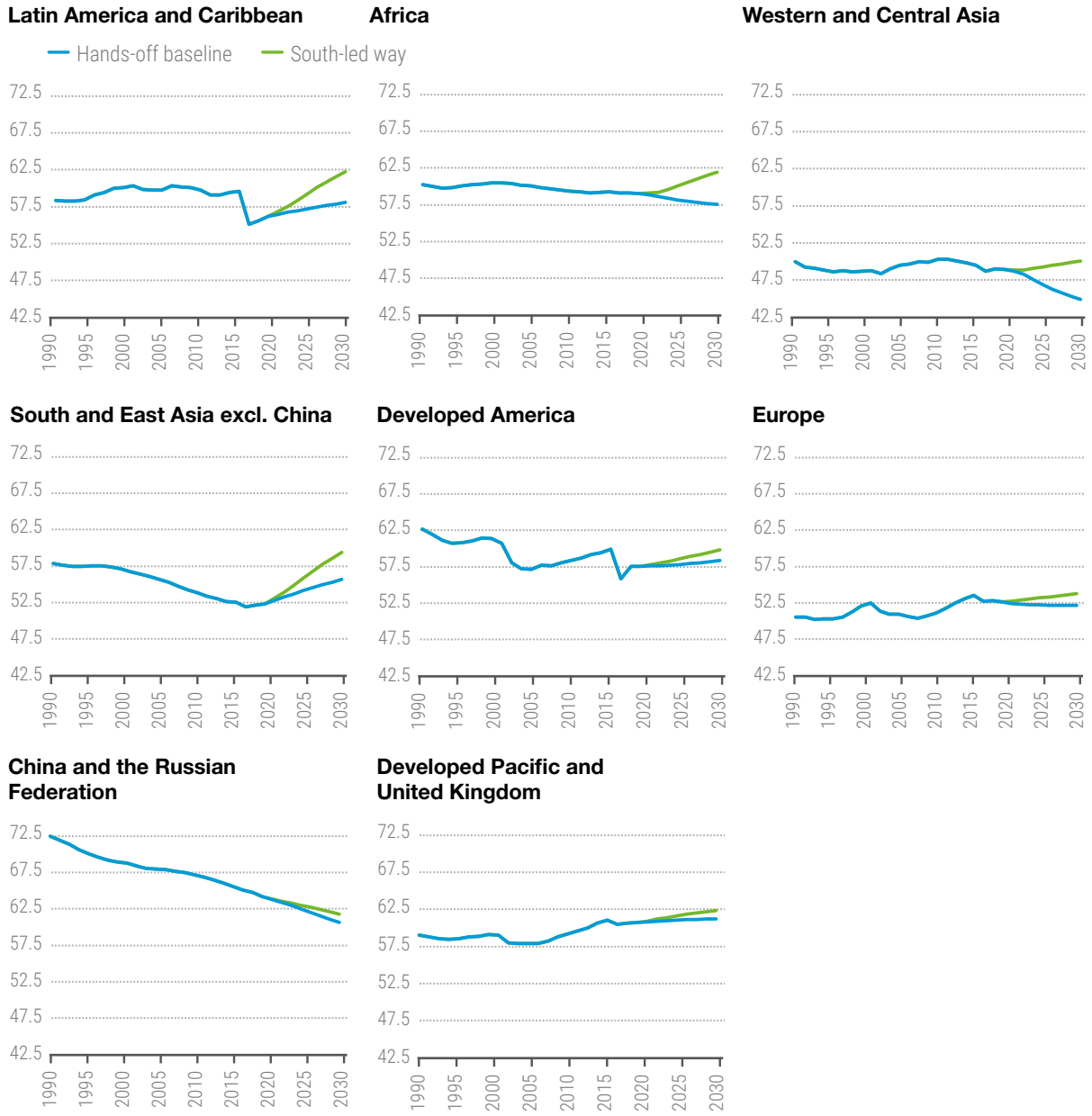
## 6. Scenarios compared: employment, distribution and the role of the State

The hands-off baseline assumes a continuum of stop-go policies to tame inflation by shocking demand, containing employment and curbing real wage income. Together with the fiscal austerity bias and the inclination to expect demand and activity to emerge from unfettered trade and financial liberalization, the simulation indicates that the global employment rate will stagnate for the rest of the decade, remaining at the low rate of 57 per cent. The distance from the averages of 62.1, 60.4, and 58.4 of the 1990s, the 2000s and the 2010s, respectively, is significant, all the more because of the global projected increase in the percentage of the elderly population, from 9.6 at present to nearly 12 per cent by 2030; importantly, their incomes will depend on a diminishing proportion of those employed. The global employment conditions, together with the increasingly concentrated structure of global production and markup pricing, will cause a fall in the labour income share from about 53.8 per cent at present to circa 52 per cent by 2030. This, apart from being socially explosive, implies a mix of global deflationary pressures, debt overhang and constraints to policy space

By way of an alternative, the South-led route assumes a greater involvement of the public sector everywhere, which by not being geared to short-term profit gains is best positioned to privilege employment creation where this is lacking, adopt wage-income policies where welfare and domestic demand are unsatisfactory and adopt supply-side inducements to lift bottlenecks in production, trade, trade-finance and credit where supply-driven inflation bites. The global employment rate in this scenario could rebound to nearly 60 per cent. This is not extraordinary; it would be close to what was achieved by 2007 but instead of arriving on the back of a global financial bubble, it will be on the back of an environmentally sustainable, state-led investment push which would crowd-in the private sector.

As indicated in figure 3.21, the employment outcomes of the baseline for developing groups are disappointingly low. They are on a declining slope for Africa and Western and Central Asia, not unrelated to the fact that most of these economies are heavily dependent on primary commodities and energy extraction, known to be poor employment generators. In the other two groups of developing economies there is a perceptible rise, but after the sharp downturn of the past few years. Hence, the benefit of the South-led scenario; by being centred on industrialization and counting on the support of the state, it would prove more effective at reversing the trend and promoting employment. For the more industrialized economies, the gains in employment rates are meaningful but less striking, partly because of the moderation of economic growth in these economies and partly because the patterns in the historical data suggest a slower response of employment to economic recoveries from recessionary episodes (“jobless recoveries”).

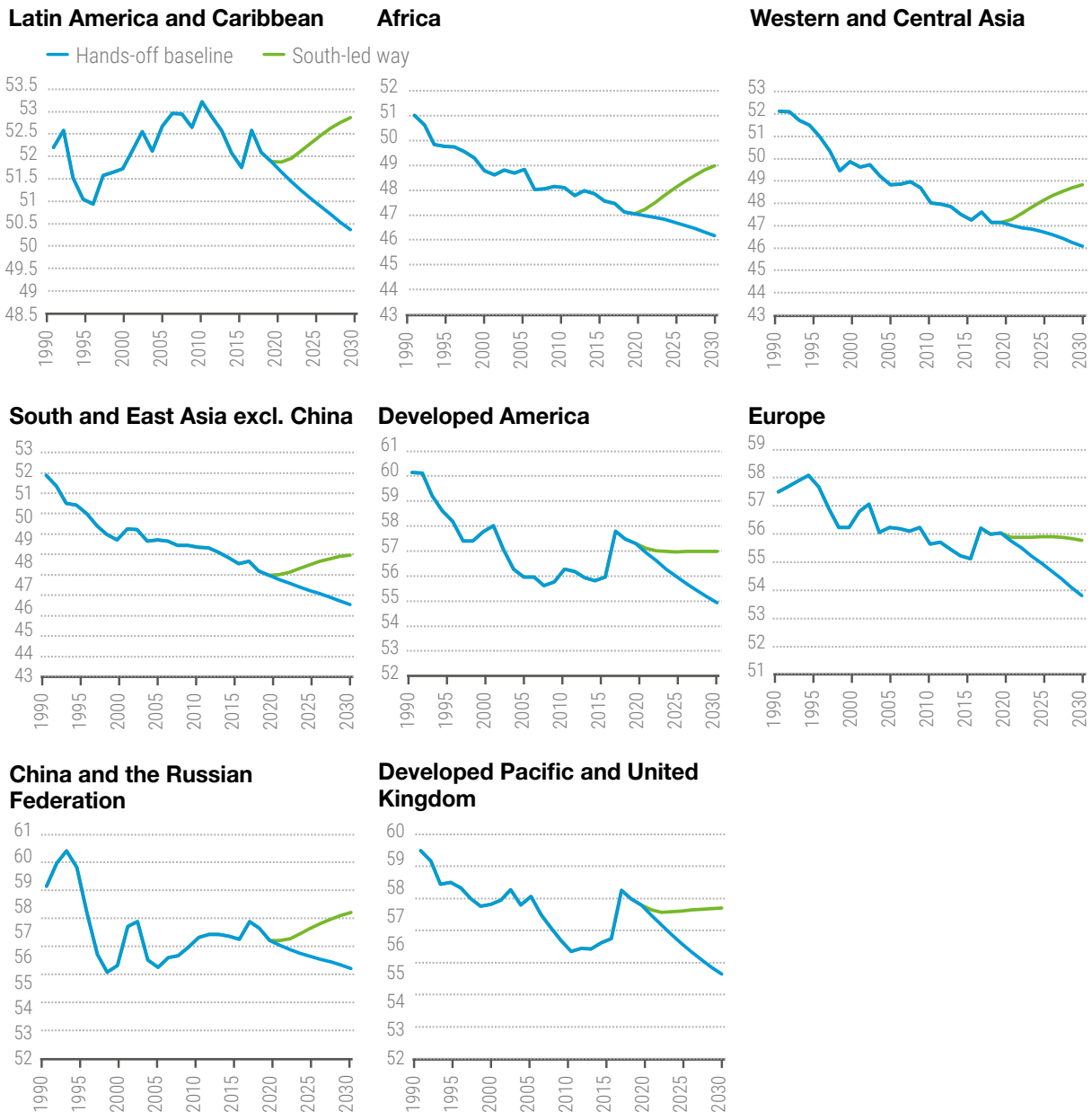
**Figure 3.21** Employment rate scenarios, selected country groups, 1990–2030 *(percentage)*




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

As the case of employment creation, figure 3.22 highlights both the need to overturn the estimated sharp decline of wage shares in the hands-off baseline and the effectiveness of an alternative strategy based on industrialization, public sector support, financial stability and a transformation of the productive matrix away from fossil fuels. Especially in developing economies, wage shares are strikingly low, and this implies profit shares are strikingly high. A South-led way offers considerable room for improvement, yet these economies will still remain at some distance from the patterns of distribution in the 1990s, as well as from those observed in the more industrialized economies.

**Figure 3.22** Labour income share scenarios, 2020–2030, selected country groups
*(percentage of GDP)*




*Source:* UNCTAD secretariat calculations based on United Nations Global Policy Model.

# D. CONCLUSION

This chapter outlines a strategy for South-led industrialization and coordination aimed at avoiding environmental meltdown and promoting employment generation globally, while rebalancing income distribution and favouring development through a sustainable path. In this strategy, trade, finance, credit and macroeconomic policies are coordinated and instrumental to the overarching goals of employment generation (especially in the North) and green industrial development (especially in the South). This is in contrast with the reality of increasing compartmentalization between key policy areas, with fiscal policy, monetary policy and trade policy all aimed at different objectives and with a systematic under-estimation of their regressive impact on income distribution and welfare (Wolf, 2022).

Results indicate that changing the course of the global economy towards a fairer and more sustainable future will take time. We project growth to reach 2.3 per cent and 5.4 per cent by 2030, respectively, in developed and developing economies. Thanks to the concatenation of industrialization and agrarian development goals in the scenario presented above, we also project that an additional 530 million jobs will be created globally, while with the current patterns and no policy change, the estimated increase will be 330 million jobs. The focus on employment and the technical progress triggered by trade and specialization in the South-led strategy would contribute to sustain increases in the share of labour income across all economies, yielding gains of 1.7 and 2.6 points relative to the baseline, in developed and developing economies respectively. Most importantly, the policy changes we explore will liberate much needed policy space for developing countries and allow a successful energy transition.

The burning question concerns the political will. The experience of the last four decades does not give much room for hope. Worse still, the accumulation of policy failures during the period have eroded the initial conditions for a sustained and equitable recovery so much that even with the best of policy efforts, the results are not likely to be sufficient to avert systemic economic, social and environmental failure. But a window of opportunity is opened, and while the room for the global South to take a leading role in changing the scenario – by leveraging its weight across key regions – exists, the responsibility (and resources) for moving in the right direction still rests with the advanced economies.

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# Chapter IV

## Regional Integration: Issues at Stake

# A. INTRODUCTION

As crises affecting the global economy become increasingly more complex and intertwined, policymakers at all levels of the multilateral system are seeking solutions that would safeguard against future shocks and ameliorate existing inequities and asymmetries across the global economy. Global issues require a coordinated response, yet inclusive multilateral dialogue requires a high degree of trust among contracting parties that is difficult to attain in the context of global instability and growing geo-political tensions. Moreover, the existing multilateral institutions established at the end of the second World War have struggled to adapt to the challenges of the new millennium, including those posed by new types of economic and financial crises.

New institutions of collective action that rely on selective participation, such as the G20, have proved to be only a partial success. The talk of strengthening the global safety net increasingly appears to be at odds with the growing number of developing countries caught in a vicious circle of recuring external shocks, mounting economic distress, climate crises and deepening uncertainty. Meanwhile, financial and corporate control over markets has become more sophisticated, while multilateral regulatory approaches are weakened by political tensions, economic disparities and institutional rigidities.

As Part 1 of this Report has shown, this global landscape reduces the policy space available to all national governments, but the problem is especially acute for developing countries faced with a myriad of external shocks, internal challenges and scarce resources.

Regional integration – whether through market-driven processes or as government-led trade and economic agreements, or a mixture of both – has long been advanced as a building block towards more effective and inclusive solutions to problems of economic development, including trade, financial integration and governance. In the past 20 years, this idea received new impetus from the growing interest of many countries of the Global South in both intra- and cross-regional trade agreements.

The new phase of formal regionalism is paralleled by the greater role of South-South trade linkages in the structure of global trade, as well as a more prominent role of South-led developmental banks in financing regional development projects. But despite these shifts, key issues affecting development paths and exacerbating existing asymmetries – including the impact of financialised markets, corporate control and market concentration – often remain outside of the purview of formal regional integration initiatives. This disparity brings up three key issues that are likely to play a central role in determining future success of ongoing regionalisation efforts.

First is the issue of the gap between *formal regionalism* based on treaty signing, and developmental regionalism that prioritises long-term, strategic national and regional developmental aims centred around the structural transformation of economies and tied to an underlying framework of the developmental state (UNCTAD, 2016). Although the distinction between formal and developmental regional integration should not be taken as a rigid classification, it is particularly important in the context of the growing scale and scope of regional trade agreements spanning many sectors (so-called, "megaregionals"[1]), along with the retreat of the state from strategic economic management and coordination. This raises the question of whether the current phase of formal regionalism driven by a plethora of regional agreements and treaties has the capacity to deliver sustainable growth and economic resilience in the absence of an established framework of development states reflected in regional development models. Chapter 5 of this Report delves into this issue in depth, analysing recent trends in trade regionalism across industry and services, and comparing them with the record of successful developmental regionalism in Asia.

[1] Mega-regionals are deep integration partnerships between countries or regions with a major share of world trade and FDI. Beyond simply increasing trade links, the agreements aim to improve regulatory compatibility and provide a rules-based framework for ironing out differences in investment and business climates.

Second is the issue of *institutional resilience, adaptability and depth*. These qualities are pertinent to any type of institution-building for development, but are particularly relevant in the context of the financial challenges of a climate-constrained world. Using the case of development finance institutions, Chapter 6 analyses the main challenge for regional development banks (RDBs) in today's global context. Having evolved in parallel to the multilateral lending institutions and spurred further by the economic rise of large developing economies in the opening decade of the millennium, RDBs if better financed, as well as better coordinated in their policy priorities, can provide a larger and more strategic role in development cooperation. This will also allow these institutions to be able to foster resilience in the face of new type of external crises confronting the development work. Chapter 6 offers recommendations on how these institutions can best adapt to meet the needs of participating countries.

Third, despite recent shifts, the expansion of regional trading areas and new challenges of multilateral lending are vastly inefficient in the face of *structural asymmetries* in the global financial system and corporate architecture which threaten to undermine regional developmental initiatives and diminish the space for development policies. Chapter 7 of this Report investigates the effects on developing countries of the North-South divide in the financialised economy of MNEs. Financialization, understood as the growth and consolidation of financial and legal innovations driving corporate arbitrage globally, is closely linked to the decreasing ability of national and regional host authorities to manage the behaviour of global corporate groups investing in their regions, while the reorganization of global value chains has been paralleled by finance-driven patterns of rent extraction, where developing countries remain at a structural disadvantage.

This is an issue that is likely not only to define developing countries' success in attracting international firms but whether or not they can bend the activities of those firms to support local development needs. It raises the question of what measures can developing countries undertake, at national as well as regional levels, to improve the regulation of global corporations, and regulate the phenomenon of corporate arbitrage that deprives national economies of financial revenues necessary for long-term stability and growth. This, as Chapter 7 of the Report shows, remains one of the steepest challenges confronting authorities across the global economy, and where regional forums are only beginning to tackle the problem.



## B. REGIONALISM: CONCEPT, EVOLUTION, CHALLENGES

International trade theory has tended to view regionalisation efforts with alarm. In the economics literature, they are often associated with trade-diverting agreements that threaten the advantages of full utilisation of factors of production in an open global trading system. In reality, more fundamental forces, dating back centuries, have linked industrialization to regional development through the rise of intra-industry trade.

These dynamics tend to generate economies of agglomeration and open channels for mutual learning across political boundaries. Together, these forces can bring cumulative benefits that can help boost productivity growth, but also encourage a higher degree of market concentration over time that allows firms to further boost their profits. These accumulated advantages, in turn, spur domestic firms into doing business abroad but also introduce their own economic asymmetries and distortions. Once such forces are engaged, there is pressure from producers within the region to lower or remove the various barriers to intra-regional trade, including bureaucratic red tape, conflicting legal restrictions and administrative procedures, etc., as well as demands for better transport and communications

infrastructure. These various demands are likely to be accompanied by the creation of institutions for closer regional cooperation, a process typified by post-Second World War European development.

For many developing countries constrained by the limited size of their own domestic markets, closer economic ties with their neighbours have been seen as a possible route to establishing cumulative advantages for their own fledgling corporations. However, the record is an uneven one, with only East Asian economies exhibiting a more lasting process of growing successful regional ties and cooperation, including, most recently, with China's development model.

Politics inevitably plays a crucial role where governments are required to coordinate more closely with each other in some policy areas and to give up certain policy options and resources in others. This has often proved a major obstacle to a building regional integration particularly among countries in the early stages of economic development. There are signs, after a series of false starts and disappointments, that such integration is again gaining converts in parts of the developing world. Proposals to forge greater consistency with respect to trade and investment policies are back on the agenda in both Africa and Latin America.

In terms of the scope of regional arrangements, there is a familiar distinction between shallow and deep regionalism – defined by the normative reach of the agreement between members and the type of regulatory impact of the agreement. *Shallow* regionalism describes those Regional Trade Agreements (RTAs) that merely concern the removal of tariff barriers, including partial scope agreements. *Deep regionalism*, in contrast, means establishing far-reaching RTAs that go beyond trade liberalization, to include trade of services, investments, competition, and public procurement, whilst also taking on some features of a common market and focusing on regulatory issues (Kang 2016, p. 250).[2] Shallow regional integration is seen as enabling participating countries to retain policy space over key areas of the economy, while modern examples of deep regionalism are often seen as constraints on national governments' ability to form strategic approaches to economic growth, financial stability, debt sustainability, public health and environmental protection (Thrasher, 2021) .

Deep integration projects can arise as a response to processes already underway in the corporate sector, often triggered by earlier regionalisation schemes. Such projects are closely associated with the institutional foundations of a common market and are based on common regulatory measures in trade of services, investments, competition, and public procurement. The EU is the most obvious example of deep regional integration, while NAFTA, prescribing coordinated regulatory provision of investment and dispute mechanisms, is an example of deep North-South regional integration (Kang 2016). At the same time, as both Euromed and NAFTA are free trade areas (FTAs), the distinction between shallow and deep integration reveals that RTAs can be considerably different not only in terms of effectiveness and scope (Capaldo, 2014)[3], but also in terms of their impact on welfare.

For example, in the case of East Asia, deep regional integration has been driven on the one hand, by the development of micro-level regionalized linkages (regionalization), including through the continued expansion of international production networks and corresponding increases in intra-regional trade and investment, and the growing number of international economic agreements that have been signed among East Asian countries on a region-wide scale, especially after the region's 1997/98 financial crisis, on the other (Dent 2008).

As survey of regional integration initiatives in the developing world shows (figure 4.1), that regional economic integration activity has been growing at both intra-regional and in particular, cross-regional levels (figure 4.1.C), with agreements covering good and services growing since 2007–08 (figure 4.1.D). For most areas of the global South, regional participation in RTA agreements increased manifold, with Free Trade Areas and Economic Integration Areas exhibiting particularly strong growth since

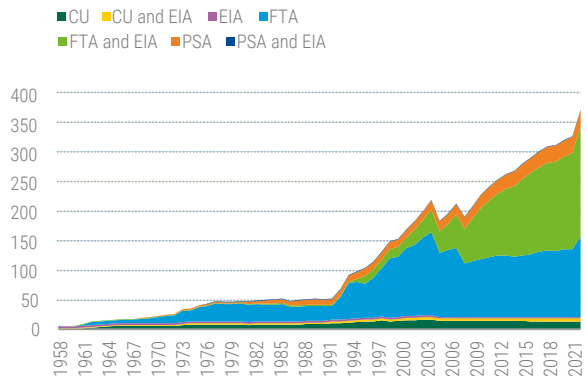
[2] Before the 1990s, most RTAs concluded between developing countries tended to be of a shallow integration nature (Kang, 2016).

[3] https://unctad.org/system/files/non-official-document/cimem5_2014_Capaldo.pdf

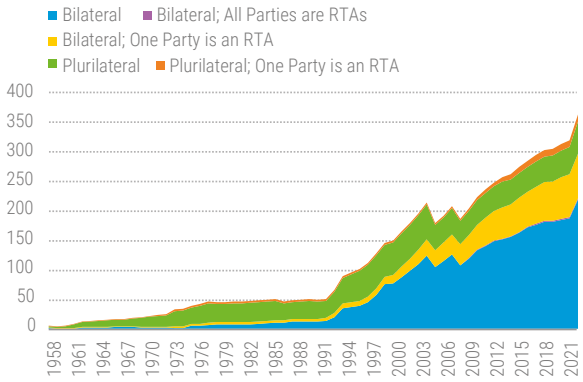
2007 (figure 4.1.A). Notably, these integration initiatives have increased at the level South-South and North-South cooperation, while North-North types of integration initiatives have been largely static (figure 4.1.C).

**Figure 4.1** Regional trade agreements, by groups, 1958-2021

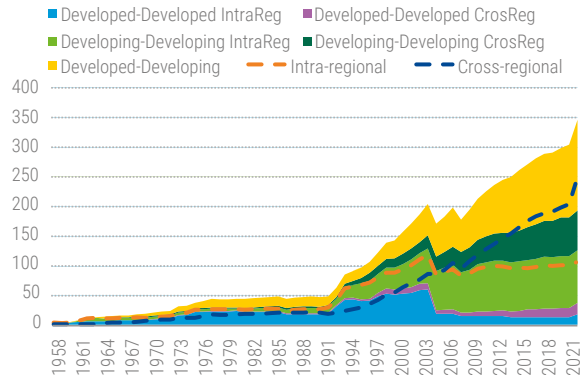
**A. By type of RTA**



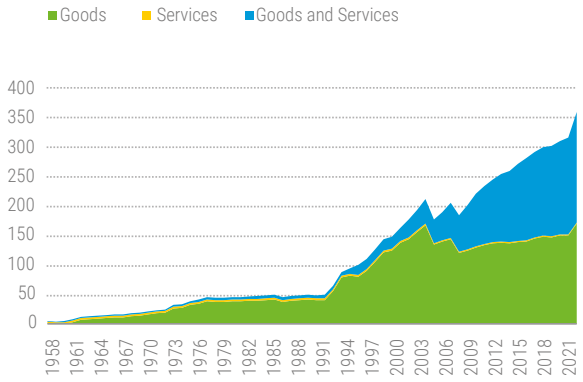

**B. By kind of integration**




**C. By development status and cross – regionalism**



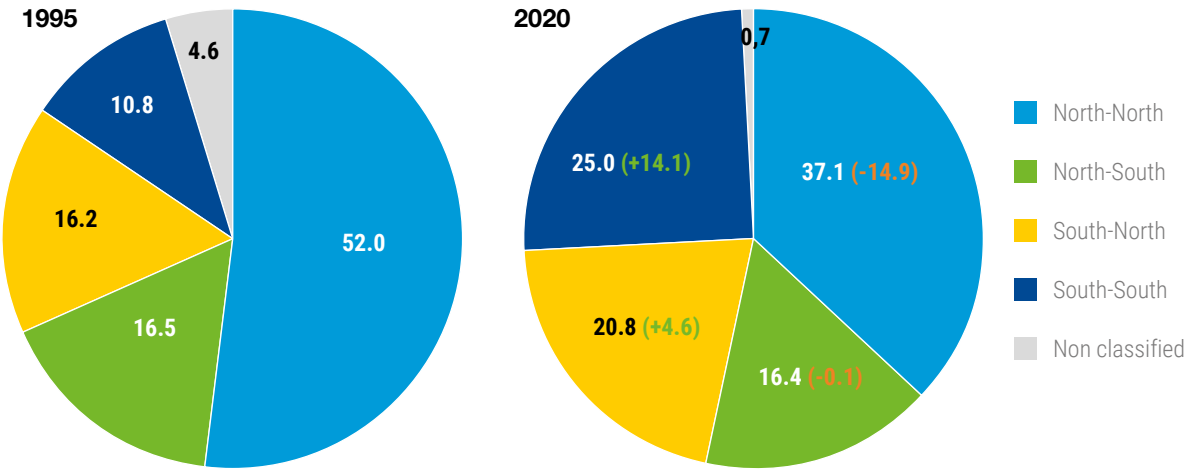

**D. By coverage**




*Source:* UNCTAD secretariat calculations, based on Regional Trade Agreements Database, World Trade Organization
*Note:* Customs Union (CU); Free Trade Agreement (FTA); Partial Scope Agreement (PSA); Economic Integration Agreement (EIA).

Within this broad trend many new, sub-regional economic areas were formed, often centred on the underlying processes of regionalization and governance of a common resource. Their format varies from trade partnerships to customs unions and common currency areas, but as a whole, these projects parallel the expansion of South-South initiatives and trade flows, and are characterized by active South-South economic links. This shift is also reflected in the changed structure of international trade over the past 25 years, where the share of trade between the developed economies has declined by nearly 15%, having been superseded by the growth in North-South (+14.1%) and South-South (+4.6%) trade linkages (see figure 4.2).

**Figure 4.2** Shares in global trade, 1995 and 2020




*Source:* UNCTAD secretariat calculations, based on UNCTADstat Database, Merchandise Trade Matrix.
*Note:* Imports are mirror figures as received exports.

# C. DEVELOPMENTAL REGIONALISM: KEY CHALLENGES

## 1. Trade and Developmental Regionalism: Issues at stake

Chapter 5 focuses on regionalism in trade and discusses its role in pathways towards open developmental regionalism. This model is closely associated with shallow trade agreements that do not unduly reduce the policy space available to developing countries to manage the trade-offs that accompany any move towards closer integration with multiple countries. The strategies of open development regionalism allow participating countries to implement the collective actions that arise from closer cooperation and at the same time, to continue to support the broad range of goals of an inclusive and sustainable development strategy. The model aims, first and foremost, at boosting productivity growth and creating jobs through economic diversification and technological upgrading. But an open and pro-active regional trade governance could also shield developing economies from adverse global effects.

By itself, however, shallow regionalism cannot evolve into an institutional framework of open developmentalism. Not only can the many rules and regulations in existing bilateral, regional and multilateral agreements constrain the use of industrial and environmental policy, but trade regionalism centred on formal treaty signing can, itself, jeopardize a more inclusive multilateral trading system.

In terms of rulemaking, open developmental regionalism would limit binding commitments to border measures, whilst relying on cooperation and an adaptive policy mix that aims at regional harmonization of behind-the-border trade measures as, for example, in the ASEAN model. Supported by institutions of the developmental state and calibrated 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 also facilitate the management of the diverging interests and sensitivities of

developing and developed countries for a more inclusive and developmental international trade governance.

In this respect, closer trade integration among neighbouring countries, the advance of regional infrastructure projects, cooperation on industrial policies and shared legal frameworks can unleash virtuous growth cycles and mediate the interface between global economic forces and domestic needs. But the nature of competition, regulatory coordination and policy autonomy, are key to the inclusiveness and sustainability of regional developmental projects.

Progress calls for the full use of the principles of special and differential treatment and common but differentiated responsibilities. Without the application of these principles, it will be difficult for developing countries to transit towards diversified and higher value-added activities in a world facing widening inequality and growing ecological instability. This implies that developing countries will need to be engaged in multilateral trade governance whilst capitalizing on the advantages of open developmental regionalism in areas that do not lend themselves to trade rules, and/or where these countries do not yet have the capacity to engage in binding multilateral commitments. In those areas, open developmental regionalism can offer a bulwark against an increasingly challenging world order.

## 2. Institutional Adaptability: The Case of Regional Development Finance

Open regionalism requires a stable macroeconomic and financial environment that can support productive capital formation and job creation. Such an environment should include policies and institutions that foster the provision of long-term investment finance. The evolution of development finance institutions analysed in Chapter 6 presents a case of institutions that can adapt to and respond to the changing international landscape of risks, and, albeit to varying degrees, respond to policy priorities of national economies.

During the post-WWII period, Regional Development Banks (RDBs) have gone through three phases in terms of their place and function in the changing global landscape of international finance (see Table 4.1). As Chapter 6 points out, the current phase in the activity of regional development finance is marked by a discernible shift in the views on the role of these financial institutions. It includes a renewed attention to the ' role of developing banks in providing "patient capital" for long-term structural transformation, as well as counter-cyclical support in times of crises. Here, the lessons drawn by the developing countries from the 1997-98 Asian financial crisis have proved particularly pertinent: the meltdown of 1997 sparked a renewed interest particularly in Asian, but also more widely Southern-led, multilateral financial institutions (Barrowclough et al., 2021; *TDR*, 2015).

**Table 4.1** Evolution of the system of multilateral development banks, 1944–2022

| Year | Bank name | Region | Assets |
|---|---|---|---|
| **WWII–1960s – Bretton Woods and the global view** | | | |
| **1944** | World Bank | Global | 263.8 |
| **1956** | International Finance Corporation | Global | 94.3 |
| **1950s–1980s – Regional development banks and regional integration for development** | | | |
| **1956** | Council of Europe Development bank | Europe | 25.7 |
| **1958** | European Investment Bank | Europe | 555.8 |
| **1959** | Inter-American Development bank | LAC | 129.5 |
| **1960** | International Development Agency WBG | Global | 184.6 |
| **1960** | Banco Centroamericano de Integración Económica | LAC | 10.9 |
| **1963** | International Bank for Economic Cooperation | Asia Pacific | 0.4 |

**Table 4.1** Evolution of the system of multilateral development banks, 1944–2022 *(cont.)*

| Year | Bank name | Region | Assets |
|---|---|---|---|
| **1964** | African Development bank | Africa | 13.1 |
| **1966** | Asia Development bank | Asia Pacific | 191.9 |
| **1967** | East African Development Bank | Africa | 0.4 |
| **1970** | International Investment Bank | Inter-regional | 1.3 |
| **1970** | Banco de Desarrollo de América Latina | LAC | 40.5 |
| **1970** | Caribbean Development Bank | LAC | 1.7 |
| **1973** | Banque de Developpement des Etats de l'Afrique de l'Ouest | Africa | 4.6 |
| **1973** | Arab Bank for the Economic Development of Africa | MENA | 4.9 |
| **1974** | Fondo Financiero para el Desarrollo de la Cuenca del Plata | LAC | 0.3 |
| **1974** | Arab Fund for Social and Economic Development | MENA | 12.2 |
| **1975** | Nordic Investment Bank | Europe | 34.9 |
| **1975** | Banque de Développement des Etats d'Afrique Centrale | Africa | 0.7 |
| **1975** | Ecowas bank for Investment and Development | Africa | 0.9 |
| **1976** | OPEC Fund for International Development | MENA | 7.4 |
| **1977** | Fonds Africaine Guarantie et de Cooperation Economique | Africa | 0.1 |
| **1977** | International fund for Agricultural Development | Inter-regional | 9.0 |
| **1985** | Shelter Afrique | | 0.2 |
| **1985** | Trade and Development bank | Africa | 5.5 |
| **1989** | Arab Trade Financing Programme | MENA | 1.2 |
| **1989** | Pacific Islands Development Bank | Asia Pacific | 0.3 |
| **1989** | Nordic Development Fund | Europe | 0.9 |
| **1990s–2000s – Regionalism and market-led development, global vertical funds, trust funds hosted by MDBs** | | | |
| **1991** | European Bank for Reconstruction and Development | Inter-regional | 68.0 |
| **1993** | African Export and Import bank | Africa | 13.4 |
| **1993** | Interstate Bank | Asia Pacific | 0.2 |
| **1993** | North American Development bank | LAC | 2.0 |
| **1999** | Islamic Co-op for the Development of the Private Sector | Inter-regional | 3.1 |
| **1999** | Black Sea Trade and Development bank | Europe | 2.0 |
| **2005** | Economic Coop. Organization Trade and Development | Asia Pacific | 0.7 |
| **2006** | Eurasian Development bank | Asia Pacific | 3.7 |
| **2010 onwards – Regionalism and the rise of the South, the return of industrial policy** | | | |
| **2014** | New Development bank | Inter-regional | 10.4 |
| **2015** | Banque Maghrébine d'investissement de Commerce Extérieur | MENA | 0.3 |
| **2016** | Asian Infrastructure Investment Bank | Asia Pacific | 19.6 |

*Source:* UNCTAD calculations, derived from data drawn from the Data Visualization Index Agence Française de Développement ADF and Peking University, Institute of New Structural Economics; Ocampo and Ortega (2020); Clifton et al. (2021); Barrowclough et al. (2021) and bank websites.
*Note:* LAC stands for Latin America and the Caribbean; MENA for Middle East and North Africa

In terms of their scope and function, the RDBs continue to focus on their continent and region, and to pursue market-oriented lending. At the same time, there is more caution about the neoliberal approaches that rose to dominance during the 1980s, as a number of RDBs have rediscovered the merits of a more interventionist, developmental policy.

The renewed interest in the strategic role of development finance includes the use of industrial policy. Development banks have gone beyond simply correcting market failures or financial gap filling (as is so often the rationale for supporting infrastructure) and are more involved in more dynamic and catalytic functions of "market shaping" (Mazzucato and Penna, 2016) and strategic support (UNCTAD, 2016). They also increasingly finance international public goods, both global and regional, especially in the space of environmental sustainability or decarbonization (Marois 2021); including for example through the emergence of dedicated green public banks (*TDR* 2021, p.150; Marois, 2021).

In some areas, RDBs increasingly involve sub-national actors such as localgovernments – suggesting a somewhat different business model that goes beyond the geographical region for lending and towards more interventionist market shaping activities. One example is the EIB – which was originated as a sub-regional bank in Western Europe with a market-promoting function, and subsequently engaged in industrial policy through the European Commission's Investment Plan for Europe and European Fund for Strategic Investment. The EIB was strongly involved in the European pandemic response, both in terms of lending in general and in lending to R&D for a vaccine, in particular. Indeed, most RDBs played a central role during the Covid economic and health shocks; sometimes out-lending the global legacy DFIs such as the World Bank, especially at the start of the pandemic and associated lockdowns, or significantly co-lending, demonstrating speed and flexibility in responding to their members' needs (Griffith-Jones et al., 2022).

This experience of RDBs during the Covid crisis presents important lessons for other crisis scenarios that are likely to confront the developing countries in the climate-constrained world. These concern, for instance, decarbonisation and the shift to low-carbon or zero-carbon development path. The transition will require not only resources beyond the scope of individual national banks, but also, co-ordination and integrated responses across many countries. Hence after decades of being ignored, dismissed or attacked, DFIs are now seen as a vital component of the multilateral development system and the source of the long-term and reliable finance, provided on favourable terms, to support development. For example, a recent OECD report (OECD, 2020: 32) argues that MDBs are the pillar of the multilateral system, thanks to their unique capacity to leverage finances beyond their initial capitalization, as well as their extensive field presence and operational capacities (ibid: 34).

Chapter 6 examines these and other challenges facing the creation and functioning of regional financial institutions in supporting developmental regionalism. Despite their expansion over the years financing remains a key issue that needs to be addressed in regional development programmes. The capacity of these institutions and their role in regional economies remains constrained by precarious funding sources, leaving them vulnerable to the effects of international crises and uncertainty. It is clear that in order to be a viable part of developmental regionalism, RDBs need to be an integrated part of a regional financial system, including liquid capital markets, appropriate regulatory mechanisms, standard-setting bodies, as well as institutions supporting national currency markets and the financial safety net. For most of the regional blocs constructing such a system remains a challenge. To what extent new types of regional integration initiatives have the potential to overcome these and other hurdles to institution-building, is discussed in Chapter 6.

## 3. The Challenge of financialization and corporate control to regional integration

Previous TDRs have delved at some length into the macroeconomic and structural aspects of financialization and, in particular, analysed the gap between the continued expansion of the private credit system and financial asset markets, and investment-led growth pathways available to the developing countries (*TDR* 2016, 2017, 2019). Chapter 7 of this Report argues that an additional set of barriers to the developmental gains from regionalization comes from *the financialization of the corporation* itself.

More specifically, financialization, understood as the growth and consolidation of of financial and legal innovation driving corporate arbitrage globally, is closely linked to the decreasing ability of national and regional host authorities to control the behaviour of global corporate groups investing in their regions. At the same time, the reorganization of global value chains has been paralleled by finance-driven patterns of rent extraction, where developing countries remain at a structural disadvantage.

Chapter 7 analyses the consequences of this problem at several levels of global political economy where, the multiplication of regional agreements and investment treaties has contributed to the creation of a highly complex network of corporate and financial regulations. These, in turn, have been conducive to the rise of the "fragmented firm". Modern MNEs are organised as a network of entities held directly or indirectly by parent through equity ownership.

In the context of developmental gains from regional integration, this means that while regional trade and investment agreements may aim to encourage investment into the region, it is the way the investments are structured through corporate subsidiaries that determines the economic impact of the investment.

This is particularly pertinent to developing economies seeking to attract productive FDIs.

Typically, as Chapter 7 details, MNEs can (and do) structure their investments indirectly, through intermediaries, and ensure that considerable portion of operational activities take place outside of the host market of the developing country. The reason they may do so is because certain countries present them with a more accommodative regulatory environment, lower taxation, as well as other advantages. Due to statistical anomalies associated with financial and legal innovation at the corporate level, none of these outcomes are picked up in FDI statistics.

Chapter 7 of this Report argues that inner organisation of global corporations plays a key role for development outcomes and the gains a host country or region can attain from private international investment. The techniques of corporate arbitrage, enabled by financial and legal innovations, come into conflict with national governments, especially in the context of developing countries, where corporate groups effectively arbitrage national rules through access to investment treaties. The analysis reveals a North-South divide in the registration of value creation in the global economy, with corporate players mostly relying on the financial, accounting, and regulatory infrastructure offered to them by competition states (the Netherlands, Luxemburg, OFC islands). As a result, the majority of developing economies, despite their efforts, remain structurally disadvantaged in the global competition for capital.

In terms of the macroeconomy, earning stripping through the use of corporate subsidiaries affects the fiscal space of any host country. Advanced economies 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 those of the advanced economies.

In the absence of a developed set of regulatory standards and a systemic framework of regulation, developing countries need to build the relevant financial, accounting, legal and data expertise, with a view of enhancing the visibility of corporate behaviour at the global level. Regional integration initiatives

have so far lagged behind in the reform of governance standards as a whole, and are yet to tackle this dimension of the financial, corporate and market governance in a systemic way.

Chapter 7 calls for reform measures aimed at tracing corporate tax arbitrage to be connected with closer policy attention to advancing FDI statistics. Similarly, corporate accountability measures in the developed countries need to take a closer look at the role and type of corporate subsidiaries and the nature of their *de facto* economic activity. The availability of reliable data on corporate financial behaviour, professional expertise and dedicated regulatory mandate at national levels, can play a key role here.

While some recent initiatives by international organizations do mark a major step towards global tax justice and corporate transparency, these efforts have so far been evolving in isolation fromeach other. A more integrated approach, aimed at comprehensive multilateral system of measures of corporate and financial regulation, is needed to address the financial-corporate nexus of economic asymmetries dividing developed and developing countries.

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# Chapter V

## Trade Regionalism and Development

# A. INTRODUCTION

Regional integration is often examined through a narrow trade lens, whereby reduced barriers to trade are viewed an end in themselves, and attention is focused on the creation and diversion effects of Free Trade Agreements (FTAs). This chapter takes a different approach, in that we see trade as a means to development, not an end. More specifically, we discuss the developmental effects of regional trade and trade agreements in the context of managing sectoral shifts to support a diversified economy and productivity growth.

The chapter starts by examining regionalization and the developmental effects of intraregional trade, measured by a higher degree of diversification and/or a larger share of domestic value added in regional than in total trade. We underline that for regionalism to be development-oriented, it must be part of a broader strategy promoting regional integration and cooperation across a range of non-trade areas. Such a strategy may be called "open developmental regionalism" whereby formal rule-setting is confined to border measures, and informal cooperation on behind-the-border measures and other policy areas works to unleash regionalization dynamics that could support structural transformation. The chapter also discusses the challenges posed to regional arrangements by the emerging digital economy and climate change and whether and how regionalism can revitalise multilateralism, rather than resulting in a fractured international trade system. It insists that a constructive and cooperative approach to multilateralism remains paramount, and open developmental regionalism can be an important tool to make the existing multilateral trading regime more inclusive, especially in new and rapidly evolving areas, such as the digital economy and the response to climate change.

# B. RECENT PATTERNS IN REGIONAL TRADE: DEVELOPMENTAL IMPACTS OF REGIONALIZATION

Trade has the potential to support national development strategies, especially if the related policy prescriptions are not confined to rapid trade liberalization but embrace a more strategic and integrated approach, including other key policy areas, such as macroeconomic and financial management, trade support and industrial policies, to name a few (UNCTAD, 1964). Any attempts to maximize the benefits and minimize the costs of trade integration are not independent of other elements that make up a healthy economy, whether capital formation (both physical and human), quality infrastructure, financial depth or technological innovation. In other words, international trade – including intraregional trade – should not be considered an end in itself but a means to support diversification and industrialization and innovation and productivity improvement more generally. Extensively researched success stories, including reports by UNCTAD, back up this approach.[1]

Several arguments seek to explain why intraregional trade could provide a route to realizing wider development goals (e.g., *TDR*, 2007, chap. 2, chap. 4). A "structuralist" approach posits that the likelihood of trade having a positive impact is greater when it takes place among countries in the same (developing) geographical region because of the advantages of proximity. Moreover, these entities are often closer in terms of their initial development conditions, making for more equally shared gains from trade; when the economic structure of trading partners is similar, gains from trade arise primarily from "economies of scale" and learning effects, rather than from "comparative advantages" reflecting pronounced differences in either technology or relative endowments. More trade can avoid the lock-

[1] The research has been reviewed in previous reports (see *TDR*, 2002, 2003, 2016).

in effects resulting from trade based on comparative advantage – such as a strong reliance on raw materials or an abundance of low-skill labour – and have the potential to promote export diversification and accelerate industrial development. Key to understanding this potential is the fact that foreign competition within a developing region is easier for both policy-makers and domestic firms to manage when it takes place vis-à-vis competitors from neighbouring countries rather than firms from more advanced countries, given the cost and capability gaps with the latter.

From a demand point of view, the gains from trade are more likely to be retained inside a region when they result from intraregional trade than from extra-regional trade, as trade organized around international supply chains is more prone to profit repatriations to headquarters of foreign multinational enterprises (MNEs). Thus, under these circumstances, intraregional trade is expected to result in greater multiplier effects than extra-regional trade.

Another argument derives from the political economy of trade agreements. Trade rules within developing regions are often less stringent than those in bilateral or plurilateral trade agreements characterized by power asymmetry among the participating countries. The risk that power asymmetries could lead to a narrowing of national policy space for developing countries signing trade agreements is probably lower when such agreements take place intraregionally.

Lastly, from a supply chain approach, the integration of countries into regional value chains may strengthen industrial networks by moving inter-industry linkages from a simple hub-and-spokes cluster to a more complex structure as witnessed in some East Asian countries around China. It is often argued that it is easier to join an existing supply chain (especially if it is close geographically) than to build one from scratch domestically as was done, for example, by both the Republic of Korea and Taiwan (Province of China).

Notwithstanding these theoretical considerations, determining whether intraregional trade is more conducive to development than extra-regional trade requires empirical analysis. The rest of this section is devoted to this exercise. We review the composition and evolution of exports of different regional groupings with three types of trading partners since 1995, first with respect to merchandise trade and then services. The idea is that the benefits of trade for economic development cannot be measured simply by the evolution of the total value of exports. Rather, they can be captured by a country's capacity to increase the production (and therefore, the export share) of the products or services more associated with higher productivity, rising incomes and ultimately economic and social development.

In the first set of empirical exercises, we examine the composition of intraregional merchandise exports and compare this to two types of extra-regional flows: first, exports to the (rest of) developing countries and second, exports to the (rest of) developed countries. We consider five country groupings. Four are in various corners of the developing world: Africa, the Association of Southeast Asian Nations (ASEAN),[2] the Commonwealth of Independent States (CIS) and Latin America and the Caribbean. The fifth group is the European Union, which partly plays the role of a benchmark because its members are advanced economies, and it has deep experience of regional integration. The choice of the European Union should not be understood as a call for developing countries to replicate this specific experience, however, as its initial conditions, its motivations, its timing and many other elements created a unique process. Yet focusing on the European Union case yields relevant findings which could be useful when comparing trade flows of other developing regions.

[2] The choice of ASEAN rather than an alternative country grouping in (developing) East and/or South-East Asia reflects its longstanding efforts to achieve regional cooperation. Although its origins reflected political considerations to promote peace in what was then an area with recurrent conflicts, this group moved up a gear in terms of economic cooperation in 1992, with the signature of the ASEAN Free Trade Area (AFTA).

## 1. Trade in goods

Two main sources of merchandise trade data are considered in this analysis: "gross exports" from UNCTADstat[3] and the "domestic value-added content of exports" from OECD Trade in Value Added (TiVA) database.[4] Both sources provide data on aggregated bilateral trade flows, as well as more granular data, thus allowing the decomposition of merchandise exports into three broad categories: primary commodities, excluding energy; energy; and manufactures. Such decomposition sheds light on our main question, with the underlying idea that a larger share of (domestic value added resulting from) exports of manufactures is more conducive to development because of their better paid jobs, their stronger linkages with the rest of the economy, in particular the amount of employment they create, and their higher technological spillover to other parts of the economy, which, in turn, can lay the basis for a strong export-profit-investment nexus (see *TDR*, 1996, chap. 2; *TDR*, 2003, chap. 4; *TDR*, 2005, chap. 2).

It should be noted that each database has pros and cons. Using gross exports allows broader coverage, especially for developing countries. UNCTADstat includes 218 jurisdictions, while TiVA reports indicators for only 66 economies, plus an aggregate for the "Rest of the World". The use of gross exports as a proxy to measure the country capacity to move up the development ladder can be misleading, however. Researchers have stressed for decades that a particular exported product no longer coincides with an entire domestic production sector. On the contrary, when the product is produced within an integrated international supply chain, the share of the value-added content of exports coming from abroad can be large. Moreover, the classification of the final product as high-skill and/or technology-intensive does not necessarily mean any particular sub-component of the chain (and the exports that result therefrom) is characterized as such.

To circumvent this issue, we may rely on the domestic value-added content in exports as reported in TiVA. Yet turning to TiVA data is not without cost either, as TiVA country coverage is extremely limited, especially in the case of Africa and CIS, and to a lesser extent Latin America and the Caribbean (see the note of figure 5.1 for more details). For these reasons, our empirical analysis considers gross exports as well as TiVA trade flows. One positive aspect is that these two sources hint at similar conclusions.

Not surprisingly, the European Union and ASEAN have a much larger share of manufactures in their exports (figure 5.1), but there are several other takeaways for the European Union exports. First, whether we consider gross exports or domestic value-added content of exports, manufacturing exports still represent the bulk of merchandise trade. This partly reflects the maturity of the economies. Second, because the extraction of primary commodities such as minerals and energy is relatively modest, the share of manufacturing exports appears even greater in the TiVA data (approximately 95 per cent) than in gross exports (approximately 80 per cent). The fact that the bulk of these commodities is initially imported from outside the region, especially to the Netherlands, before being re-exported elsewhere, explains this difference. This feature is a reminder of the potential drawback of the use of gross exports as a proxy for the production capacity of any economy and indicates the value of the TiVA data. A comparison of the two types of data for the European Union (a group with complete and high-quality data) shows that the rise of its exports to the developing world follows the same pattern (black line in figure 5.1). Similarly, the share of commodity exports in gross exports rose between the late 1990s and the early 2010s, and this trend also appears, albeit more modestly, in the TiVA data. These similar patterns suggest it may be appropriate to consider gross export data if TiVA coverage is more limited, especially if we look at the evolution of the shares, rather than their absolute levels.

[3] See https://unctadstat.unctad.org.

[4] See https://www.oecd.org/sti/ind/measuring-trade-in-value-added.htm.

**Figure 5.1** Composition of merchandise exports, selected country groups and components, 1995–2020 *(percentage)*

**Gross exports**

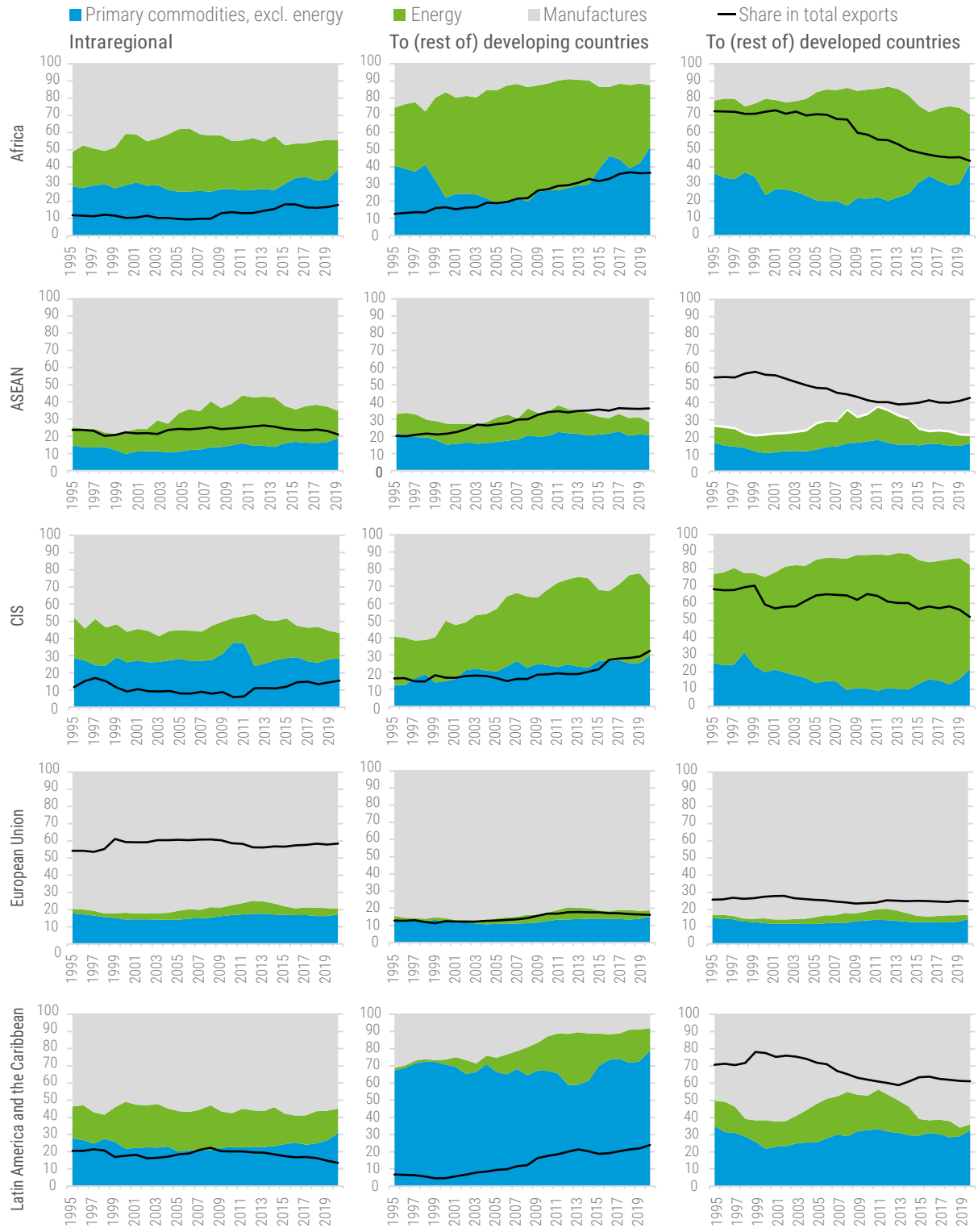
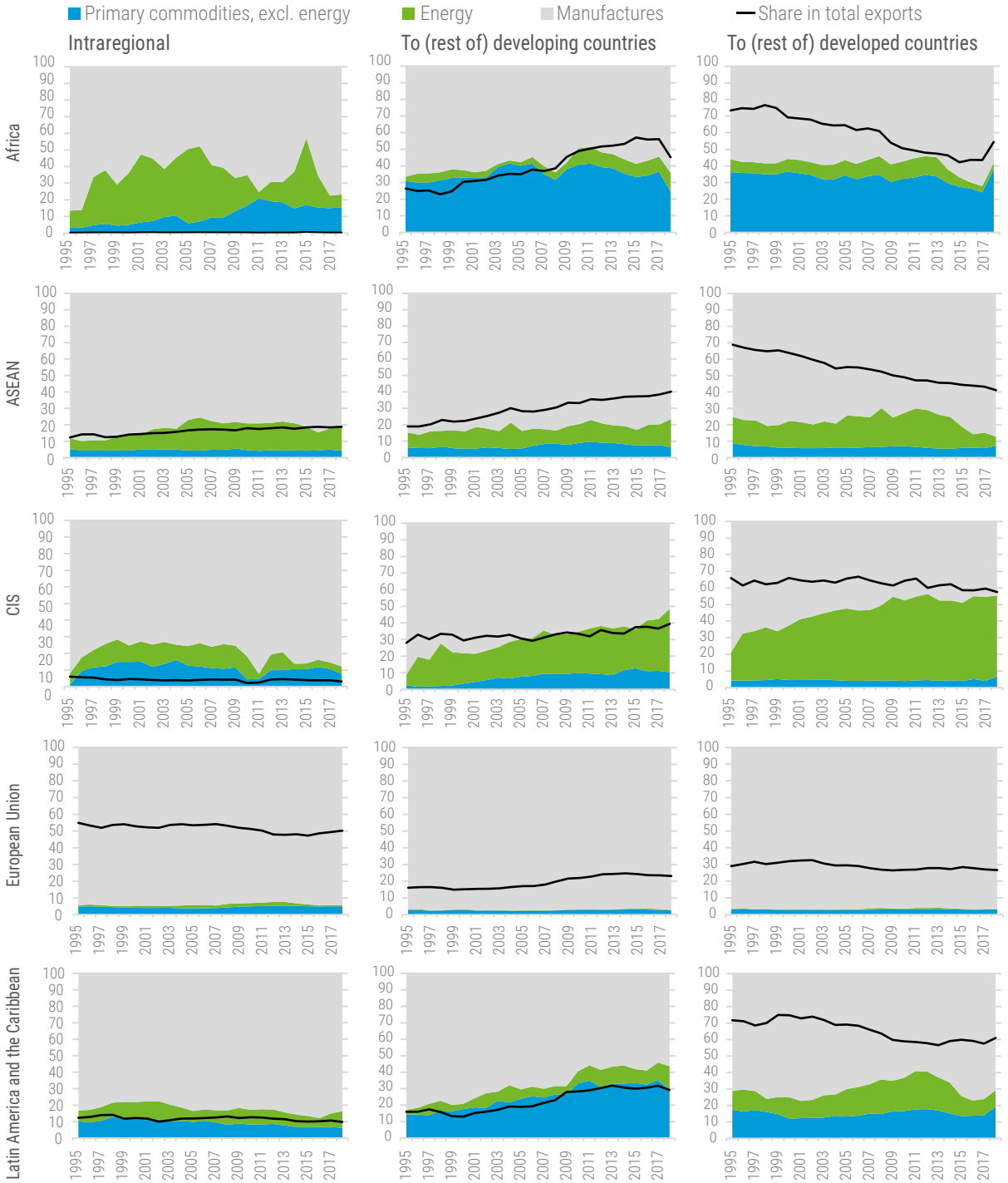


**Figure 5.1** Composition of merchandise exports, selected country groups and components, 1995–2020 *(percentage) (cont.)*

**Domestic value-added content of exports**




*Source:* UNCTAD secretariat calculations, based on UNCTADstat and OECD TiVA databases.
*Note:* Country coverage for the "domestic value-added content of exports" (TiVA database) can be limited. Africa refers to only 3 countries (Morocco, South Africa and Tunisia), CIS to 2 countries (Kazakhstan and the Russian Federation), and Latin America and the Caribbean to 6 countries (Argentina, Brazil, Chile, Colombia, Mexico and Peru). The country coverage for ASEAN and the European Union is complete. For "Gross exports," "Primary commodities, excl. energy" relates to the following codes of the SITC Rev. 3: 0, 1, 2, 4, 667, 68, 961 and 971. "Energy" refers to code 3, while "Manufactures" corresponds to codes 5 to 8 less 667 and 68.
For "Domestic value-added content of exports," "Primary commodities, excl. energy" relates to the following TiVA codes: D01T03, D07T08 and D09. "Energy" refers to TiVA code D05T06, while "Manufactures" corresponds to TiVA code D10T33.

In ASEAN, the data paint a similar picture, with exports characterized by a large share of manufactures. In fact, when measured using domestic value-added content, manufactures often generate more than 80 per cent of total merchandise exports, and this percentage is similar across partner countries. It reflects the existence of a dense regional production network in manufactures that sources the entire world, particularly in electronics industries, as well as the relatively low endowments of primary commodities, especially in some of the largest economies: Malaysia, the Philippines, Singapore and Thailand. More broadly, the outward-oriented development strategy and the strong reliance on net exports after the 1997-1998 crisis played a significant role in shaping the export structure of this group, notably in the first-tier newly industrializing economy (NIE) of this group (Singapore) and the three second-tier NIEs (Indonesia, Malaysia and Thailand), which together still accounted for approximately three quarters of ASEAN economic output in 2020.

The aggregate picture of ASEAN masks a certain heterogeneity within its members, however. In Brunei Darussalam, for instance, the domestic value added of merchandise exports mainly comes from energy-related products. Meanwhile, for Cambodia and Myanmar, the share of primary commodities (including energy) is significantly larger in intraregional trade than in extra-regional exports, especially those headed to developed countries. This reflects the demand emanating from their neighbouring commodity-dependent countries.

Another salient element is the strong relative decline of developed countries as trading partners over the last three decades. When considering the domestic value-added content of merchandise exports, data show the share of developed countries as a destination of ASEAN total exports gradually decreased from roughly 70 per cent in 1995 to about 40 per cent in 2018. Meanwhile, the share of intraregional trade gained some percentage points. Yet the bulk of the reorientation of ASEAN exports during this period was geared towards developing countries outside this group, especially China.

Turning to other developing regions where trade regionalization (and economic integration) has remained comparatively subdued, we discover more heterogeneity in the export structure to the three types of trading partners. In the case of Africa, the limited coverage in the TiVA data requires us to concentrate on gross exports. The data suggest intraregional trade is more conducive to development, as the share of manufactures is larger (about 40 per cent) for this trade than for exports either to the rest of the developing world (only about 10 per cent) or to developed countries (20 per cent to 25 per cent), even though it remains significantly lower than in the European Union or ASEAN (for a more detailed assessment, see *TDR*, 2019).[5] Unfortunately, intraregional trade has remained low and relatively constant in Africa, except during the last decade when its share increased slightly (see black line in figure 5.1) to reach almost 20 per cent.

The most dynamic segment of Africa's exports derives from its relationship with other developing countries outside the continent, notably China. However, this extra-regional trade has been dominated by a few primary commodities, sometimes almost reaching nine tenths of total exports to developing countries outside the region. This concentration of Africa's exports in primary and unprocessed goods indicates the continent's limited industrial production and processing capacities. If we replicate a similar decomposition of exports for the numerous economic groups that coexist within Africa, similar pictures emerge in the sense that for all these subgroups, the share of manufactures is greater in intraregional exports than in extra-regional ones. Moreover, in all these cases, export geared towards the rest of the developing world has been the most dynamic segment and has gained significant market shares, to the detriment of the developed country partners. These observations appear, for instance, when looking at the Common Market for Eastern and Southern Africa (COMESA), the Economic Community of Central African States (ECCAS), the Economic Community of West African States (ECOWAS), the Southern African Development Community (SADC), the Economic and Monetary Community of

[5] Similar pictures appear in TiVA data, though the fact that the intraregional figure relies on only three countries – Morocco, South Africa and Tunisia – makes it risky to draw strong conclusions for this continent.

Central Africa (CEMAC), the West African Economic and Monetary Union (WAEMU), the East Africa Community (EAC) and the Southern African Customs Union (SACU).

While TiVA data cover only few African economies, some research indicates the regional value chain integration of African economies is much lower than in Mercosur and ASEAN (de Melo and Twum, 2021). African regional economic communities (RECs) have participated mostly in non-regional value chains, and they pursue forward rather than backward activities (Black et al., 2019). The main reason for this pattern is that most of Africa's exports comprise raw and unprocessed goods, and this also explains the very limited value added created on the continent. Beyond commodity concentration, high transport costs and high non-tariff barriers (Cadot et al., 2015) have contributed to low intraregional trade. Moving ahead, Africa's limited production capabilities and its limited interconnectivity across countries, including poor (road) and missing (rail) infrastructure, represent main challenges for the continent, as Africa's trade infrastructure is mostly geared to serve trade with the rest of the world, not intraregional trade. The development of regional infrastructure and, to a lesser extent, the elimination of non-tariff barriers (NTBs) would be key to stimulating intraregional trade along regional value chains (RVCs).

CIS economies exhibit similar patterns to those in Africa, albeit in a less extreme way. First, CIS intraregional trade appears to be more conducive to development, given its broader share of manufactures (reaching almost 60 per cent in recent years when considering gross exports). This number contrasts with the structure of exports to the rest of the developing countries, where manufactures account for about 25 per cent, or to the developed countries, where they represent less than 20 per cent. Second, intraregional trade has remained relatively low and constant, except for the last decade when its share grew by a few percentage points. Third, the most dynamic segment of CIS exports, in terms of trading partners, has been the rest of the developing world, especially during the last decade. Fourth, since the early 2000s, energy-related products have often represented about half (if not more) of CIS extra-regional export revenues. Notably, the export structure of this group to the rest of the developing world changed dramatically after the collapse of the Soviet Union. While manufactures amounted to 60 per cent of the region's total exports to these trading partners in 1995, it oscillated around 30 per cent after the global financial crisis (GFC).

There is a certain asymmetry, however, within the group. The bulk of Russian Federation exports go outside this group, but for several economies of Central Asia, the Russian Federation remains the largest export destination. For instance, more than 40 per cent of Belarus exports go to the Russian Federation. This highlights the ongoing close economic ties with the Russian Federation. Meanwhile, China has become the largest export recipient of some Central Asian countries, especially those that are geographically close. Outside these two large trading partners, trade in the other countries of this group, either intraregional or extra-regional, is more subdued. This partly reflects the generally remote geographical location of Central Asian economies, their landlocked nature and the development of trade-related infrastructure, all of which imply high transport costs compared to other regions. In this context, exports of goods and services, as share of gross domestic product (GDP), decreased in many Central Asian countries in the decade after the GFC (Karymshakov and Sulaimanova, 2020).

In the years ahead, the disruptions created by the war in Ukraine and the subsequent sanctions applied to the Russian Federation are expected to affect the trade prospects of this group, even though, for the moment, the uncertainty is too high to propose any detailed prospects for the medium term or long term.

In Latin America and the Caribbean, the share of manufactures is much larger in intraregional trade than in extra-regional exports. The two sets of data confirm this finding, even though there is a significant difference between the levels of the share of each of the three main product groups depending on whether we consider gross exports or domestic value-added content of exports. This difference is partly because the Latin American countries considered in TiVA have a larger share of manufacturing exports than many less developed economies of the region.

More precisely, according to TiVA data, manufactures represent more than 80 per cent of the domestic value-added content of intraregional exports. Turning to extra-regional exports to developed countries, still accounting for approximately 60 per cent of the region's total exports, TiVA data show manufactures accounted for about 70 per cent in 2018, the last year of the sample. This is almost the same level as in 1995, at the beginning of the sample. In between, the share of manufactures fluctuated strongly. In the late 1990s, it reached almost 80 per cent, before decreasing gradually in the following decade to reach a trough of about 60 per cent in 2011. As the first commodity supercycle of the twenty-first century faded, along with Mexico's energy exports to the United States, the share of manufactures rebounded almost 20 percentage points between 2012 and 2016. For the Latin American extra-regional exports to developing countries, manufactures lost significant market shares during the observed period. From more than 80 per cent in 1995, it gradually decreased to less than 60 per cent in 2018. This reflects the strong appetite for primary commodities of all kinds in fast-growing economies, especially China.

Overall, the relative decline of manufactures, especially in exports with developing countries outside the region, is not a positive sign, as this trading relationship has grown markedly during the considered period. More generally, a large body of empirical evidence points to the premature deindustrialization of several large economies of Latin America since the beginning of the millennium, as these countries further specialized in commodities and low productivity services (e.g., Rodrik, 2016; Castillo and Neto, 2016).

Promoting regional trade integration could plausibly counteract this tendency. Yet data show that the share of intraregional trade has been either constant (TiVA) or even declined (gross exports). In parallel, the lack of trade interdependence between Brazil and Mexico, the two largest economies of this group, is worth mentioning. In short, while Brazil looks to the East, Mexico looks to the North. More precisely, over recent years, Brazilian exports to China have risen more than 10 times, making China its biggest trading partner by far and leaving its close neighbour, Mexico, far behind. Meanwhile, Mexico's exports to the United States are much more important than those to Brazil – with more than 100 times more exports to the former than the latter. Altogether this highlights some of the persistent limitations to fostering regional trade.

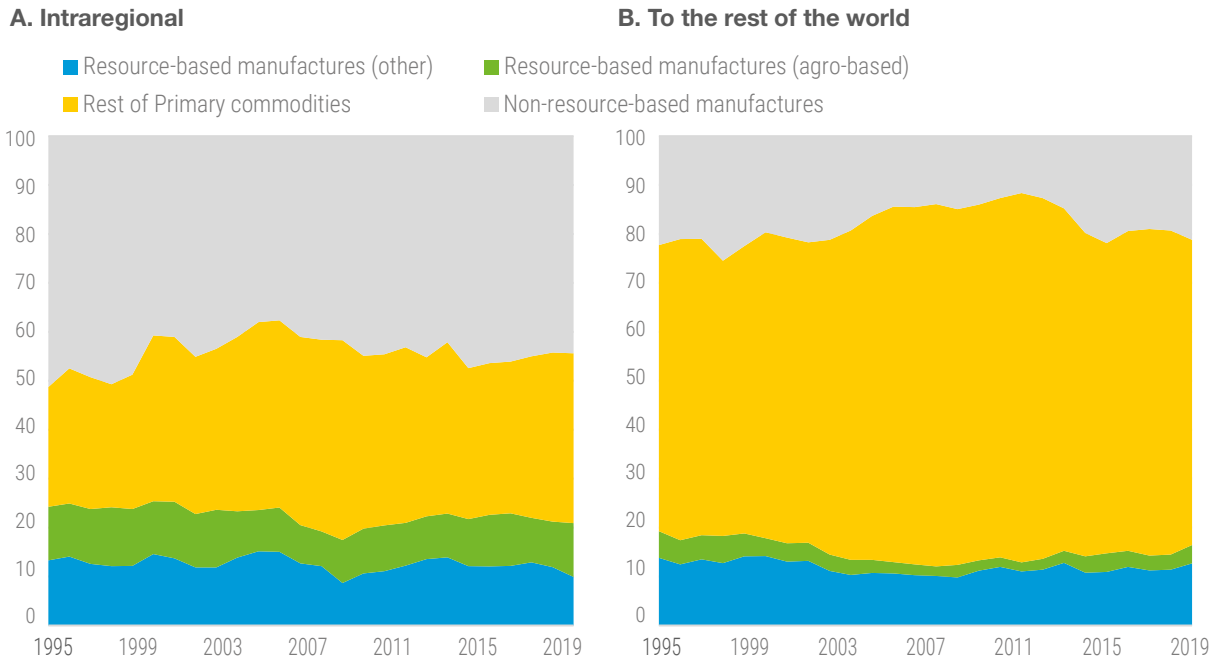
We should note that the broad classifications used in figure 5.1 have some drawbacks, because the designations "Primary commodities, excl. energy" and "Energy" include products with the potential to lift labour productivity and promote structural change. These include, *inter alia*, some of the processed goods derived from primary commodities or high-value agricultural goods such as horticultural products.[6]

Several scholars have devised development strategies based on (natural) resource-based industrialization (RBI) (e.g., Kjöllerström and Dallto, 2007; Morris and Fessehaie, 2014; Neilson et al., 2020; also UNCTAD, 2021a, and references cited therein). Thus, the primacy of manufacture over natural resources suggested in the preceding analysis does not necessarily mean a high and/or increasing share of primary commodities sends a negative signal; in fact, some of these subsectors can play a positive role in the structural transformation towards productive, higher-value and increasingly complex activities. This is especially relevant for Africa at time when the continent aims at investing in modern agriculture under its Agenda 2063.

Figure 5.2 considers two types of resources-based manufactures originally classified under either Primary commodities, excl. energy or Energy in figure 5.1. These are labelled as "resources-based manufactures," further split between "agro-based" and "other" in UNCTADstat. Such products are arguably more likely to foster development than other primary commodity products, given their greater potential to improve labour productivity. In this context, figure 5.2 shows that the share of agro-based manufactured products is larger in intra-African trade than in Africa's exports to the rest of the world. This supports the conclusion derived from figure 5.1.

[6] Technically speaking, all these products belong to sections 0 to 4 of the Standard International Trade Classification (SITC) rev. 3, the basis for figure 5.1.

**Figure 5.2** Composition of African merchandise gross exports, selected components, 1995–2020 *(percentage)*




*Source:* UNCTAD secretariat calculations, based on UNCTADstat database.
*Note:* "Resource-based manufactures (agro-based)" relates to the following codes of the SITC Rev. 3 : 016, 017, 023, 024, 035, 037, 046, 047, 048, 056, 058, 059, 061, 062, 073, 098, 111, 112, 122, 232, 247, 248, 251, 264, 265, 269, 421, 422, and 431. "Resource-based manufactures (other)" refers to codes 281 to 289, 322, 325, 334, 335, and 411. "Rest of Primary commodities" corresponds to the sum of "Primary commodities, excl. energy" and "Energy" as defined in figure 5.1 "Gross exports", to which the two above-defined "Resource-based manufactures" series were subtracted. "Non resource-based manufactures" corresponds to "Manufactures" of figure 5.1 "Gross exports".

As a whole, the merchandise trade data suggest intraregional trade is associated with greater development potential if we look at its structure, but when we take a look at the size of intraregional trade compared to extra-regional exports, it is clear that intraregional trade is not the silver bullet for development. With this intermediate conclusion in mind, we can move to trade in services.

## 2. Trade in services

Looking at the evolution of the domestic value-added content of gross exports of services sheds additional light on the potential role of intraregional exports. In what follows, we look specifically at "business sector services" (BSR). To put things in perspective, BSR represents the bulk of exports of services, although BSR weight in total exports of goods and services accounts for approximately 38 per cent in Organisation for Economic Co-operation and Development (OECD) economies and 27 per cent in non-OECD economies.

BSR encompasses five sub-aggregates of industries: distributive trade, transport, accommodation and food services (WTH); information and communication (INF); financial and insurance activities (FIN); real estate activities (REA); and other business sector services (OBZ). Of these, WTH includes the less-skilled activities, although one subcomponent of OBZ – "administrative and support services" – encompasses call centres and packaging which do not necessarily require highly-qualified workers.

In the remainder of this section, we perform decompositions similar to those we did for merchandise trade to investigate whether intraregional services trade differs from extra-regional exports, and if so, whether the former is more conducive to development than the latter. More concretely, decomposing the domestic value added of BSR exports between its five main subcomponents reveals the following patterns (figure 5.3).

For Africa, intraregional coverage is relatively limited because the underlying data only include bilateral exports between Morocco, South Africa and Tunisia. In contrast, the two other panels rely on more country partners. These are therefore less likely to suffer sample bias, even though they still rely only on these three African countries as the source of exports.[7] With this caveat in mind, Africa's BSR exports to the (rest of) developing countries show two things. First, this has been the most dynamic segment for Africa, as its share increased from slightly more than 20 per cent in the late 1990s and early 2000s to more than 40 per cent a decade later. Digging further into BSR subcategories, data show WTH industries have seen their share increasing from roughly 70 per cent to 80 per cent, mostly on the back of a relative decline in INF and FIN. This sends a mixed message in the sense that Africa's exports to developing countries outside the region have grown faster than its exports to other parts of the world, but at the same time, the WTH share of exports to other developing countries has also grown, pointing to a larger share of services industries requiring, on average, lower-skill workers.

Meanwhile, Africa's exports to developed countries contrast markedly with those to other developing countries. Data point to an improvement in the likelihood that exports can promote development in the sense that shares of two high-skill components of BSR, namely INF and OBZ,[8] have grown at the expense of WTH. Yet the declining black line in the same panel reminds us that the performance of Africa's exports to developed countries was weaker than the performance of exports to non-African developing countries between 1995 and 2020. All this points to an ambivalent conclusion on the developmental effects of exports of services for this continent because more dynamism comes with more low-skill activities, while less dynamism in terms of foreign demand comes with a growing share of industries that rely more on high-skill workers.

We can reach similar conclusions for Latin America and the Caribbean. In terms of the export structure, the segment referring to developed economies shows a growing share for OBZ.[9] Yet the performance of the exports to this trading partner group between 1995 and 2020 was muted. In addition, irrespective of the trading partner, the relative size of WTH has remained very high in the region's exports, especially in intraregional trade and in exports to other developing countries. Overall, this empirical evidence does not support the view that intraregional trade in services is more developmental in Latin America and the Caribbean, nor is it possible to infer that extra-regional trade in services is necessarily more conducive to development.

Our analysis of CIS relies on only two countries: Kazakhstan and the Russian Federation. It is therefore patchy, although the limited data hint at conclusions similar to those for Latin America and the Caribbean.

[7] Given the structure of the three underlying African economies, compared to the rest of the continent, data presented for Africa could be seen as a kind of upper bound in the sense that other less-developed African economies are less likely to have greater share of industry aggregates which require higher levels of education (i.e. INF, FIN, REA and OBZ) than the ones necessary, on average, for the services exports of WTH.

[8] OBZ includes "professional, scientific and technical activities" and "administrative and support services". Further investigations not reported in figure 5.3 find these two subcomponents contributed roughly the same to the relative increase of the OBZ share during the 1995 to 2018 period.

[9] Unlike for Africa (see previous footnote), in the case of Latin America, "professional, scientific and technical activities" contributed much more to the increase of the OBZ share, even though the share relating to "administrative and support services" also registered positive growth.

**Figure 5.3** Composition of business service exports, selected country groups and industries, 1995–2018 *(percentage)*

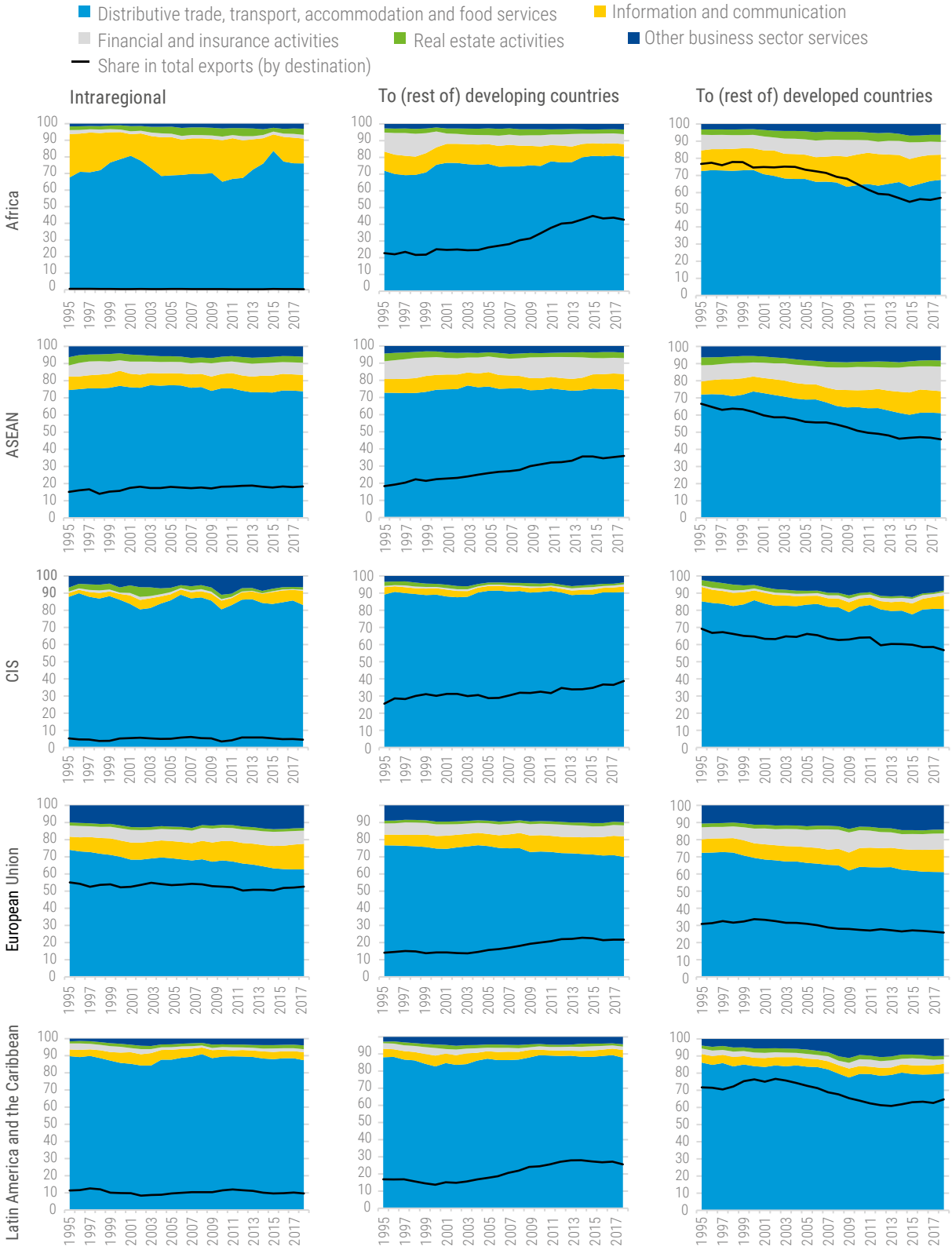
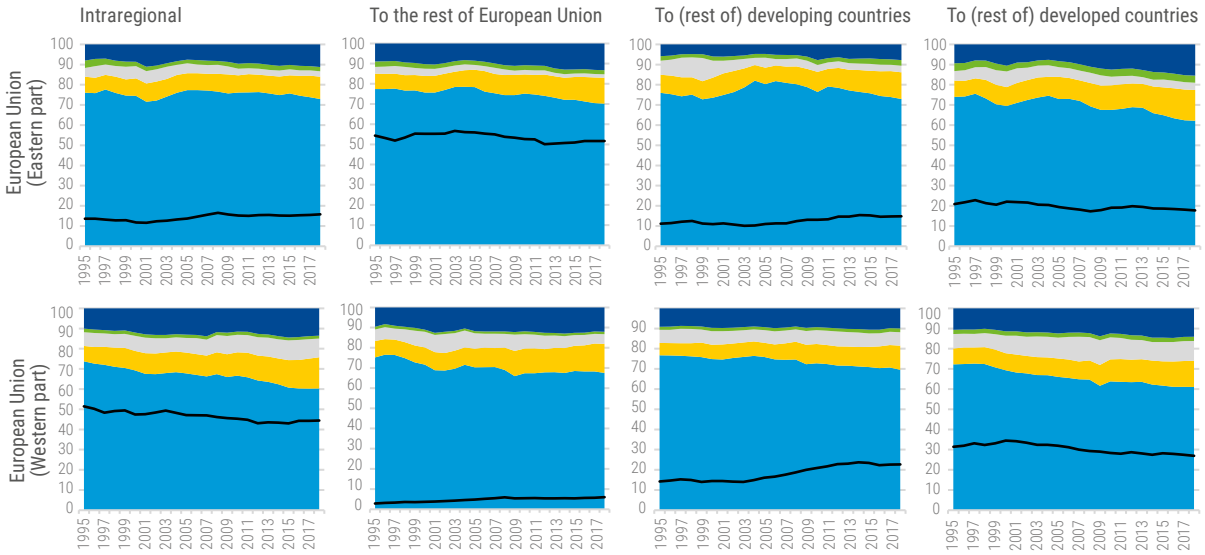


**Figure 5.3** Composition of business service exports, selected country groups and industries, 1995–2018 *(percentage) (cont.)*




*Source:* UNCTAD secretariat calculations, based on OECD TiVA database.
*Note:* Underlying data correspond to the domestic value-added content of exports. Country coverage can be limited for some groups. Africa refers to only 3 countries (Morocco, South Africa and Tunisia), CIS to 2 countries (Kazakhstan and the Russian Federation), and Latin America and the Caribbean 6 countries (Argentina, Brazil, Chile, Colombia, Mexico and Peru). The country coverage for ASEAN and the European Union is complete. The eastern part of the European Union includes: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. The Western part include: Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Spain and Sweden. Industries correspond to TiVA 2021 classification.

The ASEAN data suggest BSR exports of these two countries are likely to be conducive to development because their WTH shares are lower than in other developing regions, irrespective of their trading partners. In that sense, their BSR export structure does not differ much from the European Union in the late 1990s. The four sub-aggregates that require higher skills (INF, FIN, REA and OBZ) make up at least 30 per cent of ASEAN BSR exports, similar to the eastern part of the European Union, even in recent years. Another finding already observed for other developing groups is that ASEAN BSR exports to developed countries are again more conducive to development, though performance over time has been more subdued than ASEAN exports to other developing countries and to a lesser extent to intraregional exports.

The remaining panels of figure 5.3 look at the European Union and its subdivision into East and West. The motivation for splitting the European Union thusly is to see whether differences arise given the difference in levels of development and the roles these levels play in terms of the organization of European value chains. The overall evolution of the structure in terms of industries confirms BSR exports are more concentrated in high-skill industries, and the shares of these industries have grown over time, especially for OBZ, INF and to a lesser extent FIN. These trends appear across all types of trading partners, albeit more saliently in high-skill industries, in both intraregional trade and exports to other developed countries.

In the East European Union, the structure of BSR exports is similar across the four considered trading partners, though data suggest they are slightly more conducive to development when this subregion exports to developed countries outside the European Union or to a lesser extent to the West European Union. Findings are similar when we look at the West European Union.

The main observations that emerge from our analysis of BSR exports for all regions can summarized as follows.

- The structure of BSR exports in terms of industries seems more prone to development when regions export to (more) developed regions, yet the demand of these trading partners has been relatively subdued over time, resulting in declining market shares.
- Across developing regions, the structure of BSR exports from ASEAN is more conducive to development than the structure of BSR exports from Africa, Latin America and the Caribbean or CIS. We base this conclusion on the fact that ASEAN reports the larger share of high-skill industries in BSR exports.
- Unlike the merchandise exports described above, the sense that intraregional exports are more conducive to development is not clear in BSR exports. Having said that, while it has not been the most dynamic segment in terms of export destinations, intraregional trade, unlike exports to developed countries, has grown at the same rate as the trade registered by the total BSR exports in each region. This points to a certain resilience for intraregional trade, given the robust demand emanating from large fast-growing developing countries, most notably China. In other words, the relative increase of the share of other developing countries in total BSR exports observed in all developing regions has come at the expense of the exports to developed countries, not intraregional trade.

Findings for trade in services are ambivalent. This might partly be because TiVA export data are less complete, especially for some developing regions. Moreover, the underlying disaggregation in TiVA relies on a much smaller number of industries, thus precluding a deeper understanding of the business services sector. More concretely, unlike for merchandise exports, we cannot strongly affirm that intraregional trade in services is more or less conducive to development.

This leads to two broad take-away messages. First, there is a more similar structure in services exports than in merchandise trade in terms of trading partners. Second, as goods still represent the main component of total exports of goods and services, the findings for merchandise trade seem comparatively more important than those for trade in services. This suggests that, overall, total intraregional exports are more impactful than total extra-regional exports.

## C. DEVELOPMENT-ORIENTED TRADE INTEGRATION AND REGIONAL VALUE CHAINS

The intensification of cross-border production and market linkages in support of structural transformation cannot simply rely on tariff reductions and the elimination of other border measures. Having a trade liberalization agenda does not imply having a structural transformation agenda. This is especially true for mega-regional trade agreements extending the scope and depth of earlier, geographically more limited, bilateral and regional North-South trade agreements whose commitments often go far beyond border measures and tend to reduce policy space (*TDR*, 2006, 2014). Trade integration must be part of a broader development strategy that promotes 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 (*TDR*, 2016). 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.

Such an approach is best described as developmental regionalism (*TDR*, 2007; UNCTAD, 2013; Davies, 2019) or open developmental regionalism to underline its close relationship with shallow trade agreements that do not unduly reduce the policy space available to developing countries to manage the trade-offs that accompany any move towards closer integration with multiple countries, to implement the collective actions that come with closer cooperation among those countries and to continue to support the broad range of development goals of an inclusive and sustainable development strategy. Developmental regionalism aims first and foremost at boosting productivity growth and creating jobs through economic diversification and technological upgrading. In this respect, closer trade integration among neighbouring countries, the development of regional infrastructure projects, cooperation on industrial policies and shared legal frameworks can unleash virtuous growth cycles and mediate the interface between global economic forces and domestic needs.

Rather than the derivation of formal trade agreements with deep commitments, the strategy involves the informal coordination of policies. Open developmental regionalism requires a stable macroeconomic and financial framework that supports fixed investment and the creation of productive capacity and employment, including by avoiding real exchange-rate instability and overvaluation and by fostering the provision of long-term investment finance (see next chapter). Moreover, policies must be coordinated both across policy areas within an economy and among countries in a region. Institutional structures such as those associated with a developmental state (*TDR*, 2016) are critical, as are joint infrastructure and industrial policies – broadly understood as shaping incentives for structural change and technological upgrading – that complement exchange-rate based international competitiveness with a view to avoiding dependence on cheap labour.

The provision of regionally oriented physical infrastructure, particularly in the form of customs, transport, energy and communication networks, is an indispensable element of developmental regionalism. Energy and water resource management remains a constraint on crop yields, but the process of structural transformation in many developing countries and regional cooperation in this particular area can create supply capacities that expand both trade and growth potential. It has been estimated, for example, that a well-coordinated addition to the irrigated area of Africa's drylands could increase cereal production by 52 per cent (Ward et al., 2016), and an increase in the share of public agricultural expenditure devoted to research and development could greatly increase the use of high-yielding varieties and hence yields (Gollin et al., 2021).

Regarding transport infrastructure, the orientation towards international trade may have led to the overloading (and deterioration) of infrastructure on the main export routes and inadequate funding for the arteries required for enhanced regional trade. Because tackling these challenges will often involve high sunk costs, long gestation periods and free-rider problems, there is a danger that neither market forces nor national government projects will provide effective solutions. Combined or common action by countries at the regional level are more likely to achieve sustainable results.

Similar considerations apply to industrial development and support for RVCs.[10] RVCs are characterized by stronger backward linkages, with many high value-added activities undertaken within a region. They may allow regional producers to export end products to a country within the region and to gain experience and build the local capacities needed to compete globally, thus providing a stepping-stone to global value chains (GVCs). Moreover, by creating income opportunities and domestic demand, such activities can leverage the links between domestic demand and production for the GVCs or RVCs that are critically important for inclusive economic growth.

That said, industrial policies to encourage RVCs face difficult trade-offs. For one, achieving a more efficient regional division of labour will enable economies of scale but also imply that specific countries specialize in specific activities or products and renounce the option of investing in others. In the short

[10] It should be noted that this discussion refers to bottom-up RVCs. These differ from RVCs in the European Union spurred by the integration of poorer South European countries in the 1980s and the low-wage Central European countries in the 1990s, combined with a reduction of trade costs through the creation of the Euro area.

run, this will imply the location of high value-added activities in some parts of the region, while others specialize in more basic activities, inevitably leading to diverging economic performance across the region and complicating the coordination of sectoral support policies. Moreover, entrenched business interests and established practices in a country's financial system will work to reproduce established production and investment structures, while complicating the provision of the investment finance required to create RVCs.

Addressing such trade-offs will require clear communication of the objectives and directions of regional integration agendas, as well as their complementarity and comparative benefits. This may prove difficult in regions without a regional identity. Nevertheless, strong disruptions, such as those wrought by the Covid-19 pandemic or a potential shift of production activities in GVCs, may be propitious moments to undertake such changes.

Similar considerations extend to constraints on diversification associated with a lack of interoperable regional digital payment systems and technological development. Most developing countries access technology from abroad and absorb it within local production systems, supported by national policies and institutions. Yet innovation systems may be devised with an explicit regional dimension involving collaborative research, training schemes and information gathering and may extend to complex institutional issues, such as those relating to the design of intellectual property rights or data management regimes. Regional collaboration will also be required to harmonize the business rules and laws required for RVCs, and resources must be pooled to ensure the effective management RVCs in light of changing needs and conditions.

The global economic restructuring and trend in international supply chains towards regionalization will require an adaptation of policy responses to different value chains and local contexts, not only because of differences in the governance structure of value chains but also because of differences in local and regional productive capacities. Supply-chain regionalization may be led by advanced economies and multinational enterprises involved in near-shoring or friend-shoring their sources to reduce supply-chain disruptions or protect technological advantages. But they may also be backed by a rise of middle-income consumers in a range of developing countries and expanding South-South trade and led by regional efforts to support the structural transformation and economic resilience of regions in the Global South.

Digitalization and intangible assets play a crucial role in international supply chains in high-tech sectors, such as electronics and the machinery and equipment industry, so the digital platforms, mostly from advanced economies, that provide the enabling digital infrastructure are likely to capture increasing shares of value added. The concentration of value added in these advanced economies will be further enhanced by the extent to which higher-technology activities are reshored in them, not only for economic but also for geopolitical reasons. The potential of developing countries to capture value added in such supply chains depends on their digital industrial policy, discussed in the previous section, and their establishment of a digital and data infrastructure and a related local and regional digital and data regulatory framework – this is instrumental in ensuring local and regional firms' confidence in the confidentiality and security of their data. Both elements will be required to improve the bargaining power of local and regional firms in determining the location of supply chain related digital activities.[11]

RVCs may be easier to create when forces within developing regions lead the efforts to do so, the diversification of suppliers increases opportunities for new entrants and there are important regional end markets. This is likely to be the case in relatively simple manufacturing activities, for example, the apparel industry, where labour costs and market access conditions, such as those set in trade agreements, play an important role. But it may also apply to technologically more sophisticated areas, such as the automotive sector. It has been prominent in structural transformations because of its

[11] ASEAN's Framework for Data Protection, Digital Framework Agreement, Data Management Framework and the Model Data Transfer Law (MTT) are examples of attempts to provide regionally consistent rules to make the use of data compatible at the regional level.

multiple linkages: sectors with widespread linkages offer more opportunities to create value added, gain experience and build capacities in design, marketing, branding and distribution at the local and regional levels particularly to the extent to which regional tastes and consumer demands differ from those in advanced country markets. One recent study (Mayer, 2021) showed how access to data on local and regional consumer tastes can create a comparative advantage for developing countries with manufacturing capacities and allow them to re-bundle production stages by replicating value chains but directing them at local and regional markets.

Examples of RVCs in the automotive industry in ASEAN indicate the role of industrial policy in managing foreign direct investment (FDI) inflows and shaping domestic and regional supply chain participation as a stepping stone to industrialization and diversified regional trade (e.g., Natsuda and Thoburn, 2021). Crucial determinants of the overall success and the success in individual regional economies were flexibility (including to changing trade regimes such as brought about by the Uruguay Round agreements) and the timing and sequencing of policymaking, such that trade measures support the structural transformation at different development stages of both the regional economies and the local and regional supply networks in their automotive sectors. Moreover, effective industrial policy[12] is supported by regional monetary arrangements, as well as regional legal frameworks, that, in addition to trade, govern regional investment, capital flows and business practices, with a view to mediating the interface between regional and global developments in these areas.

# D. NEW CHALLENGES TO REGIONAL INTEGRATION: THE DIGITAL ECONOMY AND CLIMATE CHANGE

Deep trade agreements, including emergent mega-regional trade agreements, and recent discussions at the World Trade Organization (WTO) have devoted considerable attention to a wide range of new issues, most prominently the digital economy and climate change.[13] Other issues are gender and human rights, labour standards and the like, especially in mega-regional trade agreements. Our main argument in this section is that these issues do not lend themselves to trade agreements. Instead, they require a large enough policy space that emerging challenges can be addressed in a way that fosters tangible economic, social and environmental benefits. A developmental approach to regionalism would allow multidimensional progress on these issues and move towards a more inclusive multilateralism.

## 1. The digital economy: challenges of data governance

There is wide agreement that data are at the heart of the digital economy and, as such, represent a crucial economic asset. However, although data affect many economic areas – including trade, finance, production, market structure and taxation – data issues are increasingly systemic, impacting health, the environment, national security and human rights, such as privacy. To formulate appropriate policy responses to the evolving digital economy from a developmental perspective, it is important to understand the multi-dimensional nature of data. Gaining such an understanding is hampered by the absence of a generally accepted definition of data or a measure of data flows that would allow

[12] An important ingredient of industrial policy in the region is "product champion policy". Earlier industrialization experiences in East Asia used "national champion policy", targeting the development of particular national automobile makers, but the Uruguay Round agreements made these considerably more difficult to apply. Product champion policy aims at steering demand towards vehicle segments with a potential for economies of scale even in relatively small domestic or regional markets.

[13] The discussion in this section focusses on the relationship between these issues and trade regionalism. For a broader discussion of the digital economy, see TDR, 2017, 2018; for discussion of climate change, see *TDR*, 2019, 2020, 2021.

the economic and social values of data to be traced and thus ensure an inclusive and fair distribution of their related benefits. It is also important to understand that raw data have little economic value. Rather, it is the capacity to access, control, process, analyse and use data that provides economic benefits, and the size of any such benefit is dependent on the context (*TDR*, 2018; UNCTAD, 2021b).

To harness the benefits data can provide to economic development, developing countries need to bridge existing digital and data gaps. Digital industrial policy will be an important instrument to achieve that end. The aim of such policy should be to identify the development objectives of engaging in the digital economy and use these objectives as a basis for building a regulatory framework for the digital economy and data governance, establishing soft and hard digital infrastructure (such as the building of data centres and the capacity to store, process and analyse data) and most importantly targeting measures to increase the data-related value-added content in the production and export of goods and services (*TDR*, 2018). In manufacturing supply chains, this can be done in the pre-production stage through data processing and analysis, in the production stage through robot-based automation and in the post-production stage through e-commerce, while in the services sector, it can be related to the digitized treatment of health-related issues or to the provision of digitized services as an input to manufacturing (e.g., Mayer, 2021).

The objective of regulatory frameworks should be to move developing countries away from the periphery of the digital economy, the financial centres of which are concentrated in the advanced countries of the North. One key objective of global regulatory frameworks in the digital economy should be to address global competition and antitrust issues (*TDR*, 2018; UNCTAD, 2021c). Although social objectives, consumer protection and data confidentiality are clearly important, a perspective that puts digital industrialization at its centre is likely to have more developmental impact. Many developing countries do not yet have national regulatory frameworks that govern who can store, process and use their data.[14] The absence of such national legal frameworks risks providing existing global digital platforms, most of which are headquartered in the United States and China, first-mover advantages and monopoly powers. With no legal frameworks in place, these platforms can use the data of developing countries and appropriate the economic value, leaving little if any benefit to those providing the data or the local economy. Similarly, jobs created in the digital economy in developing countries tend to be low productivity and precarious, with millions of people employed in "microwork".

There may be a presumption that developing countries can only influence how international digital rules are framed by participating in related debates. However, the developmental outcome of international regulatory frameworks depends on the perspective from which these debates are approached and the inclusiveness of the forum in which they are held.

Approaches to data governance in trade agreements have increasingly supported restrictions on data flows, treating these like any other trade barrier and generally minimizing them. This is the case for the e-commerce chapters of mega-regionals, with related commitments going much further than e-commerce and including issues related to data localization, national security and technological leadership, such as in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Including data issues in mega-regional agreements exposes the digital economy to a race for leadership in technological developments, given the economic and strategic advantages accrued from controlling the data and related digital technologies. This risks consolidating oligopolistic market structures and hampering inclusiveness, thereby amplifying long-standing inequalities between developed and developing countries in the digital economy.

[14] An important exception is China. Other exceptions include Saudi Arabia's National Strategy for Data and AI (see https://ai.sa/Brochure_NSDAI_Summit%20version_EN.pdf), India's Data Protection Bill 2021 (see https://trilegal.com/knowledge_repository/the-data-protection-bill-2021/) and its Draft National E-Commerce Policy (see https://dpiit.gov.in/sites/default/files/DraftNational_e-commerce_Policy_23February2019.pdf), as well South Africa's Draft National Policy on Data and Cloud (see https://www.gov.za/sites/default/files/gcis_document/202104/44389gon206.pdf). Other countries (including Indonesia, Malaysia and Sri Lanka) are finalizing their regulations. For broader discussion, see UNCTAD, 2021b, pp. 136–138; Aaronson, 2022.

Endeavours to subject the digital economy to trade norms and commitments is apparent also in recent activities related to the Joint Statement Initiative on e-commerce at the WTO.[15] The legal standing of the Initiative is open to question, however, and some argue its justifications rely on tenuous interpretations of WTO rules (e.g., Kelsey, 2022). Moreover, the initial texts[16] determining the direction and agenda of these rapidly evolving activities may be seen as reflecting the interests of advanced economies and big digital platforms, without accommodating the interests of those at the periphery of the digital economy. In fact, ongoing regulatory activities in the United States and the European Union deviate from the main thrust of these texts and explicitly address market concentration. For example, the European Union Digital Market Act sees competition law as an *ex-ante* instrument that sets out what firms are allowed to do and what not, although it makes important exceptions for small and medium-sized enterprises, probably to protect European firms.[17] In the United States, in October 2020, the majority staff of the Congress House Subcommittee on Antitrust, Commercial and Administrative Law published a set of recommendations to promote competition in technology markets, and in June 2021, the House Judiciary Committee advanced six bills that paralleled many of these recommendations, focusing on the anticompetitive impacts of self-preferencing, mergers and acquisitions, data accumulation and network effects related to digital platforms.[18]

There are general doubts as to the appropriateness of attempts to govern the digital economy and data through trade agreements. For one, a large proportion of data is not linked to any trade flow. This is the case, for example, with the use of foreign online services, such as Internet search engines or social media platforms, where users generate a cross-border flow of data that the service provider can process and monetize without engaging in any trade flow. Trade rules are more generally developed for goods and services that are produced and cease to exist when they are consumed. In contrast, using data does not imply their consumption and cessation of existence. Rather, data are intangible and non-rival. Many people can use the same data simultaneously or over time without their depletion. Data also often involve positive externalities; for example, they can be combined with other data or show network effects of digital platforms (*TDR*, 2018).

Two main sources of distortion in the digital economy are high market concentration and the proliferation of anticompetitive practices. New policies must address the power they give to large digital enterprises to influence the rules of the game to their favour. These distortions are facilitated by the dismantling of large parts of regulations designed to curtail market monopolization and corporate rent seeking and the incomplete updating of existing antitrust and anti-monopoly laws to account for the specific challenges posed by the digital economy. More complete regulation could start with The Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices adopted by the United Nations General Assembly in 1980 (UNCTAD, 2000). It could also take into account the recent efforts of United States and European Union regulators to curb the dominant positions of global digital platforms.

[15] At the 11th WTO Ministerial Conference in December 2017, Ministers declared they would pursue the 1998 Work Programme on Electronic Commerce on the existing mandate, but on the same occasion, a group of 71 WTO members agreed to initiate exploratory work towards future WTO negotiations on trade-related aspects of e-commerce. In January 2019, 76 WTO members confirmed in a joint statement their intention to commence these negotiations, agreeing to "seek to achieve a high standard outcome that builds on existing WTO agreements and frameworks with the participation of as many WTO members as possible" (see https://www.wto.org/english/tratop_e/ecom_e/joint_statement_e.htm). See also UNCTAD, 2020.

[16] The European Union stated: "Most proposals broadly align with the topics put forward by the EU" (see https://www.europarl.europa.eu/RegData/etudes/ATAG/2020/659263/EPRS_ATA(2020)659263_EN.pdf). Moreover, "The US proposal is not public, but a [now publicly available] leaked communication resembles the digital trade provisions of the US–Mexico–Canada Agreement (USMCA)" (see https://worldtradelaw.typepad.com/ielpblog/2019/05/us-wto-e-commerce-proposal-reads-like-usmca.html).

[17] See https://www.europarl.europa.eu/news/en/press-room/20220315IPR25504/deal-on-digital-markets-act-ensuring-fair-competition-and-more-choice-for-users.

[18] See https://judiciary.house.gov/uploadedfiles/competition_in_digital_markets.pdf; and https://www.nytimes.com/2021/06/23/technology/big-tech-antitrust-bills.html.

Regional collaboration frameworks on e-commerce could be a powerful complement to such global efforts (UNCTAD, 2018, 2021b). Digital and data gaps make it difficult to reach consensus on how to harmonize existing rules and standards at the global level, but these gaps tend to be much narrower at regional levels. Regional cooperation on capacity development and the creation of digital infrastructure and data-sharing mechanisms could play a crucial role in investment and competition policies supporting the growth of enterprises in developing countries and maximizing the inclusiveness and developmental impact of the digital economy.

The ASEAN regional cooperation frameworks may be a good example in this context.[19] The ASEAN Economic Community Blueprint 2025 highlights the importance of e-commerce as a channel for cross-border trade and investment. This focus was substantiated in the ASEAN Agreement on E-Commerce, which entered into force in December 2021. In it, ASEAN members recognize the importance of allowing information to cross borders "provided that such information shall be used for business purposes, and subject to respective laws and regulations" (para. 4(a)). They agree to facilitate cross-border e-commerce by working towards eliminating or minimizing barriers to the flow of information across borders, subject to safeguards that ensure security and confidentiality of information and when other legitimate public policy objectives so require. The Framework on Personal Data Protection, a second ASEAN agreement of this nature, "serves to strengthen the protection of personal data in ASEAN and to facilitate cooperation among the Participants, with a view to contribute to the promotion and growth of regional and global trade and the flow of information" (para 1), but this "Framework serves only as a record of the Participants' intentions and does not constitute or create, and is not intended to constitute or create, obligations under domestic or international law and will not give rise to any legal process and will not be deemed to constitute or create any legally binding or enforceable obligations, express or implied" (para 2).[20] One important characteristic of these agreements is that in line with the ASEAN way, they establish cooperation that is flexible enough to accommodate countries' different digital development trajectories, but they do not establish digital economy governance in the form of legally enforceable commitments. Such flexibility contrasts with the binding commitments in mega-regional trade agreements, such as CPTPP.

Approaching the digital economy from a development perspective and ensuring inclusiveness of related governance frameworks would probably be best achieved by the United Nations and its 193 Member States (*TDR*, 2018; UNCTAD, 2021b; United Nations, 2019). Contrary to the narrow trade angle, the United Nations can adopt a systemic approach to reflect the specificities of data flows, taking into account relationships with competition, taxation, data access and consumer protection. Deliberations can be based on multistakeholder exchanges that include government representatives from various ministries, as well as experts and representatives of organizations that deal with competition, taxation, technology, consumer protection and other issues related to the digital economy.

## 2. Climate change

Discussions at the WTO, megaregional trade agreements and unilateral trade measures indicate increased attention to issues related to the environment and climate change. Although formal negotiations on a plurilateral Environmental Goods Agreements stalled in 2016 (*TDR*, 2021), some members of the WTO initiated Trade and Environmental Sustainability Structured Discussions (TESSD) and The Informal Dialogue on Plastics Pollution and Environmentally Sustainable Plastics Trade (IDP) in 2020.[21] These member-led plurilateral initiatives have gathered steam, giving rise to two ministerial

[19] For the Digital Transformation Strategy for Africa (2020 to 2030), see https://au.int/en/documents/20200518/digital-transformation-strategy-africa-2020-2030.

[20] For the respective documents see https://aseandse.org/wp-content/uploads/2021/02/AEC-Blueprint-2025-FINAL.pdf;https://asean.org/asean-agreement-on-electronic-commerce-officially-enters-into-force/#:~:text=The%20E%2DCommerce%20Agreement%2C%20which,strengthen%20capacity%20to%20implement%20them; https://asean.org/wp-content/uploads/2012/05/10-ASEAN-Framework-on-PDP.pdf.

[21] For a recent discussion of TESSD, see Bellmann, 2022.

statements. One is co-sponsored by 71 members as part of TESSD and includes a commitment to launch dedicated discussions on how "trade-related climate measures and policies can best contribute to climate and environmental goals and commitments while being consistent with WTO rules and principles". Another on fossil fuel subsidy reform is co-sponsored by 45 WTO members.[22]

Outside the WTO, sustainability chapters in bilateral and plurilateral trade agreements have been the main channel through which climate concerns are reflected in the trading system. These chapters have arguably mainly helped to secure the regulatory advantage of industrialized economies as global standard-setters (Goldberg, 2019). In 2019, discussions began on an Agreement on Climate Change, Trade and Sustainability (ACCTS) between Costa Rica, Fiji, Iceland, New Zealand, Norway and Switzerland, with a focus on liberalizing "environmental goods and services", eliminating "harmful" fossil fuel subsidies and encouraging eco-labelling.

Around these ongoing discussions, developed countries have tabled unilateral trade-environmental proposals, such as the European Union's Carbon Border Adjustment Mechanism, are establishing new sectoral deals, such as the European Union-United States Green Steel Deal, and have coordinated their positions, notably through G7 trade ministers' meetings. Developing countries, by contrast, have not yet formulated a coordinated and coherent approach to the trade and climate nexus.

Although better linkage of climate and trade objectives may seem a positive step forward, the majority of these initiatives lack a strong development dimension. As an example, the OECD has identified a Combined List of Environmental Goods (CLEG) of 268 products at the harmonized system (HS) six-digit level, but around 60 per cent of these products fall under the seven industries identified as high CO2 emitting industries. Any agreement to liberalize the trade specified in CLEG will mostly benefit the exporters of these products, and these tend to be advanced economies. At the same time, an analysis of the tariff revenues collected (using applied duties) on the imports of items on the CLEG shows that in 2019, developing countries collected $15 billion (*TDR*, 2021). Reducing tariffs on these goods, many of which are not climate-enhancing, would disproportionately benefit advanced economies and significantly reduce domestic resource mobilization for developing countries precisely when they are facing mounting economic pressures.

When assessing the various producer and consumer fossil fuel subsidies deployed around the world, it is crucial to remember the very different position of developing countries, where around 940 million people continue to lack access to electricity,[23] and the objective must be to increase energy access, not decrease it. For this reason, decreasing fossil fuel subsidies has often led to political unrest, as it essentially becomes a regressive measure impacting the most economically vulnerable. These subsidies need to be rechannelled to renewable energy sources, but transition in developing countries will need to move at a different pace to prevent political and economic instability.

A recent UNCTAD report estimates the European Union proposal of a carbon border adjustment measure (CBAM) will reduce global carbon emissions by not more than 0.1 per cent while decreasing global real income by $3.4 billion, with developed countries' incomes rising by $2.5 billion and developing countries' incomes falling by $5.9 billion (*TDR*, 2021). Put simply, the tariffs imposed will have adverse implications for the foreign exchange earnings of developing countries while having little impact on global emissions.

These concerns about a missing developmental dimension in trade commitments combine with mounting evidence that industrialized economies are outsourcing pollution (Copeland et al., 2021, p. 6, 15) at the same time as they avail themselves of industrial policy tools to bolster their dominance within emerging green industries.

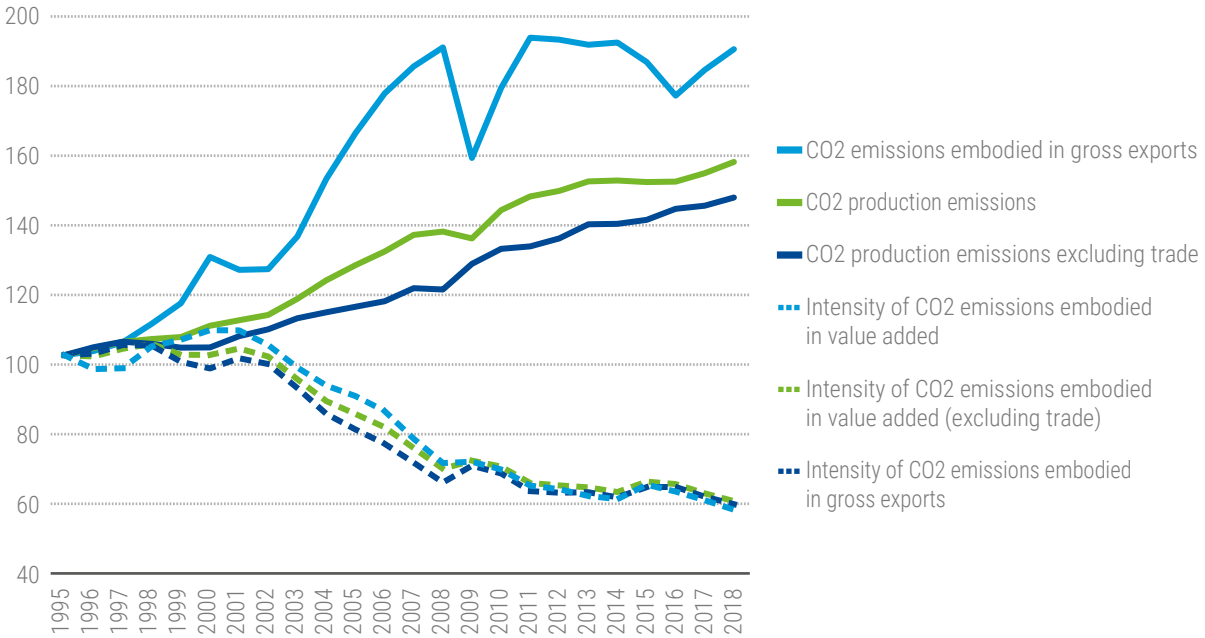
Extra-regional trade plays an important role in these trends. Between 1995 and 2018, CO2 emissions embedded in global trade increased by 90 per cent, from 4132 tonnes to 7464 tonnes, thereby

[22] See https://www.wto.org/english/news_e/news21_e/envir_15dec21_e.htm.

[23] See https://ourworldindata.org/energy-access.

increasing its share in global CO2 emissions from 23.9 per cent to 29 per cent (figure 5.4). Over the same period, global emissions grew by 57 per cent, and global emissions excluding trade by 46 per cent. Meanwhile, the emissions intensity of trade declined slightly faster than that of territorial production, partly because of rising trade in services, but the former remained 24 per cent higher in 2018. These figures underline that the existing regulations, including in trade agreements, have not decoupled GDP (especially trade) from fossil fuel extraction and CO2 emissions, as hopes or claims of "green growth" are increasingly unsubstantiated by empirical investigations (Haberl et al., 2020).

**Figure 5.4** Evolution of global trade-embodied and production emissions of CO2 and their intensities, 1995–2018 *(index numbers, 1995=100)*

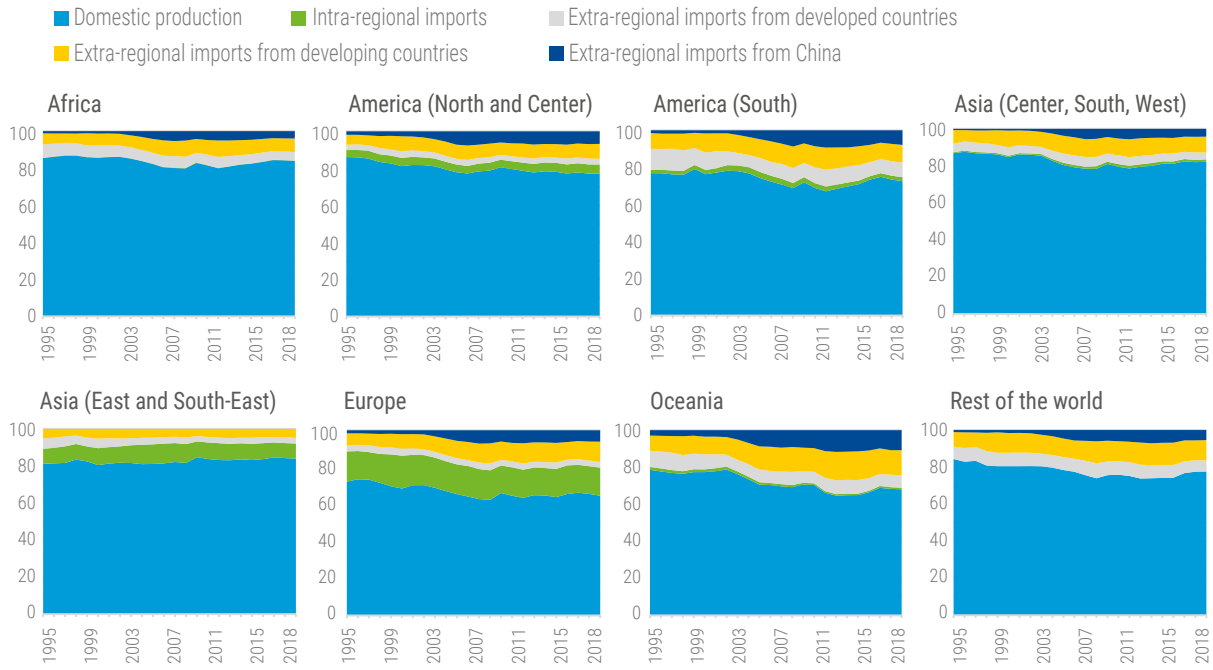



*Source:* UNCTAD secretariat calculations, based on OECD TiVA and TiVA-TECO2 databases.
*Note:* All series are aggregated at the global level and depict their own evolution since 1995. CO2 production emissions represent the sum of territorial emissions. This sum is composed of CO2 emissions embodied in gross exports, and of a residual defined as CO2 emissions excluding trade. Intensities represent the amount of CO2 emissions (of production, gross exports or production excluding trade) per monetary unit.

Evidence suggests extra-regional imports account for the lion's share of trade-embodied CO2 emissions, and most of these originate in developing countries.[24] As figure 5.5 shows, emissions caused by intra-regional trade have expanded most rapidly in East Asia, whereas in Europe and Oceania, trade-embodied emissions from intra-regional trade declined slightly in absolute terms between 1995 and 2008.

[24] Countries included in TiVA-TECO2 by continent/region: Africa (3): MAR, TUN, ZAF. North America (4): CAN, CRI, MEX, USA. South America (5): ARG, BRA, CHL, COL, PER. Central, Western and South Asia (6): CYP, IND, ISR, KAZ, SAU, TUR. East and South-East Asia (15): BRN, CHN, HKG, IDN, JPN, KHM, KOR, LAO, MMR, MYS, PHL, SGP, THA, TWN, VNM. Europe (32): AUT, BEL, BGR, CHE, CZE, DEU, DNK, ESP, EST, FIN, FRA, GBR, GRC, HRV, HUN, IRL, ISL, ITA, LTU, LUX, LVA, MLT, NLD, NOR, POL, PRT, ROU, RUS, SVK, SVN, SWE. Oceania (2): AUS, NZA. Rest of the world: all remaining countries.

**Figure 5.5** Shares of carbon emissions embodied in final demand by sources, selected country groups, 1995–2018 *(percentage)*



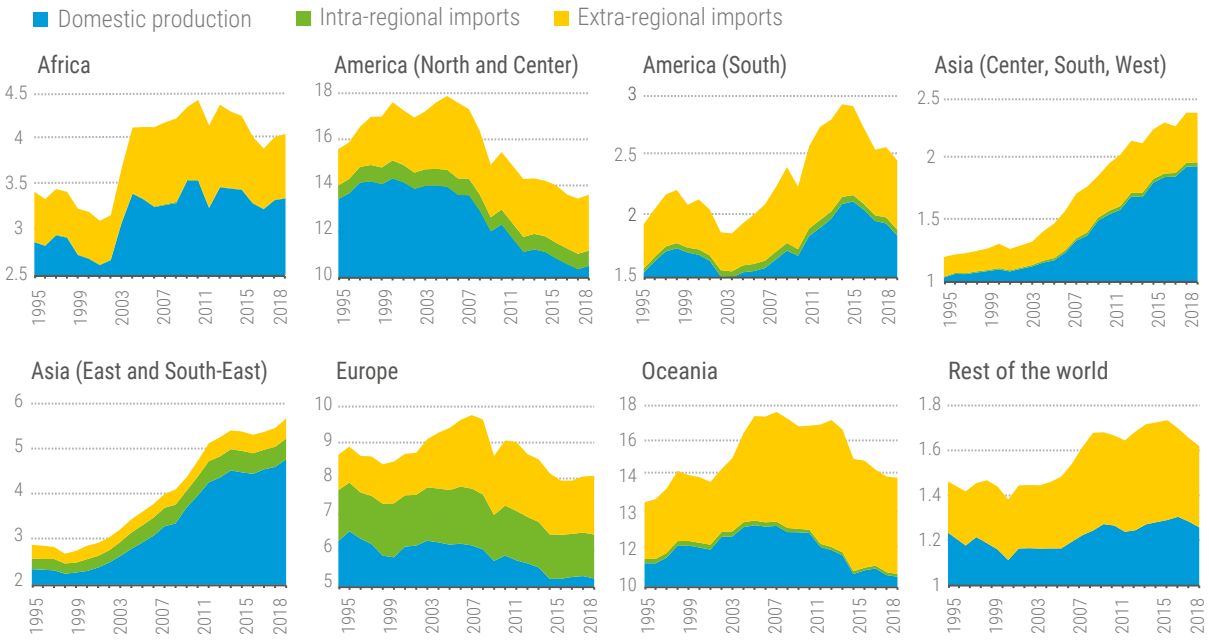

*Source:* UNCTAD secretariat calculations, based on OECD TiVA-TECO2 database.
*Note:* CO2 emissions embodied in final demand are aggregated for each region and decomposed according to their geographical origin (i. domestic emissions, ii. emissions imported through intra-regional imports or extra-regional imports from either iii. developed countries, iv. developing countries, or v. China). For East and South-East Asia emissions imported from China are included in intra-regional imports. Rest of the world being a single entity in the database, it has no emissions from intra-regional imports.

Given the limited progress in reducing global trade-embodied CO2 emissions, the per capita emissions of poorer and richer regions still have a ratio 10 to 1, respectively (figure 5.6). While final demand emissions amounted to 1.6 tonnes of CO2 emissions per person in smaller developing countries (rest of the world (RoW)) in 2018, with 0.36 tonnes imported, they represented 15.4 tonnes in Oceania, 13.6 tonnes in North America and 8.1 tonnes in Europe, with extra-continental imports amounting to 4.8 tonnes, 2.4 tonnes and 1.6 tonnes in those regions, respectively.

These numbers support recent more detailed empirical findings (Dorninger et al., 2021) showing trade enables a structural and massive South to North material drain representing an "ecologically unequal exchange". For 2015, Dorninger and colleagues estimated that South to North trade flows embodied a net transfer (i.e. net appropriation by high-income countries) of 10.1 billion tonnes of raw materials, 379 billion hours of human labour, 22.7 EJ of energy and 800 million hectares of land.

Because trade liberalization creates larger markets and opens possibilities for economies of scale, it also strengthens global material extraction, production, consumption and waste. In conventional accounting, this improves consumer welfare, but offsetting trends include growing employment vulnerability and inequality induced by trade, particularly in the Global North (*TDR*, 2018), and growing material extraction and pollution offshoring affecting populations in the Global South. Multilateral initiatives and regional trade agreements are designed to eliminate tariffs and boost trade flows, and the evidence suggests they also lead to a significant increase in carbon emissions (Tian et al., 2022).

**Figure 5.6** Per capita carbon emissions embodied in final demand by sources, selected country groups, 1995–2018 *(tons)*




*Source:* UNCTAD secretariat calculations, based on OECD TiVA-TECO2 database.
*Note:* Per capita CO2 emissions are aggregated for each region and decomposed according to their geographical origin (i. domestic emissions, ii. emissions imported through intra-regional imports, or iii. extra-regional imports). Rest of the world being a single entity in the database, it has no emissions from intra-regional imports.

Rather than building a trade and environment agenda on trade liberalization related to commitments in trade agreements, making the most of the coherence between special and differential treatment and the United Nations Framework Convention on Climate Change (UNFCCC) principle of common but differentiated responsibilities may offer a better point of departure for a development-oriented approach to the trade-climate nexus (*TDR*, 2021). A related positive Trade and Environment Agenda would focus on the following: (i) facilitating patent-free green technology transfer; (ii) providing additional finance to promote trade of environmentally sustainable products, such as through the Trade and Environment Fund; (iii) building technical capacities, especially of least developed countries (LDCs) and small island developing states (SIDS), in setting up climate-smart infrastructure and broader adaptive measures; (iv) providing incentives like preferential market access based on progress towards nationally committed goals or incentives for promoting trade of renewables and substitutes; and (v) ensuring adequate policy and fiscal space for developing countries to design their trade policies around environmental goals.

This more multidimensional approach could translate into deeper economic cooperation and planning at the regional level on a series of climate-critical sectors, such as energy, waste, food and infrastructure. By pooling resources, capacities and expertise, regionally devised development plans could build-in resource efficiency from the beginning. As climate impacts rarely stay within borders, such regional developmentalism would become an adaptation measure, strengthening regional resilience to systemic shocks. A central aim should be to tackle ecologically unequal exchange, retaining materials, labour and land to promote developmental ambitions. At the same time, advanced economies will need to regulate for rapid mitigation within their jurisdictions, tackling their dependency on over-consumption.

# E. TOWARDS A COMPLEMENTARY RELATIONSHIP BETWEEN REGIONALISM AND MULTILATERALISM

That international trade can contribute to structural transformation and help establish sustained and inclusive growth is firmly grounded in economic theory (e.g., Colantone et al., 2022; von Arnim, 2017). Successful developers, particularly in East Asia, have used trade to complement the traditional drivers of sustained growth and development. However, the many factors considered critical for the prosperity-enhancing effects of international trade to materialize do not emerge spontaneously and are often absent in today's highly interdependent world. If aggregate demand and global growth are weak, financial instability is endemic and international trade in goods and services is dominated by a relatively small number of large firms, trade runs the risk of creating more losers than winners (Gallagher and Kozul-Wright, 2022).

While the external economic environment has a major effect, the commitments embodied in trade agreements also shape the extent and nature of a country's integration and economic development prospects. It is therefore vital that these commitments respond to development priorities rather than the narrow interests of a few large corporations, whether multinational or domestic (*TDR*, 2014, 2018).

Unfortunately, trade rules have increasingly come to foster incentives skewed to boosting cost competitiveness through labour market flexibility and wage restraint and to crushing or buying out competitors, rather than boosting profitability through investment and increased productivity. The many rules and regulations in the WTO agreements, especially in the many bilateral and regional FTAs between developed and developing countries, constrain the use of industrial policy and are unlikely to support aspirations to enhance the structural transformation and diversification of developing countries. Without special and differential treatment and policy space, it will be difficult for developing countries to transit towards diversified and higher value-added activities in a world facing widening inequality and impending disruptive technological change (*TDR*, 2006, 2014; Davies, 2019).

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 which are hard to reconcile, weakening the appetite for, and effectiveness of, the global coordination needed to respond to current global challenges. 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 achieving a more synergetic relationship between global institutions and regional arrangements.

A constructive and cooperative approach to multilateralism remains paramount. An inclusive multilateral trading system must accommodate the diverging interests of the largest trading nations but must also broaden the space for development policy. This implies seeing the multilateral trading regime as a mechanism by which trade globalization and the nation state are not competitors but are mutually reinforcing.

Multilateralism is beneficial for developing countries because individually they have weak bargaining power vis-à-vis the rich countries. Moreover, multilateralism as a central pillar of global trade governance provides transparency, security and predictability in global trade relations. Trade regionalism can risk marginalizing the rulemaking function of the WTO and the multilateral trading system. But recognizing the virtues of the multilateral system does not mean defending the status quo. If the multilateral system is not made more inclusive, multilateralism may be eclipsed by mega-regional trade agreements driven by the most powerful nations.

This implies that developing countries will need to be engaged in multilateral trade governance while recognizing the possible advantages of open developmental regionalism in areas that do not lend themselves to trade rules and/or where these countries do not yet have the capacity to engage in binding multilateral commitments. In those areas, open developmental regionalism can offer a bulwark against an increasingly challenging world order. When combined with the rolling back of elements of the multilateral trade agenda that have encroached too far into the responsibilities of the state and the adoption of a more integrated approach to the different components of the multilateral architecture (*TDR*, 2016), open developmental regionalism may also help to remedy the insufficient developmental focus of existing multilateral regimes, as demonstrated by the inadequate attention to the "in-built" agenda of the Uruguay Round agreements, especially on agriculture and implementation issues in the operationalization of special and differential treatment, the inability to conclude the Doha Round, the envisaged changes in special and differential treatment and the challenges to consensus decision-making.

For regionalism to support multilateralism, the connections between regional and global governance must be properly managed. FTAs cannot mandate lower standards than WTO rules because doing so would risk WTO members suing parties to the regional agreement for failing to comply with WTO rules. Yet experience tells us it is difficult and takes a long time 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 made under a compulsory licence that was mandated in 2001, but it took 15 years before the amendment to the Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement came into force, and the amendment has been widely criticized by several observers as unworkable;[25] (ii) by agreeing to longer transition periods, such as in Trade-Related Investment Measures (TRIMs) agreements 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 still have not been agreed upon; or (iii) by allowing countries which graduate from LDC status to continue enjoying LDC status for 12 years after graduation, but this has not yet been agreed to either.

Contrary to the deep FTAs of the 1990s and early 2000s or the recent mega-regionals inspired by the Trans-Pacific Partnership (TPP) which aim at extending the era of hyper-globalization, open developmental regionalism could help developing countries' voices be heard and reinforce South-South cooperation towards achieving a more development-oriented international trade governance. Pursuing regionalism in a form that remains open and developmental may yield fresh insights into the dynamics of trade governance that would support sustainable development in the Global South. An open and pro-active regional trade governance could shield developing economies from adverse global effects and not simply make them wait for such effects to occur and then adopt national policy to contain their economic and social impacts. In terms of rulemaking, open developmental regionalism would limit binding commitments to border measures, while relying on cooperation and creating flexible policies that aim at regional harmonization of behind-the-border trade measures as, for example, in the 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 also facilitate the management of the diverging interests and sensitivities of developing and developed countries for a more inclusive and developmental international trade governance.

[25] See https://www.citizen.org/wp-content/uploads/TRIPS-waiver_Existing-TRIPS-Flexibilities-Unworkable-for-Scale-Up-of-Covid-19-Medicines-Production-.pdf.

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# Chapter VI

## Regional Development Finance: Progress and Challenges

# A. INTRODUCTION

With less than a decade left to implement Agenda 2030 and agree on more ambitious emissions targets to prevent a climate meltdown, neither multilateral financial institutions nor private capital markets are providing the scale of financial support needed by developing countries to meet these goals. Scaling up on both fronts will be key to building sustainable development pathways, but many governments and industries will, in the meantime, rely on "their" regional institutions to finance transformative investments and deliver public goods that are beyond national capacities alone.

There are now more choices for this than there used to be, thanks to the creation of new regional financial institutions and arrangements and the expansion of existing ones. Over the last two decades, through regional development banks, regional foreign exchange reserve funds, regional currencies and new regional financial mechanisms and instruments, trillions of dollars have been added to the global pool of finance. Some of these institutions are lending more than the Bretton Woods institutions, and some of the most innovative are owned and led by countries in the South (Grabel, 2018; *TDR*, 2018, 2015; Gallagher and Kring, 2017; Barrowclough et al., 2020, 2022; UNCTAD, 2018a, b).

There are other benefits of regional arrangements, including the advantage of pooling scarce resources, tapping into local knowledge of capacities and needs, increasing the size of local markets and strengthening "voice" in multilateral forums. For smaller economies, these benefits can be huge, but even the larger developing countries in a regional arrangement can derive advantages. At the same time, the definition of "regional" is becoming more amorphous. Either due to the fact that easier communications have broadened horizons or simply because development financial institutions (DFIs) which focus tightly on their own region are more vulnerable to external shocks and financial constraints, many seek members and operations outside their region.

This chapter surveys some of the most important trends in regional DFIs and their evolving role in the global financial architecture, and explains how they meet the needs of their members. It finds that no single approach offers the best formula of success: differing structures may be more appropriate in some regions than others. In Asia, the Chiang Mai Initiative Multilateralization (CMIM), the New Development Bank (NDB) and the Asian Bond Markets Initiative (ABMI) emerged without a formal political framework; whereas in other regions, the regional financial institutions can be nested in broader political arrangements. Whichever structures are chosen, the common challenge is one of scaling these efforts up to meet the multiple challenges facing developing countries over the coming decade and beyond.

Section B of this chapter summarizes what is available at the regional level to developing countries in terms of short-term foreign exchange and balance of payments liquidity, using the lens of the recent Covid-19 experience to show that different countries have very different arrangements and ways to cover liquidity needs in times of crises.

Section C delves into the long-term, patient and counter-cyclical finance available in regional development banks and funds, showing their different experiences during Covid-19 in terms of lending and points to new roles being played in terms of research and development innovations. It builds on the evolving views and understandings of regional institutions and the benefits of regionalism, as described earlier in Chapter IV. Specifically, the latest phase in the evolution of regional development banks is marked by the changing and more prominent role of the South-led institutional initiatives. Section C details the consequences of these trends.

Section D discusses some important ways of scaling up these regional institutions and arrangements so they are better equipped to meet their members' needs, including the use of Special Drawing Rights (SDRs) from countries that do not use or need them, as well as regulatory reforms that can remove current constraints. Part E draws key policy recommendations.

# B. REGIONAL PROVIDERS OF FOREIGN EXCHANGE LIQUIDITY IN TIMES OF CRISIS

In the three decades after the Bretton Woods Conference (1944), the International Monetary Fund (IMF) was the only available source of financing to cover balance of payments difficulties for the majority of the world's countries. From the 1970s onward, regional financial arrangements (RFAs) created by emerging and developing economies, the Arab Monetary Fund (AMF) and the Latin America Reserve Fund (FLAR) emerged as alternative lending sources, anticipating a wider role for regional arrangements alongside multilateral and bilateral arrangements, in what is today called the global financial safety net (GFSN).

In part, their emergence represented reactions to oil price volatility and debt crises in Africa and Latin America. A second wave of RFAs gathered momentum following the Asian financial crisis of the late 1990s and the global financial crisis (GFC) of 2007–2008, which prompted the creation of a number of diverse institutions that could provide emergency liquidity at various levels and reinforced a sense that South-South solutions could offer special features for their members as a "first resort" to which they could turn in times of crisis, complementary to the "last resort" of the Bretton Woods institutions.

Rather large regional funds were created or previous funds were enlarged in Europe and Eurasia, such as the Eurasian Fund for Stabilization and Development (EFSD), alongside developing region initiatives, such as the CMIM and South Asian Association for Regional Cooperation Swap Arrangement (SAARC), or transregionally between emerging markets, such as the BRICS countries (Brazil, Russian Federation, India, China, South Africa), who created a Contingent Reserve Arrangement of their NDB (*TDR*, 2015; Gallagher and Kring, 2017; Grabel, 2018; Mühlich and Fritz, 2021; Barrowclough et al., 2022).

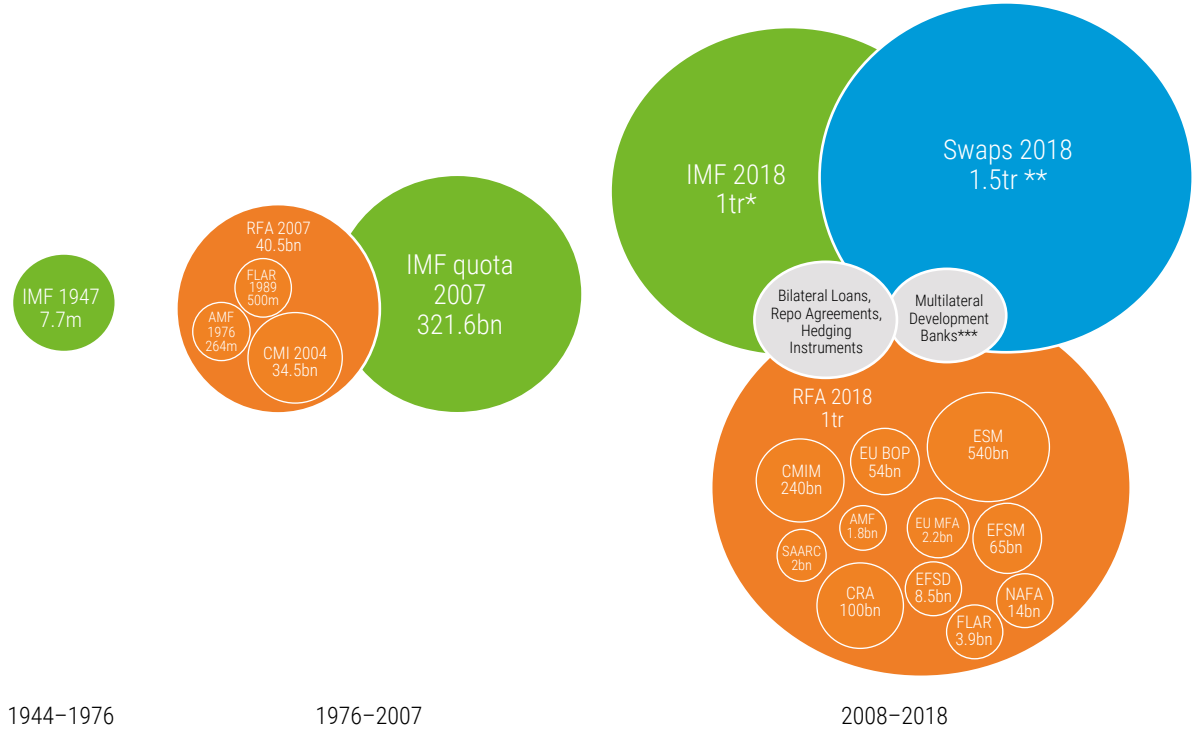
By 2020, the GFSN had expanded to ten times its size at the time of the GFC, offering unprecedented capacity for crisis prevention through a variety of sources (table 6.1). RFAs offered as much as the equivalent of $1 trillion to their members on preferential terms and without the austerity and pro-cyclical conditionalities typically imposed by the IMF. They also offered an economic "voice" that was absent in the Bretton Woods institutions who have still not altered voting rights to reflect the new economic weight of developing country members. Nonetheless, they remain small in comparison to a new, third source of finance in the form of bilateral swaps, as shown in figure 6.1.

**Table 6.1** Major regional financial arrangements within the global financial safety net

| Regional financial arrangements (RFA) | Year of inception | Members |
|---|---|---|
| Arab Monetary Fund (AMF) | Founded in 1976 by the Economic Council of the League of Arab States | Algeria, Bahrain, Comoros, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, State of Palestine, Qatar, Saudi Arabia, Somalia, Sudan, Syrian Arab Republic, Tunisia, Yemen |
| BRICS Contingency Reserve Arrangement (CRA) | Founded in 2015 by the country grouping known as BRICS | Brazil, Russian Federation, India, China and South Africa |
| Latin American Reserve Fund/Fondo Latinoamericano de Reservas (FLAR) | Established in 1978 as Andean Reserve Fund (FAR), transformed into FLAR in 1991 | Plurinational State of Bolivia (1988), Colombia (1988), Costa Rica (1999), Ecuador (1988), Paraguay (2015), Peru (1988), Uruguay (2008), Bolivarian Republic of Venezuela (1988) |
| Chiang Mai Initiative Multilateralization (CMIM) | CMIM was signed in December 2009 as successor to the Chiang Mai Initiative (CMI) founded in 2001 | Members of the Association of Southeast Asian Nations (ASEAN) plus three partner countries: China, Republic of Korea and Japan |
| Eurasian Fund for Stabilization and Development (EFSD) | 2009 | Armenia, Belarus, Kazakhstan, Kyrgyzstan, Russian Federation and Tajikistan |
| European Stability Mechanism (ESM) | 2012, successor to European Financial Stability Facility established in 2010 | Austria, Belgium, Cyprus, Estonia, Germany, Finland, France, Greece, Ireland, Luxembourg, Malta, Portugal, Slovakia, Slovenia, Spain, Netherlands |
| South Asian Association for Regional Cooperation (SAARC) | 1985 | Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka |

*Source:* UNCTAD secretariat based on Mühlich and Fritz (2021, 2022); RFA websites and reports.

**Figure 6.1** Evolution of the global financial safety net, 1994–2018 *(current dollars)*



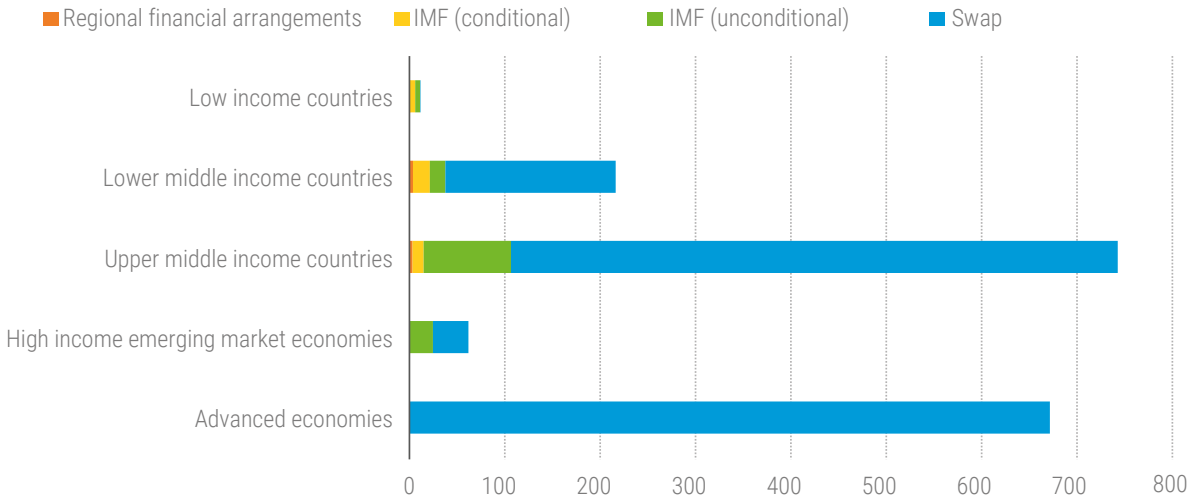

*Source:* Mühlich et al. (2020).
*Note:* AMF – Arab Monetary Fund; CMI(M) – Chiang Mai Initiative (Multilateralization); CRA – Contingent Reserve Arrangement of the New Development Bank; EFSM – European Financial Stabilization Mechanism; EFSD – Eurasian Fund for Stabilization and Development; ESM – European Stability Mechanism; EU BOP – EU Balance of Payments Assistance; EU MFA – EU Macro Financial Assistance; FLAR: Latin American Reserve Fund (according to its Spanish acronym); SAARC – South Asian Association for Regional Cooperation Swap Arrangement; NAFA – North American Framework Agreement.

## 1. Counter-cyclical and counter-intuitive? Covid-19 and the untapped liquidity of RFAs

Despite the expanded capacity of the RFAs, they remained largely untapped during the recent Covid-19 period, with IMF facilities and bilateral swaps used more extensively. This is a change from previous crises, when many developing countries turned in the first instance to their regional financial institutions. This time around, the RFAs lent out more than $5 billion to their members; however, this was much less than their capacity. Further, it was dwarfed by bilateral currency swaps between central banks, standing at more than $1.5 trillion and IMF lending of $119 billion (figures 6.2 and 6.3). The RFAs between emerging and developing economies have been used very unevenly and at a relatively small scale (AMF: 10 programs with a total volume of about $1358 million; EFSD: three programs, $650 million; SAARC: 5 programs, $1200 million; FLAR: one program, $308 million) or have not been used at all (CMIM and CRA). The total loan amount approved for RFAs requested by such countries amounted to $3.5 billion.

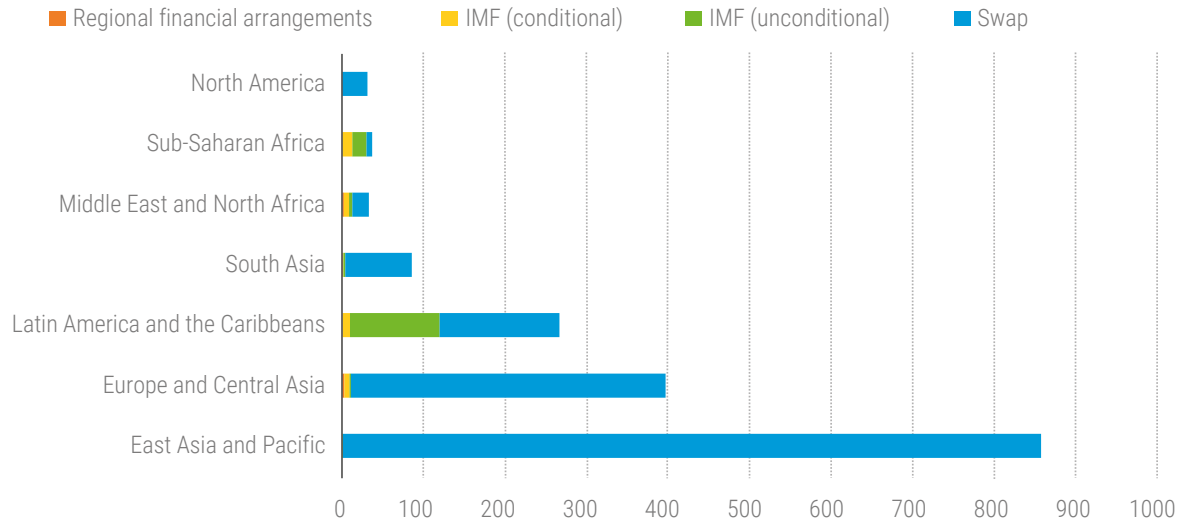
This pattern is evident for both the lower-income countries and the higher-income ones (Hawkins and Prates, 2021; Mühlich and Fritz, 2021, 2022; Mühlich et al., 2020, 2022). This trend of heavy reliance on bilateral swaps was already observed in the year before the Covid-19 crisis and was causing concerns (Mühlich and Fritz, 2022; Barrowclough et al., 2022). The experience of the last three years has only magnified those concerns.

**Figure 6.2** Active central bank currency swaps and lending from IMF and regional financial arrangements, selected income groups, March 2020–December 2021 *(billions of dollars)*




*Source:* UNCTAD secretariat calculations based on Mühlich et al. (2022) and UNCTAD/Boston University Global Financial Safety Net tracker.
*Note:* Data refer to accumulated amounts by country groups. Country group classification follows IMF (2021, October) World Economic Outlook and World Bank criteria. In particular, "high income emerging market economies" relate to high-income countries that are not considered advanced economies by the IMF. Because of the primary reserve currency status of the dollar in the global economy, data for the United States were not considered in this figure. Based on an assumption of reciprocity, swaps between advanced economies are counted twice, while those between advanced economies and emerging market and developing economies (EMDEs), only appear on the EMDE side. Also, swaps between the People's Bank of China (PBOC) and other EMDEs are only reported for PBOC partners. The volume of unlimited swap agreements is based on the maximum amount activated during the analysed period while limited swaps correspond to the total amount made available per country between March 2020 and December 2021. IMF conditional instruments include stand-by arrangements (SBA), catastrophe containment and relief (CCR), extended fund facility (EFF), while non-conditional instruments include rapid credit facility (RCF), rapid financing instrument (RFI), flexible credit line (FCL), precautionary and liquidity line (PLL), short-term liquidity (SLL). IMF lending corresponds to the sum of IMF loans agreed between March 2020 and October 2021. Lending relating to regional financial arrangements (RFAs) corresponds to the sum of loans by all RFAs agreed between March 2020 and December 2021.

**Figure 6.3** Active central bank currency swaps and lending from IMF and regional financial arrangements, selected geographic areas, March 2020–December 2021 *(billions of dollars)*




*Source:* See figure 6.2.
*Note:* See figure 6.2.

An obvious question is why countries who are members of RFAs would not turn more to their use, given their apparent benefits. Another paradox is that while the RFAs with the largest lending capacity were not used at all, RFAs with the smallest and mid-sized lending capacity were the most used. Analysis of members of a variety of RFAs comparing their pre-Covid-19 borrowing patterns with Covid-19 borrowing found RFAs tended to be used more when the funds had an autonomous institutional setup (i.e. with lending not contingent on an IMF package) and a balanced decision making and governance structure, whereby member country voting rights and borrowing were not solely dependent on their capacity to contribute capital. Whereas the small, autonomous and relatively egalitarian regional funds, such as the AMF and the FLAR, were repeatedly in demand from their member countries, even if at lower intensity than during the prepandemic period, the more unevenly organized but relatively voluminous regional funds, such as the EFSD or the SAARC swap agreement, were less used as standalone crisis finance providers. Furthermore, nonautonomous voluminous regional funds, such as the CMIM or the CRA, were not in use at all (Mühlich and Fritz, 2022).

Another factor contributing to the trend is that the IMF offered more lending without conditionalities. From the beginning of the spread of the Covid-19 related economic fallout until the end of December 2021, the IMF disbursed about $137 billion (80 per cent) of overall lending as unconditional lending. Nonetheless, in total, the IMF provided less than a fifth of its available lending capacity of $1 trillion, and the bulk of financing went through a very small number of countries that had previously prequalified for unconditional IMF lending.

At the same time, however, swap arrangements were offered by a wide range of central banks, including some from developing countries, such as the central banks of India, Maldives, Sri Lanka, Bhutan, Qatar and Indonesia, to name a few. They are, of course, dwarfed by swaps arranged by the United States Federal Reserve (Fed) and the People's Bank of China (PBOC) and to a smaller degree by other advanced economies' central banks, such as Japan, the United Kingdom, Australia, Sweden and Switzerland. These may be smaller but they represent an important source of finance to their users.

This new formation of the GFSN is raising concerns, however, because while these seem to be a voluminous source of finance, in practice, such bilateral swaps lack many of the advantages of multilateral global or regional lending – including its predictability and transparency. This aspect of the GFSN is discretionary and not driven by standard practices or protocols; it is therefore not a level playing field, given that not all countries have the ability to negotiate such bilateral agreements and the relationship between lender and borrower is not necessarily equal, depending on the interests of the creditor country, especially with respect to trade and financial ties, but also with respect to political and geostrategic issues. In practice, this form of liquidity provision during Covid-19 was strongly skewed towards higher income countries (figure 6.2) and to certain regions (figure 6.3) in East and Central Asia and Europe.

## 2. Implications for the RFAs

There have long been concerns about the inequities and inefficiencies of the GFSN, with so-called knots and gaps persisting even as the emergence of new institutions and mechanisms has given developing countries wider options. It was not, however, ever a real concern that the regional multilaterals might become marginalized in favour of bilateral arrangements. Now, there are at least five major concerns:

I - If demand for liquidity grows – which seems likely given the continued post-Covid-19 environment of rising interest rates and spiraling food prices – poorer countries and regions less covered by the GFSN will struggle to find the required crisis financing.

II - The extent to which bilateral swaps have out-paced multilateral liquidity provision throughout the crisis raises questions about countries' confidence in these institutions' crisis resolution capacity.

III - Maintaining choice and competition in the system is important to encourage better service delivery and enhance the bargaining power of governments in programs to return nations to stability and sustainability and to ensure all countries have the support they can depend upon, not just a few. Regional financial arrangements provide an important "voice" for member countries not included in significant multilateral institutions. The G20 (Principle No. 5) urges the prevention of arbitrage and facility shopping, especially for policy conditions and pricing (G20, 2011); yet this is what many developing countries want and a partial reason for the establishment of their RFAs in the first place.

IV - The threat of potential marginalization of RFAs was evident before Covid-19, and some writers argued they should ensure their member countries had ownership of regional surveillance and enforcement systems, rather than giving it to outside institutions (Grimes, 2011). The reluctance to use the CMIM in the last decade, for example, was linked to the fact that lending was concomitant with agreement on an IMF program (Mühlich et al., 2022, p. 148). Nonetheless, the longstanding inequalities in access to and availability of short-term financing point to the lack of coordination in the existing GFSN.

V - Finally, a reduction in the use of regional multilateral institutions raises the spectre of national interests increasingly influencing the crisis finance regime. Swaps are an option only for a small minority of countries and maybe not those who most need support. This vast volume of bilateral liquidity is not the same as a global safety net.

## 3. Countering dollar hegemony

The persistence of United States dollar hegemony in a context of continued hyper-globalization, marked by open capital accounts, floating exchange rates and financial deregulation, has played an essential part in facilitating the emergence of an international monetary system that has favoured short-term financial and corporate interests over developmental ones in a systematic fashion (box 6.1). This has come at a high cost to developing countries in terms of the financing of reserve accumulation and the servicing of dollar denominated debt contracts (*TDR*, 2019).

This changes the stakes for developing countries in seeking at least a partial escape from dollar hegemony by strengthening regional monetary cooperation and marshalling their own financial firepower to ease the constraints imposed on their development prospects in today's debt-driven global economy. This, it should be noted, is not about longer-term South-South cooperation to prop up development finance through large-scale lending programs, much as these are both necessary and welcome in view of hesitant, limited and often unpredictable development financing initiatives from developed countries. Rather, regional monetary cooperation among developing countries can complement and support longer-term South-South financial cooperation, if it substantially increases the ability of developing regions to refinance and promote intraregional trade and develop intraregional value chains (see Chapter V).

The scope and effectiveness of regional monetary arrangements depend on agreed-upon objectives. These range from simple regional reserve swap and pooling agreements to bridge liquidity constraints when these arise, to the full-scale development of regional payment systems and internal clearing unions. The latter extend credit to members through the regular offsetting of accumulated (trade-related) debts and credits between them and thus at least partially replace reliance on external foreign-denominated financial resource and associated exchange-rate volatility with local financial resources. This requires the use of a non-tradable regional unit of account, much like the international accounting currency proposed by Keynes to manage the international monetary system, that promotes intraregional trade by allowing accumulated credits within the regional clearing mechanism to be offset against debits only through imports from, or foreign direct investment in, member states at fixed intraregional exchange rates against the regional unit of account (Kregel, 2018).

The scope for deeper monetary integration in the form of payment systems and clearing mechanisms largely depends on the initial trading patterns and positions of prospective member states, as the extent to which intraregional credit creation and clearing can be used to substitute for external financial resources depends on countries' ability to extend credit. The higher the share of intraregional trade, the greater the scope for intraregional monetary arrangements to help expand this. But the net commercial trade balances within country groupings also matter, as the idea of a regional clearing union is precisely to use the extension of trade credits to participant deficit countries to replace covering trade imbalances by compensating external capital inflows.

The purpose of such clearing arrangements is, of course, also to increase intraregional relative to extraregional trade, such that current trade patterns change. This, in turn, requires political will. For regional clearing unions to function properly in the interest of freeing up the regions' own financial resources and policy space to pursue national development strategies, regional interests have to be prioritized. Sometimes, even over immediate national interests, in the understanding that reverse priorities will ultimately undermine both collective and national developmental goals. (See Barrowclough et al., 2022 for a review of different countries' experiences of these mechanisms and institutions.)

### Box 6.1 The Persistence of the US Dollar as an International Currency

The one continuous feature of the international economic system that emerged from the wreckage of the Second World War has been the central role of the dollar as the premier vehicle currency in the private sector and the premier reserve currency in the official sector.

Over the past few decades, however, financialization has evolved at an accelerated pace; the financial sector now dominates the real productive economic sector on which it rests. In 1980, the combined nominal value of the world's equity and bond stocks stood at about $11 trillion, a figure on a par with that for nominal world GDP in that year. By 2020, the combined value of those securities stocks had grown over 20-fold to $234 trillion, while world GDP only registered an eight-fold increase to $84 trillion (SIFMA, 2021). This divergence between financial and productive assets is fuelling a narrative, if not of an impending collapse of the dollar-based international financial system, then of its growing fragmentation (for an in-depth debate, see Lysandrou and Nesvetailova, 2022; Galbraith, 2022).

Between 1986 and 2019, daily forex turnover rose from about $0.4 trillion to $6.6 trillion (BIS, 2019). During this period, the dollar's share of this turnover averaged about 44 per cent. In today's terms, this percentage is roughly on a par with the United States respective percentage contributions to the world's equity stocks (40 per cent of the $95 trillion outstanding in 2019) and the world's bond stocks (39 per cent of the $106 trillion outstanding in 2019; SIFMA, 2020). However, it is also far above the United States percentage share of nominal world output (23 per cent of the 2019 world gross domestic product (GDP) figure of $88 trillion). These numbers, taken in combination with the trend increase in the United States trade deficits, underpin the widely held view that there will soon come a time when foreign investors will lose confidence in the dollar and thus abandon it in the face of mounting concerns about the ability of the United States to meet its financial obligations in the face of its deteriorating macroeconomic fundamentals and recurrent financial shocks.

But financializaton is not a one-dimensional force. Its depth is just as important an indicator of its historical significance as its speed of development, because it reflects the structural role of finance in economic

transformation. To be specific, the recent scale of growth of the world's equity and debt securities markets is an outcome of fundamental changes in both their supply and demand sides.

From the supply side, there has been a growing dependence of both corporate entities and governments on security issuance, in tandem with the increasing size and complexity of modern economies. In this respect at least, what the United States offers, beyond possible alternatives, is a huge and varied abundance of securities (not only equities but also bonds, including corporate, financial, Treasury, agency and municipal bonds) in which foreign investors can store large amounts of funds. Given the need for dollars as a means of accessing the United States securities markets, it follows that while the sheer depth and liquidity of these markets attract foreign institutional investors in droves, this attraction serves, in turn, to further amplify the depth and liquidity of the market for dollars. This development helps to explain why the dollar remains the most widely used currency in the execution of various cross-currency transactions. Moreover, the depth and liquidity of the dollar market mean that even when those institutional investors holding globally diversified portfolios transfer funds from one set of non-dollar securities to another non-dollar set of securities, they usually do so indirectly, via the dollar, to contain the costs of these fund transfers.

The same persistence holds for predictions about the dollar's primacy as a reserve currency. The share of dollars in globally identified foreign exchange reserves has dropped over the last two decades by around ten percentage points from around 70 per cent in 2000. However, the drop occurred in the first few years following the introduction of the euro and has remained stable since then (*TDR*, 2019). The fundamental reason why the dollar has maintained this 60 per cent share of foreign exchange reserves even as these continue to grow exponentially in absolute terms comes down to the large mass of United States Treasuries. In today's era, when the world's capital markets are deep and highly integrated and cross-currency capital movements accordingly combine huge scale with high mobility, central banks who want to minimize the impact of these movements on their domestic currencies need to have in reserve financial securities that: (i) have a large and safe value storage capacity, (ii) are available in abundance, and thus (iii) are highly liquid. No other financial securities and no other financial instruments, including crypto and digital currencies, can match United States Treasuries in these criteria.

Thus, as with institutionally managed asset portfolios, foreign exchange reserve portfolios are organized according to a hierarchical structure, with the core segment typically comprising United States Treasuries and satellite segments comprising higher-yielding securities of other governments.

If any EME-based central banks needed any reminder of this crucial fact, the events of early March 2020 provided it. By that time, the Covid-19 pandemic's negative impact on the global economy was clear to the world's institutional investors, and they quickly withdrew funds amounting to over $100 billion from the EMEs in the space of days. That withdrawal was catastrophic for many countries, but the impact would have been even more devastating had their central banks not quickly intervened in their domestic currency markets with huge sales of the United States Treasuries kept in their reserves.

On 1 April 2022, the Bank for International Settlements (BIS) launched its Thirteenth Triennial Central Bank Survey of Foreign Exchange Transactions and Over-the-Counter (OTC) Derivatives Markets, the full results of which are due to be published in November 2022. In the two full years between the 2019 survey and the current one, the world economy suffered its biggest shock since the Great Depression of

the 1930s with the outbreak of the Covid-19 pandemic. In 2020, nominal world GDP fell from its 2019 figure of $87.4 trillion to $84.9 trillion, while the world's combined bond and equity stocks increased by more than 15 per cent from $200.9 trillion in 2019 to $234.3 trillion, an increase principally driven by the steep increase in government bond issuance on the one hand, and the increase in security prices fuelled by monetary policy easing, on the other. In 2021, economic recovery saw nominal world GDP rise above its prepandemic level to $94.9 trillion, but the world's combined equity and bond stocks also rose substantially, to reach over $241 trillion (SIFMA, 2022).

In both these Covid-19-impacted years, the United States share of the world's supplies of equities and bonds remained stable at around 40 per cent. Thus, going by the observation that forex turnover volume is overwhelmingly driven by financial sector interests as distinct from those of the real sector, the dollar's share of the new 2022 figure for daily forex turnover will remain largely unchanged.

*Source:* Derived from Lysandrou P and A Nesvetailova (2022) "Why the Ukraine crisis will make little difference to dollar supremacy", *Institute for New Economic Thinking*, 24 June 2022, https://www.ineteconomics.org/perspectives/blog/why-the-ukraine-crisis-will-make-little-difference-to-dollar-supremacy.

# C. LONG-TERM FINANCE: NEW ROLES FOR REGIONAL AND MULTILATERAL DEVELOPMENT BANKS

More than 90 per cent of development banks across the world are either national or subnational (Xu et al., 2019). While few in number, however, the multilateral and especially regional multilateral DFIs have a particularly important role to play. Regional banks – meaning banks with multiple owners, usually governments from the same region – are an integral part of the global financial infrastructure and the development system. They play the important role of linking national development banks with the international financial system and in some cases they help by coordinating multiple governments and multiple banks across projects greater than any can do alone. For some countries and projects, they may be the most important source of long-term and reliable finance, whether it be for financing and promoting trade (the main priority for many higher-income countries) or for financing infrastructure, agriculture and development in general (the goal of middle-income and lower-income countries' banks) (Xu et al., 2019, p. xi). They are needed now, more than ever, given the rise of challenges that go beyond national borders – like responding to climate change or to global shocks such as the recent experience of Covid-19. Table 6.2 shows how these important regional, inter-regional and global multilateral banks have emerged in a series of waves over the decades since the establishment of the World Bank in 1944.

**Table 6.2** Evolution of the multilateral development bank landscape, 1944–present

| Establishment year | Bank Name | Geographical scope | Total Assets in 2020 *(billions of dollars)* |
|---|---|---|---|
| **WWII-1960s – Bretton Woods and the global view** | | | |
| 1944 | World Bank | Global | 536.6 |
| 1956 | International Finance Corporation | Global | 105.3 |
| **First regional development banks – regional integration and development** | | | |
| 1956 | Council of Europe Development bank | Europe | 34.2 |
| 1958 | European Investment Bank | Europe | 766.8 |
| 1959 | Inter-American Development Bank | LAC | 147.5 |
| 1960 | Banco Centroamericano de Integración Económica | LAC | 13.3 |
| 1963 | International Bank for Economic Cooperation | Asia Pacific | 1.0 |
| 1964 | African Development Bank | Africa | 50.9 |
| 1966 | Asia Development Bank | Asia Pacific | 271.7 |
| 1967 | East African Development Bank | Africa | 0.4 |
| 1970 | International Investment Bank | Inter-Regional | 2.0 |
| 1970 | Banco de Desarrollo de América Latina | LAC | 46.8 |
| 1970 | Caribbean Development Bank | LAC | 2.1 |
| 1973 | Banque de Developpement des Etats de l'Afrique de l'Ouest | Africa | 6.0 |
| 1973 | Arab Bank for the Economic Development of Africa | MENA | 5.5 |
| 1974 | Fondo Financiero para el Desarrollo de la Cuenca del Plata | LAC | 1.7 |
| 1974 | Arab Fund for Social and Economic Development | MENA | 12.9 |
| 1975 | Nordic Investment Bank | Europe | 43.3 |
| 1975 | Banque de Développement des Etats d'Afrique Centrale | Africa | 1.2 |
| 1975 | Ecowas bank for Investment and Development | Africa | 1.0 |
| 1976 | OPEC Fund for International Development | MENA | 5.9 |
| 1977 | International fund for Agricultural Development | Inter-regional | 9.6 |
| 1985 | Trade and Development Bank | Africa | 7.2 |
| 1989 | Arab Trade Financing Programme | MENA | 1.2 |
| 1989 | Pacific Islands Development Bank | Asia Pacific | 0.0 |
| 1989 | Nordic Development Fund | Europe | 0.9 |
| **1990s–2000s – Regionalism and market-led development, global vertical funds, trust funds hosted by multilateral development banks** | | | |
| 1991 | European Bank for Reconstruction and Development | Inter-regional | 85.3 |
| 1993 | African Export and Import Bank | Africa | 19.3 |
| 1993 | Interstate Bank | Asia Pacific | 0.2 |
| 1993 | North American Development bank | LAC | 2.2 |
| 1999 | Islamic Co-op for the Development of the Private Sector | Inter-regional | 3.3 |
| 1999 | Black Sea Trade and Development bank | Europe | 3.4 |
| 2005 | Economic Coop. Organization Trade and Development | Asia Pacific | 0.7 |
| 2006 | Eurasian Development bank | Asia Pacific | 5.6 |
| **2010 onwards – Regionalism and the rise of the South, the return of industrial policy** | | | |
| 2014 | New Development Bank | Inter-regional | 18.8 |
| 2015 | Banque Maghrébine d'investissement et de Commerce Extérieur | MENA | n.a. |
| 2016 | Asian Infrastructure Investment Bank | Asia Pacific | 32.1 |

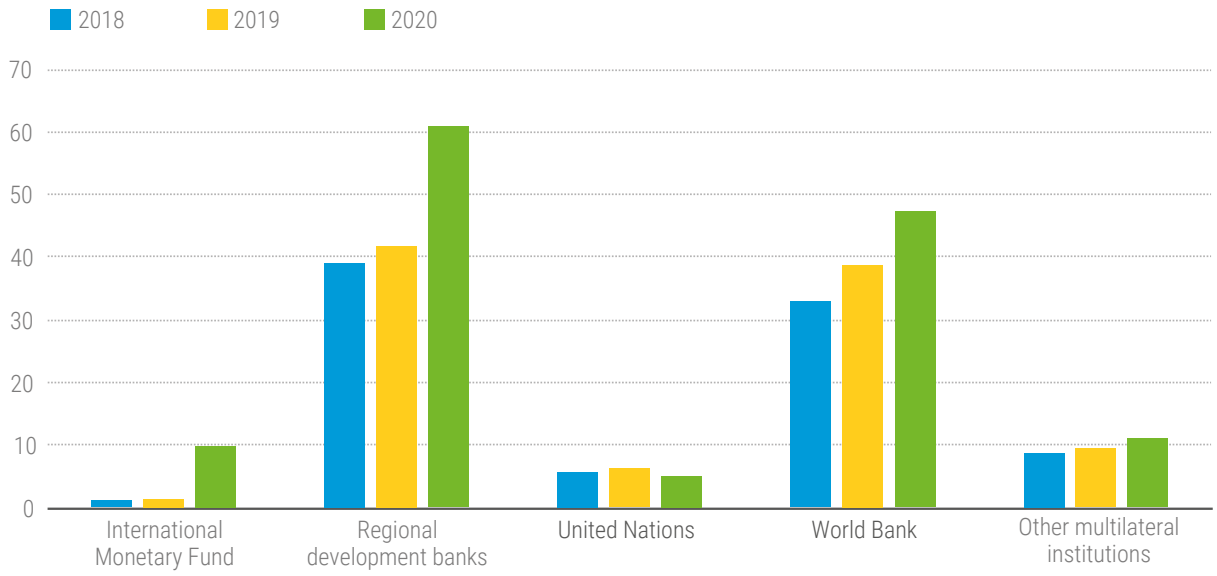
*Source:* Update of Ocampo and Ortega (2020) using the July 2022 version of the Public Development Banks and Development Financing Institutions database provided by Xu et al. (2021).

## 1. The new landscape of long-term regional finance

Regional sources of development finance have been increasing significantly in the last decade – from the creation of new regional DFIs to the scaling up of existing ones and new trends where some national banks lend to their region or even beyond. Some of these changes have been particularly marked in the South.

This matters because regional banks are an important source of long-term finance – and for some regions, one of the most important. As shown below, loans committed by regional banks have increased steadily over decades, sometimes growing faster than Bretton Woods lenders and exceeding total disbursements as well (figure 6.4). According to OECD Development Assistance Committee (DAC) statistics, they provided at least $180 billion in aggregate in 2018, more than double the funds the banks initially received from their owner governments, reflecting that banks leverage their capital by borrowing on international financial markets in addition to receiving revenues from loans and profits from investments. When other banks that are not officially defined as regional multilateral development banks (MDBs) are included, such as the European Investment Bank (EIB) or Asian Infrastructure Investment Bank (AIIB), this rises to over $300 billion (Ocampo and Ortega, 2020).

**Figure 6.4** Multilateral disbursements to developing countries by institution, 2018–2020
*(billions of constant 2020 dollars)*

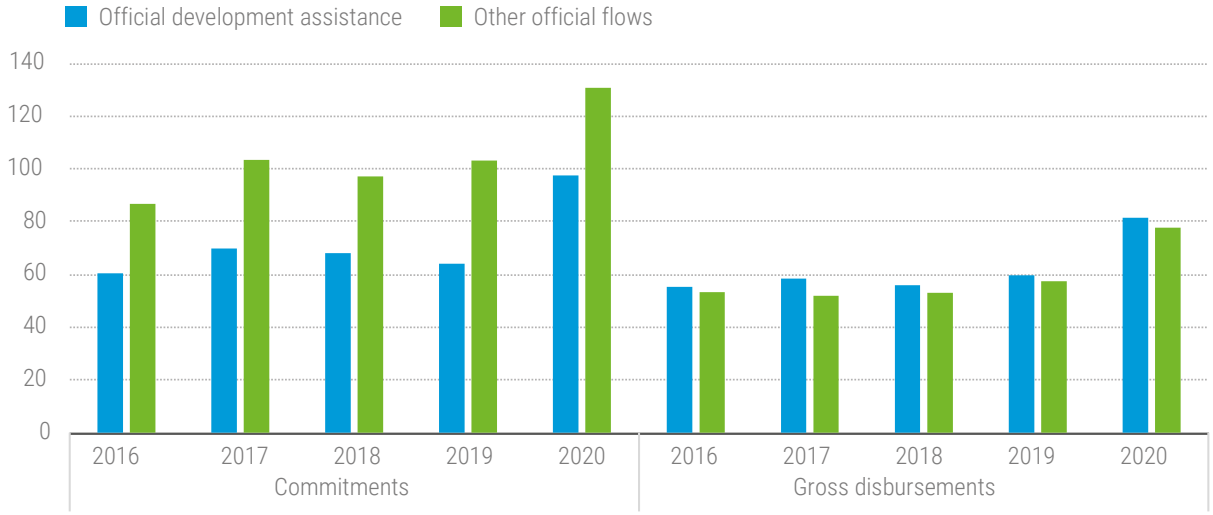



*Source:* UNCTAD secretariat calculations based on OECD Creditor Reporting System.
*Note:* Disbursements consider official development assistance (ODA) and other official flows (OOF), both following OECD definitions. Regional development banks include: AfDB, ADB, IADB, AIIB, CABEI, CarDB, CEDB, EBRD, and IsDB. Other multilateral institutions include: Adaptation Fund, Arab Bank for Economic Development in Africa (BADEA), Arab Fund (AFESD), Black Sea Trade and Development Bank (BSTDB), Center of Excellence in Finance (CEF), Central Emergency Response Fund (CERD), Climate Investment Funds (CIF), Eurasian Fund for Stabilization and Development (EFSD), Global Alliance for Vaccines and Immunization (GAVI), Global Enviromental Facility (GEF), Global Fund, Global Green Growth Institute (GGGI), Green Climate Fund (GCF), Montreal Protocol, Nordic Development Fund (NDF), OPEC Fund for International Development (OPEC Fund), OSCE, UNCTAD, and the WTO International Trade Center.

Most importantly, slightly more than half the official lending was concessional (OECD, 2020b, p. 23) with respect to the interest rate charged to borrowers, maturity or other characteristics compared to commercial lenders or grant-based lending (figure 6.5). This feature is important because the kind of lending that is typically the province of public development banks, namely infrastructure or social investments with high capital costs upfront and very long-term revenue prospects, is eschewed or under-provided by commercial lenders.

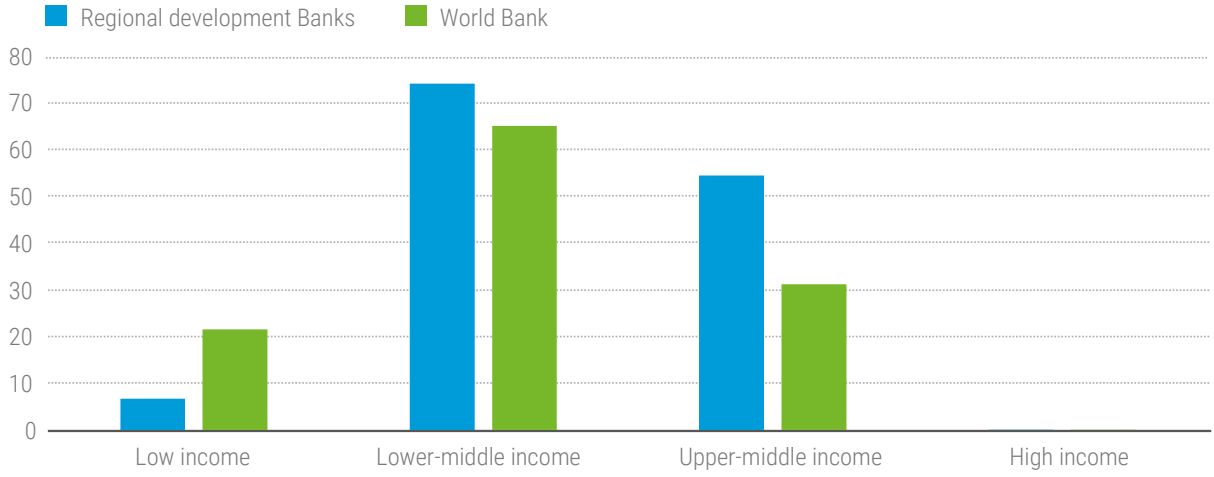
Not all regions are equally well served, and as shown in figure 6.6, there can be a big variation between individual banks, countries and regions. In Sub-Saharan Africa, lending by the MDBs is estimated to account for as much as 10 per cent of GDP, divided roughly half and half between the World Bank Group and regional banks. For South Asia, Latin America, the Caribbean and Europe, lending from MDBs is just over 4 per cent of GDP, indicating the availability of other sources of finance from national banks and commercial sources (Ocampo and Ortega, 2020). North Africa and Oceania are particularly poorly served. The evidence shows that both the World Bank and regional development banks disburse less to lower income countries than they do to middle income countries overall, presenting the challenge to scale up development finance to the poorest countries across the globe.

**Figure 6.5** Commitments and disbursements of international financial institutions to developing countries by lending type, 2016–2020 *(billions of constant 2020 dollars)*




*Source:* See figure 6.4.
*Note:* See figure 6.4. International financial institutions include the regional development banks of figure 6.4, together with IIB, IMF and World Bank.

**Figure 6.6** Disbursements by regional development banks and World Bank to developing countries by income group, 2018–2020 *(billions of constant 2020 dollars)*

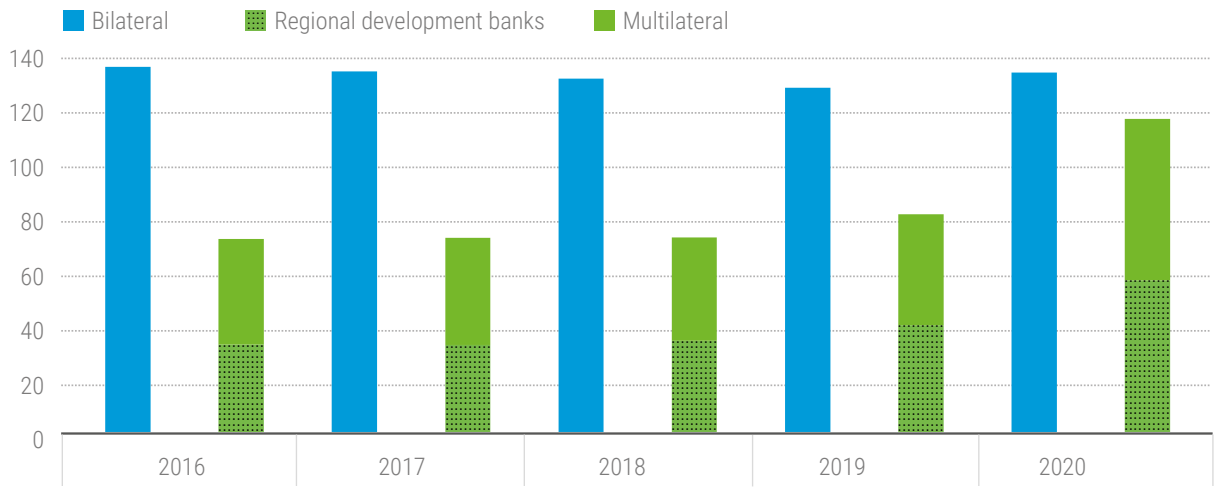



*Source:* See figure 6.4
*Note:* See figure 6.4. Income groups follow the World Bank classification.

A third reason the regional MDBs are important is that some of their new firepower is coming from the South, with Southern-owned and led banks offering an alternative to the traditional sources of finance and a fresh "voice" in international debate more commensurate with their economic weight. The national development banks lending outside their national borders and into the region and beyond are also often Southern-owned (*TDR*, 2015; UNCTAD, 2018a, b; Gottschalk and Poon, 2020; Barrowclough et al., 2020; UNCTAD, 2018b). This is not captured in the official DAC statistics but is changing the landscape significantly, enabling choices that did not exist before (Grabel, 2018).

These trends notwithstanding, it is remarkable to see the rise of non-multilateral, ad hoc bilateral flows and "ear-marked" donor funding. As the richer countries of the North have mostly not significantly increased financing for the regional development banks (RDBs) in which they have a stake, new sources of finance are filling the void. As shown in figure 6.7 and echoing the story of liquidity finance told in Section B, the regional multilateral sources represent less than half of the value of bilateral flows in the latest year for which data are available – even though this includes one of the biggest years for RDBs in a long time.

**Figure 6.7** Bilateral and multilateral disbursements to developing countries, 2016–2020
*(billions of constant 2020 dollars)*




*Source:* See figure 6.4
*Note:* See figures 6.4 and 6.5. Bilateral disbursements consider only DAC countries. The dotted area represents the contribution of regional development banks in multilateral disbursements.

## 2. The role of RDBs during crisis: counter-cyclical responses during Covid-19.

Many regional development banks played a strong counter-cyclical role during Covid-19, either increasing their lending significantly compared to other years or redirecting lending to other uses for their members or yet again, being the main sources of lending in the absence of other finance from national lenders (in the case of the lower-income countries) or from global financial providers (in the case of the middle-income developing ones) (Griffith-Jones et al., 2022 forthcoming). Many geared up quickly, as shown in table 6.3. Some also lent outside their immediate regions, in the search for new clients, as few governments were able to begin new infrastructure projects during this difficult time (box 6.2).

**Table 6.3** Loan commitments and disbursements by selected regional development banks, 2019–2020 *(billions of dollars)*

| Regional Development Bank | Loan commitments | | | Loan disbursements | | |
|---|---|---|---|---|---|---|
| | 2019 | 2020 | Percentage change | 2019 | 2020 | Percentage change |
| European Investment Bank | 65.8 | 108.8 | 65 | 53.8 | 66.4 | 23 |
| Asian Development Bank | 24.0 | 31.6 | 32 | 16.5 | 23.6 | 43 |
| Development Bank of Latin America (CAF) | 13.0 | 14.1 | 9 | 10.0 | 10.4 | 3 |
| Inter-American Development Bank | 11.3 | 12.6 | 10 | 10.9 | 14.9 | 38 |
| New Development Bank | 7.2 | 10.3 | 43 | 0.9 | 5.4 | 488 |
| Asian Infrastructure Investment Bank | 4.5 | 10.0 | 120 | 1.5 | 6.2 | 321 |
| Islamic Development Bank | 7.8 | 6.8 | -13 | 8.2 | 7.0 | -15 |
| African Development Bank | 10.0 | 5.8 | -42 | 5.3 | 7.2 | 36 |
| Trade and Development Bank (formerly the PTA Bank) | 5.1 | 5.5 | 7 | n.a. | n.a. | n.a. |
| Banque Ouest Africaine de Développement (BOAD) | 0.9 | 1.2 | 36 | 0.7 | 0.9 | 32 |

*Source:* Griffith-Jones et al. (2022 forthcoming).

### Box 6.2 What does regionalism mean to the new Southern-led banks?

The membership of the new Southern-led banks may be as much about shared and common development goals, challenges and capacities as about close proximity in terms of geography. Physical location is still important for many of the institutions established in earlier decades but less so for the most recent ones, born in an age when communications and travel are easy. Even the AIIB – which by name is rooted in Asia – has both borrowers and lenders that are far from Asian borders.

Similarly, the NDB was never meant to be just concentrated on the original BRICS founding members (Brazil, Russian Federation, India, China, South Africa) and has always had a global vision, albeit focused on developing and emerging economies. From the outset, it was interregional rather than narrowly regional, as its founding members in 2015 came from countries in all corners of the world. With an initial capitalization of $50 billion in paid in and callable capital and subscribed capital of $100 billion, the bank aims to be a powerful resource for its Southern borrowers around the globe. New members were added last year, again broadening the interregional flavour – Bangladesh, Egypt, the United Arab Emirates (UAE) and Uruguay – and another five to ten members will be added next year.

Taking on new members will inevitably dilute the ownership of the original founders and potentially change the direction of lending, an issue for any bank considering increasing its capitalization by taking on new

members. However, in the NDB's case the founders' share is retained at 55 per cent of the total, with another 25 per cent to be owned by other emerging countries and the final 20 per cent to be held by governments from advanced economies. The fact the founders managed to attract new funds and yet retain the dominant vote is seen as reflecting the rise in influence commensurate with economic weight of some of the larger members. It suggests the NDB can increase capitalization significantly, thereby raising the bank's firepower for lending, without changing its intrinsic nature because the initial founders will retain voting predominance. Similarly, in the AIIB, with its very large number of shareholders drawn from the entire world, China retains the veto right on voting.

Both new banks have the ambition to focus on green lending, which could be relatively easier for them than for older banks with long histories of supporting activities that are now considered problematic, but which were not decades ago. The NDB, for example, has no lending to coal. Moreover, despite having advanced country members, both banks aim to lend to emerging markets, being quick and agile with lending and following the environmental standards of borrower countries, not those of more advanced countries. At the same time, these banks have many partnerships with other banks, including the World Bank, and this is needed for technical capacity and expertise. NDB officials say the bank learned a great deal from its partnerships with the legacy and other multilateral banks, with whom it did many co-financings during Covid-19 relief and recovery programs. While the NDB aimed to be different from, and complementary to, the World Bank, it is still one of its key partners. Hence, regionalism does not bring competition but distinctiveness.

From the borrowers' perspective, the benefits of membership in specialized Southern-oriented DFIs were evident during the Covid-19 crisis. The NBD moved extremely quickly and was the first institution to lend to members South Africa and India when their economies were struck by Covid-19. Perhaps because the pandemic was first noted in a member country, when the pandemic ravaged the BRICS members, it was seen by the bank as the "central and most critical development challenge facing our countries." "When the building is on fire," said one senior official, "we don't discuss medium-term investment such as infrastructure."

The AIIB is also interregional and Southern-focused in its lending, although it has global owners, including many from the North. Before Covid-19, it limited its lending to the Asian region, and any lending outside Asia had to be somehow related to Asian investments, Asian markets or Asian development needs. This requirement was lifted only when the impact of lockdowns meant the bank had to seek alternative investments further afield. Much of this lending is still at the national level as cross-national projects are difficult to initiate, in part because they need to be supported by complementary regulations and other policies, and interests need to be balanced between the different countries involved. The AIIB has a goal for 25 per cent of its lending to be "cross border" by 2030, inspired by regional trade treaties, including the Regional Comprehensive Economic Partnership (RCEP), Trans-Pacific Partnership (TPP) and the Comprehensive and Progressive Agreement for a Trans-Pacific Partnership (CTTP), which are expected to have a transformative impact on the region and should make it easier for the bank to arrange interregional lending associated with trade, such as transforming transport, power grids and connectivity or trying to access the giant supply chains running across Asia.

*Source:* Derived from Griffith-Jones et al. (2022, forthcoming); UNCTAD interviews with senior bank officials, May and June 2022.

### Box 6.3 Regional banks and projects: how a Multilateral Development Bank financed the anti-Covid-19 vaccine

Public development banks, it is often argued, provide more than just finance – they can also provide expertise and technical advice on how to design and manage difficult or complex projects. Both attributes are needed for the kinds of projects characterized by uncertainty, risk, the prospect of low or zero profits and the need for coordination among many parties – all of which are deterrents to attracting finance from commercial or private banks. This may be particularly so when benefits and costs are spread across multiple countries, as was the case with the health impacts of Covid-19. The following describes how the EIB helped to finance the research and development of an anti-Covid-19 vaccine.

On 11 June 2020, EIB and BioNTech, a German company, signed an agreement for a Venture Debt (VD) operation of €100 million debt financing for the development of a Covid-19 vaccine in partnership with the pharmaceutical company, Pfizer. The German company, which had already signed a VD agreement at the European level in December 2019 for cancer research, also agreed to increase its own manufacturing capacity for a faster distribution of the vaccine at its own risk. The loan was guaranteed by the European Commission and the EIB, and they equally shared the guarantee. Resources, distributed in two equal instalments, came from the European Fund for Strategic Investments (EFSI) and from the InnovFin Corporate Research Equity fund, part of the Horizon 2020 program, specifically from the Infection Diseases Finance Facility (IDFF), which had already invested more than €500 million in the Covid-19 vaccine. In December 2020, the Covid-19 vaccine developed by BioNTech and Pfizer was approved by the United Kingdom medicines regulatory authority, and a few days later, the vaccine began to be administrated in the country. A few weeks later, Canada, Mexico and the United States approved the vaccine, and the European Union followed suit, though slightly later. The vaccine was ultimately approved and used worldwide, including in developing and emerging economies.

Thus, the European regional development bank EIB contributed to the creation of an important global public good, as a response to the Covid-19 pandemic. The example is also important because of its central idea that development banks can be deployed in ways that maximize their development impact, and the use of the VD mechanism enables the bank to pursue sustainable and inclusive impacts while maintaining some financial profits or at least avoiding losses. It is a way of appropriate risk sharing as opposed to the so-called “de-risking” that usually means transferring risks from the private sector to the EIB and ultimately to its member governments and tax payers (see also Mazzucato and Mikheeva, 2020).

*Source:* More details available in Griffith-Jones S and Carreras M (2021) and European Investment Bank (2021).

# D. SCALING UP CAPITALIZATION AND CAPACITIES: NEW SOURCES OF FINANCE FOR RDBs.

One way to redress the striking and growing disparity between multilateral lending versus ad hoc and bilateral capital flows would be to direct more funds to RDBs. One of the most obvious lessons to emerge from the Covid-19 experience of RDBs is the importance of having sufficient and reliable sources of capital. Unsurprisingly, those banks that were well capitalized were better able to provide assistance when needed (Griffith-Jones et al., 2022, forthcoming). Many national banks – often already under pressure before the shock of Covid-19 – relied on their regional DBs, so it makes an important difference when the RDB has some spare capacity to cope with the unexpected. These lessons are important given that future shocks are likely – whether climate related or financial – on top of the fact that RDBs face a far bigger role in the future in helping fund the investment needed to carry out the transition to low-carbon and more inclusive economies. Moreover, some policies now under consideration to address these challenges – such as carbon border taxes or other heightened environmental standards – will likely require additional financial investments in developing countries. If development banks are to be in a position to respond to such demand, they will need to be backed by higher levels of capital. This is especially important given the concern that CBAM and other mechanisms will likely hit revenue streams of developing countries much harder than those of more advanced or higher-income ones (for a discussion of this, see *TDR*, 2021, pp. 141–142). Recent research for UNCTAD's Least Developed Countries Report shows that trade imbalances and hence revenues would be worsened for LDCs, because they tend to be both import-dependent in "dirty" sectors and significant exporters of raw materials to those sectors (UNCTAD, 2022, chap. 2).

In advanced economies and in some (but certainly not all) middle-income countries (MICs), governments have the fiscal space to capitalize further their national development banks. Some did during the pandemic, such as the Uganda Development Bank, but, in fact, recapitalization was rare compared to the responses during the GFC. Moreover, it is often more difficult for the national governments of most low-income countries (LICs), many low-middle-income countries (LMICs) and even some MICs, which have limited fiscal space to respond to financial shocks or crises such as Covid-19 or to meet the challenges of the green and inclusive transition, to significantly capitalize their PDBs. In that case, it becomes desirable for the international community to step in and provide additional resources. As will be shown below, for many, this has taken the form of bilateral flows. There is a strong case that argues it is better – more transparent, more democratic and more equitable – to use the funds to help governments capitalize these national PDBs. Thus, providing them with additional credits, guarantees or help capitalize and provide additional finance to their RDBs so they can do the on-lending.

There are different ways this can be done, many of which have been discussed in previous Reports, such as taking on additional members, including from higher-income countries, as this both increases the pool of capital available and makes it easier for the banks to raise additional capital on international markets. Another would be to revisit the triple-A requirements imposed on most banks by their government owners, as this would enable them to hold smaller cash reserves. Still another is not to take on new members but rather to increase the capital contribution from existing government members. These are all important measures. The focus in the following section is on the most topical and current debate about the potential transfer of IMF special drawing rights (SDRs), including from those originating from a potential redistribution of the $650 billion SDRs already issued in 2021. This redistribution from advanced countries that do not need SDRs to poorer economies that need them was discussed as a principle supported by the G20. A tentative figure of $100 billion was approved for such a redistribution. The significance of this would be huge, as it is already more than the entire concessional lending by MDBs in 2018.

## 1. Recycling unused SDRs through RDBs

As Plant (2022) has pointed out, sharing access to global reserves could be an important component of the response to any crisis, especially as the only truly global financial response to the Covid-19 crisis was precisely the issuance of SDRs discussed above. This is different from the GFC, when there were important increases in the capital of MDBs and RDBs, facilitating strong increases of their lending commitments (see, for example, Griffith-Jones and Gottschalk, 2012).

The reallocation of these SDRs, to be channelled via RDBs and MDBs, so they can increase their capital and use it to harness their advantage of having knowledge of local borrowers' capacities and needs, is already technically possible. Some financial institutions possess the prescribed "holder status" for SDRs, and this includes the main RDBs and MDBs. Holder status could be broadened in future to other institutions, if the international community so wished, but for the moment, these institutions seem the best suited for this role.

MDBs and RDBs are natural candidates for SDR rechannelling because they match the policy objectives underlying the SDR general allocation with the existing public bank mandates, tools and experience. Their mission is to support development and to supply global public goods and they can do so because of their long-term financing and their ability to achieve maturity transformations across a wide range of schedules. They can also take the long view when it comes to financing the goods and services countries need in a way that other sources of finance cannot or will not do. MDBs and RDBs can create and guide capital, borrowing on capital markets and lending resources at affordable or concessional rates to their borrowing members, and these functions are closely compatible with the SDR mechanism. Most of the main RDBs and MDBs, in fact, are already prescribed holders of SDRs and can therefore use or borrow SDRs. In addition, the RDBs are often requested to increase their financial support in crisis times. And there has been somewhat of a signal to do so: in a virtual meeting on 15 April 2020, G20 Finance Ministers and Central Bank Governors called on the World Bank and RDBs to swiftly implement the response package previously adopted by their respective Boards but without increasing their capitalization, hence raising the question of how to do it.

In recent years, RDBs and MDBs have been increasingly active in the fight against climate change, on top of other important policy priorities; thus, they have no shortage of uses for which to direct the additional lending. Indeed, these MDBs and RDBs are a key but underused pillar of the international development finance architecture aiming at financing both mitigation and adaption to climate change projects, so they have a major role to play in contributing to reaching global goals such as the ones enshrined in the 2015 Paris Agreement.[1]

As banks, they already have the ability to leverage their capital and experience, whether through co-financing ventures with the private sector or with other public co-financiers. According to the African Development Bank (AfDB), MDBs can leverage SDRs by a factor of 3 to 4 by co-financing with private and public actors; this would multiply the positive effect on borrowing countries considerably[2] and help them meet the financing needs of national development banks in their member countries. The Joint MDB Report on Climate Finance (2020) further reported that for every dollar MDBs invested, an additional $0.29 came as co-financing from private sources, while some banks (AfDB and AIIB) reported another $3 from public sources, again indicating the potential advantages of augmenting the finance available to these banks (AfDB et al., 2020).

They also have the technical expertise to guide and manage the funds once created, benefitting from their close relationships with governments and experts in Ministries around the world. During the Covid-19 period, many RDBs were in regular contact with representatives of their government owners, helping to chart the path to relief and recovery. In this context, they can act as intermediaries between

[1] Reflecting this, most MDBs and RDBs announced that they would align all operations on the Paris Agreement, but there is a need for continued clarity on and evaluation of how to do this (*TDR*, 2021, pp. 151–154).

[2] AfDB presentation at a French Treasury/CGD event, Exploiting the Full Power of SDRs, Paris, 2 February 2022.

the global financial system and countries in need, especially countries with difficult and particularly expensive access to private capital markets. This includes both LICs and many MICs urgently requiring increased long-term funding to finance investment essential for recovery as well as for health – for example, vaccine production – not to mention urgent investment in climate mitigation and adaptation.

Another benefit of channelling the SDRs to MDBs is their "preferred creditor" status. Some development banks in the low-income regions where it is already difficult to raise finance from other sources (for example, the Development Bank of Rwanda) have signalled a desire to access increased resources via use of SDRs through their regional banks (the AfDB), as have the RDBs themselves. They are hopeful for progress on the issue and are making proposals on how to implement them. African governments have also thrown their support behind such initiatives.[3]

For all these reasons, there have long been important calls for such a use of SDRs (*TDR*, 2019), but to date, we have seen little progress. There may be some technical challenges to reallocating SDRs to RDBs and MDBs stemming from the requirement to retain their reserve asset characteristic (see Plant, 2022, forthcoming; Lazard, 2022). Research is currently underway on how this could potentially be addressed, to examine ways of structuring any SDRs given to MDBs to both count as their capital and to maintain their reserve asset characteristic.

Given the need for increased scaling up of RDBs, the arguments above suggest it is both important and feasible to rechannel SDRs from countries that do not need them to those countries that urgently require them. This can be done efficiently by rechannelling excess SDRs held by advanced economies that do not need them via RDBs and MDBs, given that (a) RDBs and MDBs are prescribed holders of SDRs; (b) they can leverage their balance-sheet, multiplying their effect; and (c) they can undertake maturity transformation to finance long-term projects around the climate transition and other key development aims. There is, therefore, a strong case economically and technically for such a path to be taken and to do so on a significant scale. Indeed, the main obstacles seem political.

## 2. Where next?

Other long-standing issues addressed in previous Trade and Development Reports include the important role of deepening and widening regional capital markets. While the potential of public regional financial institutions such as development banks has been the focus of this chapter, private capital markets can play an important complementary role. The Asian region has been particularly active in exploring this possibility, with the creation of the ABMI in 2002 by the ASEAN+3 group of countries (10 original ASEAN states, Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Republic of the Philippines, Singapore, Thailand and Vietnam, plus China, Japan and the Republic of Korea). Its aims were to promote regional financial integration through local currency bond markets and to help Asian countries reduce their reliance on international finance, having suffered in previous economic crises when foreign capital fled abruptly (see Chapter IV; Park and Bae, 2002).

Measured by some yardsticks, such initiatives have been very successful – the Asian region, for example, saw a boom in local currency bonds that are now measured in the tens of trillions of dollars. However, this does not mean the bonds are necessarily "regional" in the sense of raising the resources regionally, nor of investing them in cross-border as opposed to national projects. First, most bond issuers are national (governments or corporations) with the exception of a small number of bonds issued by regional development banks. In Asia, green bonds issued by the Asian Development Bank (ADB) raised some $766 billion over seven years since 2015 (EMEAP, 2022); while in Latin America, bonds issued by the supraregional banks Corporación Andina de Fomento (CAF) and Central American Bank for Economic Integration (CABEI) represented some 5 per cent of the total for the region (Nunez

[3] If recapitalizing them right away with SDRs is a bridge too far, solutions involving hybrid subordinated debt are being actively contemplated. Lazard (2022) suggests allowing SDRs to be invested in a junior fixed income product issued by an RDB, whose equity features would allow some leveraging. The investment risk would be relatively limited, given that such banks are generally significantly less leveraged than Basel-regulated commercial banks.

et al., 2022). Second, the purchasers of these bonds are not necessarily regional. Despite taking the precaution of issuing bonds in local currency, in the Asian region, only Japan has succeeded in largely eschewing foreign obligations (Lim, 2021). In comparison, for Indonesia and Malaysia, some 38 per cent and 31 per cent respectively of local currency bonds are held by non-residents, suggesting these markets are vulnerable to foreign flight in times of difficulty.

This was borne out – to some extent – during the recent Covid-19 crisis. Research by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), a cooperative organization of central banks and monetary authorities from 11 economies in East Asia and the Pacific, found that having bonds in local currencies was no guarantee of protection from global financial volatility, as the emerging markets in the region with significant foreign investor participation in their local currency bond markets experienced a brief self-reinforcing cycle of currency depreciation, bond fund outflows and rising bond yields. This was especially evident in the sharp unwinding of market positions by foreign investors, who may not have hedged their currency risk (EMEAP, 2022). Although flows eventually returned, this magnitude was extreme – comparable to the outflows in the first few weeks after the collapse of Lehman Brothers in September 2008 during the GFC and more severe than during the taper tantrum in 2013 (EMEAP, 2022, p. 12). The authorities in the region responded to the heavy sell-off of government and corporate bonds by shoring up demand for bonds and supplying liquidity to the financial system, with central banks using a wide range of innovative policies (EMEAP, 2022, p. 16), but the point for current purposes is that they were national responses, not regional.

Finally, there is the question of how the funds are invested, and again, it seems this is usually national in orientation and less often involves cross-border projects. Despite the ABMI, intraregional investment has not picked up significantly in Asia, and the region continues to rely on external capital despite high domestic saving rates (Lim and Lim, 2012). The ADB's green bonds, for example, were raised in a multiplicity of currencies ranging from Australian dollars to euros, Honk Kong dollars, Indian rupees, Norwegian kroners, British pounds, Swedish kroner and Turkish lira and the funds allocated to a special subportfolio linked to ADB lending for eligible projects. While the bank may be a regional one, its lending is not particularly so, potentially reflecting the fact it is very difficult to design and implement large investments that cross national borders. Out of 58 projects listed on renewable energy and energy efficiency, only two were described as "regional" and neither has succeeded in allocating finances anywhere near the approved amounts (ADB, 2022, pp. 11–52). Similarly, out of 41 project loans for sustainable transport, none was regional, and there were no regional projects in the 8 water and urban infrastructure categories.

This matters because the investment demands for climate change and green or sustainable transition need to address challenges that go beyond national borders. It is not easy to link or compare the precise nature of the underlying investments for which bonds are issued, in part because there is no clear framework for reporting or measuring impacts. This is a problem, given the fast growth of these instruments.

For many reasons, the rather limited intraregional aspect of corporate bond issuances and investments may remain so. For one, spending the money across the region requires a degree of harmonization of development plans and objectives, rules and regulations, along with agreement on how to divide the respective costs and benefits. For another, promoting regionally integrated markets requires complete capital account liberalization among the participating countries, and for well-known reasons, this is seen as a risky strategy with uncertain benefits (see *TDR*, 2015). Finally, credit rating agencies (CRAs) are not only constraining many banks' lending operations but are also provoking instability as much as warning of it (see box 6.4).

### Box 6.4 Giving banks more policy space: reducing the role of credit rating agencies

CRAs have long held a powerful yet ambiguous position in international finance as both player and umpire, with profound effects on economic policymaking and investor decisions. Their track record in meeting their objective to dampen pro-cyclicality is disappointing, often contributing to macroeconomic instability by amplifying cycles and contagion, with asymmetrical impacts on vulnerable populations. This was evident already in the Asian financial crisis and again during the late 2000s and 2010s; to an extent, the unintended but self-reinforcing impacts of their "spectacular and disastrous power" appear inevitable given the reflexive role played, especially by the "Big Three" CRAs, identified by Barta (2022) as Fitch, Moody's and Standard and Poor's. The irony and costs of this were further evident during the pandemic, when countries availing themselves of G20 debt relief initiatives were faced with downgrades despite attempting to achieve a more sustainable fiscal position (Li, 2021; Griffith-Jones et al., 2022, forthcoming).

Triple-A credit ratings from all the major CRAs are the explicit goal of most MDB capital adequacy frameworks and one of the reasons provided for not participating in recent debt relief initiatives. According to MDBs, these ratings allow them to access markets safely and at low cost, even during times of stress, allowing a much larger contribution to liquidity provision and enhanced fiscal space through continued and extended provision of concessional financing (World Bank, 2020). Consequently, CRA assessments exert considerable influence in determining MDB risk tolerance, de facto embedding rating agency methodologies into internal policies, leading to a highly conservative approach to financing. Evidence gathered by one of the leading CRA agencies (S&P Global) suggests major public banks could increase lending by at least $1 trillion without losing ratings (see *TDR*, 2019).

A recent independent review of MDBs' capital adequacy frameworks commissioned by the G20 argues MDBs can relax their strict aversion to risk, ease capital requirements and increase financing by hundreds of billions of dollars without losing their high credit ratings. The review provides a range of proposals for MDBs, shareholders and CRAs to allow a more realistic and evidence-based assessment of risk. According to the review, the full series of reforms would allow MDBs to start increasing their lending capacity over the next 12 to 24 months by hundreds of billions of dollars but would protect their triple-A rating.

In addition to adjusting their approach to risk tolerance, MDBs and other public and development banks need more support. They require a boost to their capital base, made possible through transfers from the banks' shareholders and augmented by borrowing on international capital markets, with a measured relaxing of their triple-A credit rating where appropriate. Government owners should send clear signals of their support for the banks they own; their developmental mandate should support increased lending to enable more socially beneficial projects to begin.

UNCTAD has long argued that a different kind of CRA is required, one that would support countercyclical policy responses, avoid conflicts of interest in operations, challenge the monopoly of the three major CRAs and refocus priorities on sustainability and financial stability.

A public multilateral credit rating agency (MCRA) could improve and stabilize credit rating assessment of sovereign and public banks with explicit priority to achieve the Sustainable Development Goals (SDGs). An MCRA would provide a distinctive and more effective assessment for developing countries, as it

would integrate both long- and short-term horizons. Moreover, it would develop an alternative model to better align with the realities of developing countries and mainstream climate considerations, including double materiality wherein considerations of both climate's impacts on finance and finance's impacts on climate are recognized. An MCRA would ultimately prioritize the assessment of economic development trajectories, rather than credit-worthiness, while reorienting financing towards productive investment.

Without this kind of innovation, the world is stuck with a system where firms, institutions and even governments are caught in a predictable yet inevitable vicious cycle, where the logic of credit ratings overpowers any stabilizing effects. At the sovereign level, this can have the effect whereby democratically elected governments follow policies imposed by non-elected technicians, which could be the opposite of what their citizens voted for (Barta, 2022).

Another core and related issue is the banks' mandate, including the expectations of their government owners – whether expressed in a vision statement, in the legislation that enacted them or in the reporting requirements and indicators of performance. Nearly all of the public banks established since 2010 have "green" in their title or high up in their mandate (*TDR*, 2021, p. 150), and while much will depend on the actual impact of lending decisions, it is surely significant that the MDBs have made climate pledges with targets for their lending (*TDR*, 2021, pp. 151–153). This matters because, as shown in the recent experience of Covid-19 lending, it makes a very big difference if banks are unambiguous about their role and purpose. Public banks – regional as much as national – with clear and unambiguous mandates in addition to sufficient capital were the ones most able to respond quickly and in line with their members' needs (McDonald et al., 2020; Barrowclough and Marois, 2022).

The regulatory environment is also extremely important in determining the policy space afforded to regional public banks as to all banks; there are concerns that the current rulings which do not recognize the special role of these public banks are causing a negative constraint that needs to be addressed (box 6.5).

### Box 6.5 Is financial regulation constraining lending capacity by development banks?

Against a backdrop of limited finance available to support regional integration, the question is whether financial regulation further constrains the ability of development banks to lend at the required scale to finance large cross-border infrastructure projects. Research shows the Basel Capital Accords – financial standards internationally designed to create a level playing field for internationally active banks – constrain both multilateral development banks (MDBs) and national development banks (NDBs) playing regional and international roles in their ability to provide development finance.

A first critical problem arising from the Basel framework is its risk-based approach to capital determination. It is in the nature of banks to evaluate risk in credit allocation decisions. And this is definitely a reason why in the end banks normally do not lend over the long term to the extent required. Basel, however, in adopting a risk-based approach for capital determination, only reinforces a pattern of lending biased against the long term, because it attaches higher risk-weights to long-term exposures (Gottschalk, 2019).

Notably, MDBs (and NDBs with an international role) do finance long-term and riskier projects, as well as large projects. This implies these banks have a portfolio concentration on assets at the higher end of risk buckets. This, in turn, means for the same amount of assets, development banks hold more capital relative to other banks, while the latter have a more diversified portfolio. So from the start, development banks under the Basel framework are penalized, because their ability to lend to larger and riskier projects is constrained. Yet, the Basel framework affects the various categories of development banks differently. MDBs and RDBs are not under the purview of national regulators, but Basel affects these banks by assigning them fixed risk weights, thereby affecting their funding costs.

Under Basel III, 11 MDBs are assigned zero risk weight. These banks are: World Bank Group (WBG); ADB; AfDB; EBRD; Abu Dhabi Islamic Bank (AIDB); EIB; National International Bank (NIB); Commercial Bank of Dubai (CDB); IsDB; CEDB; AIIB. This implies banks who lend to those MDBs do not need to allocate capital for such credits. All the other MDBs face risk weights varying from 20 to 150 per cent, while unrated banks are assigned 50 per cent risk weight. The BRICS founded New Development Bank (NDB), for instance, does not have zero risk weight despite having strong shareholders, and even though, unlike other MDBs, it raises funds in national financial markets, which helps it avoid currency mismatches. According to Basel, MDBs need to meet strict requirements to be granted zero risk weight, which means following "conservative financial policies," in Basel's own words. Basel standards, therefore, affect MDB funding costs and, as a consequence, the way these banks manage their balance sheets on the assets side (Gottschalk, 2019).

On the assets side, the biggest constraints for MDBs are the ratings from CRAs. The latter follow Basel standards closely in the models they use to assess risks facing banks. The consequence is that the ratings which these agencies assign to these banks follow the same conservative approach as recognized by Basel. The result is that MDBs and RDBs maintain low gearing ratios (loans to equity ratio) to obtain high ratings, but this limits their leveraging.

National development banks with regional and international roles, in turn, which are under the purview of national regulators, are affected by Basel through Basel's large exposure framework. The framework restrains banks' ability to finance large infrastructural and industrial projects. For these banks, international loans also imply currency risks, which are also affected by Basel standards. These risks can be quite significant, to the extent that these banks issue loans in currencies other than those in which they are funded.

Finally, NDBs lending abroad often support innovation using a range of instruments and practices. In this regard, the Basel standards that matter here are those relating to equity finance, an instrument NDBs use to support innovation, and those relating to climate finance, which may involve yet untested clean technologies. Equity exposures from the banking book are assigned risk weights between 100 and 1250 per cent, thereby penalizing NDBs with large exposures. In the area of climate finance, NDBs are becoming increasingly engaged in support for a just energy transition. Supervisors, however, are incorporating climate-related risks in their supervisory work, because of concerns with banks' vulnerability to such sectors and with weather events that can cause losses to the banks (Gottschalk et al., 2022).

# E. CONCLUSIONS AND POLICY RECOMMENDATIONS

This chapter has shown that while regional development banks and funds are needed as much as ever, if not more, they are frequently not adequately supported by their government owners. A massive scaling up and redirection of development finance is needed to face the challenges and opportunities of today's post-Covid-19 and climate-aware world.

- Membership in regional banks and funds can be extremely useful, offering funds, expertise and other benefits, including a voice more commensurate with economic weight and more choices of sources of finance.
- However, regional arrangements cannot solve the limitations of the international financial architecture; they may be a useful stepping-stone, but some countries will never receive the kind of support needed from the region, especially during systemic crises when all countries in a region may be hit at the same time.
- Regional liquidity arrangements were not used much during Covid-19, and bilateral currency swaps were the main source of liquidity in the GFSN. While RFAs provided vital support to those countries that tapped them; the trend of bilateral swaps is a concern because many countries lack the capacity to negotiate them.
- In comparison, regional development banks were a major provider of counter-cyclical funds during Covid-19, especially those banks that were well capitalized and had a clear public purpose. Some banks increased lending by more than 100 per cent to provide relief and recovery; others supported regional research and development to find a Covid-19 vaccine.
- Looking forward, regional banks and funds need more reliable and sufficient capitalization (i.e. much more than they get now), more representative governance and economic performance measures and indicators that reflect their catalytic developmental role and allow them to fulfil it, rather than narrow financial measures.
- RDBs and RFAs can usefully receive new or unused allocations of special drawing rights, as currently under debate. One benefit DBs offer for the effective use of SDRs (versus national budget transfers) is that they can be leveraged; another is that they are potentially seen as politically more independent.
- G7 or other high-income owners in RDBs should increase their capitalization and policy space to allow the banks they co-own to support more experimental, developmental, green technology and enterprises. Regional banks could also seek new members to beef up their capital bases.
- Regional credit ratings or regional regulatory agencies are needed to overcome the stranglehold of the "Big Three" CRAs. Some banks have it in their mandates that they must achieve AAA status from at least two of these ambiguous – private sector – institutions.
- Finance can be found at times of urgency, as during the Covid-19 years, but this does not mean it goes where it is most needed. Some countries missed out in the pandemic. RDBs can help by providing public leadership in coordinating and delivering reliable long-term finance. In their special role as a bank with a public purpose, they can tap both public and private channels, and as they have technical expertise and management skills, they can ensure these are directed to developmental purposes.

- Regional capital markets are seen by some as an important complement to national markets and a potential counterpart to public bank lending; for these reasons, some regions have keenly promoted them. However, simply issuing bonds in local currency does not offer protection from exchange rate volatility and cross-border capital flight.[4]
- Other forms of financial arrangements, such as regional bonds (social, blue and green), are seen by many as offering hope for the financing of regional public goods. But the evidence does not yet support this, and it is likely that regional market-based financial institutions will suffer the same obstacles as regional projects everywhere – including tension about real or perceived allocation of the benefits and costs between the individual members of any regional grouping. For such reasons, it is hoped that public regional institutions, with their intergovernmental processes and negotiation fora, coupled with their potential for taking a longer-term view than the market, can address some of these. For such reasons, South—South sharing of experiences and solution-seeking, in addition to North—South, North—North, triangular and indeed global arrangements, will continue to be important for the future.
- While regional arrangements have been able to offer a lot in short-term and liquidity financing, these are still really only regional on one side of the equation – the supply side – by pooling finance to make a reserve fund larger than what individual countries could create. Demand for lending is still mostly national, and this limits the provision of urgently needed public goods and the removal of public bads. Most of the regional multilateral banks lend quite a small proportion of their total to projects that are cross-boundary or multicountry, certainly less than one quarter. It seems regional projects require more harmonization between countries in terms of regulations, physical infrastructure, regional procurement policies and the ability to perceive benefit and share it among regional members fairly. This is most evident in the issue of oceans or blue-based lending.[5] Many banks have the ambition to lend more regionally, but this will require significant negotiations and soft-capital investments first.

[4] Some of the new regional arrangements are an unusual form of quasi-public and quasi-private structure, as yet untested. For example, a new regional repurchasing agreement ("repos") to help participating countries reduce their cost has been created by United Nations Economic Commission for Africa (UNECA) and Pimco USA Liquidity and Sustainability Facility. However, this would perhaps not appear as attractive had banks in Africa not been so capital-constrained in the first place.

[5] For example, only a very small proportion of total loans from the Green Climate Fund appear to be targeted to oceans or blue economy activities. Many of these are regional or multi-country project loans, reflecting the fact that ocean resources (such as fish) and ocean-related problems (such as pollution) cross national borders and thus need multilateral responses. Co-ordinating these is typically more complex and time consuming than more simple single country loans for obvious reasons (Vivas et al., 2021, pp. 7-9).

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# Chapter VII

## Multinationals, Development and Corporate Arbitrage

# A. INTRODUCTION

Between 1945 and the early 1980s, an increasing volume of foreign direct investment (FDI) flows occurred among advanced countries. It was closely connected to their rapid post-war rates of industrial expansion, particularly in more capital and technology intensive sectors, and their rapidly growing and converging levels of income. These tended to be two-way flows, often in the same sector, undertaken by large firms operating in the already well-established export markets.

Given these structural determinants of FDI, developing countries offered only marginal attractions to international investors. Incoming foreign capital was directed towards primary resource extraction, although technological changes in the consuming countries and rising political tensions in some host countries increased the economic risks for foreign investors in that sector. Expanding local markets could also attract multinational enterprises (MNEs) to some selective sectors requiring medium levels of skill and technology, such as chemicals and transportation, primarily in larger developing countries with an emerging middle class, where tariff barriers offered assured rents that could offset the perceived economic and political risks.

Since the early 1980s, FDI has grown considerably faster than both output and international trade in goods and services, with a marked increase beginning in the early 1990s in the share going to developing countries, including through the spread of global value chains (GVCs). Policymakers in the developing world have not only placed much greater emphasis on attracting FDI as a trigger for catch-up growth, but as carefully documented in UNCTAD's *World Investment Reports (WIRs)*, have done so by allowing much greater freedom to MNEs to choose how they operate in their countries: of the thousands of country-level reforms in FDI identified since 1990, the vast majority have been liberalizing (*WIR*, various years).

Bilateral and regional treaties and agreements have been a particularly important force behind this "liberalizing" trend. In most cases, these have been linked to a wider package of measures aimed at extending the influence of market forces. Indeed, because affiliates are generally more dependent on imported inputs than domestic firms, and as they rely on close financial relations with their respective parent companies, other affiliates and foreign financial institutions, competition to attract and retain inward FDI has been associated with broader efforts to accelerate the liberalization of trade and finance.

Liberalization is often presented as a simple policy choice of scaling back politically inspired infringements on an otherwise pristine world of economic decision-making based on relative prices and perfect competition. In reality, liberalization – whether of trade, the movement of capital or labour markets – is itself an act of state (and regulatory) intervention that requires political decisions and a change in the legal framework, usually paralleled by the creation of new norms and rules, as well as adjudication and enforcement mechanisms which also require political construction. All these have profound consequences for how businesses operate and who benefits (and loses) from their implementation and operation. Moreover, as liberalization can be pursued through domestic, regional and global processes, harmonization across the different constituencies is an additional political challenge on the liberalization agenda.

Whether conceived as a move away from previously agreed-upon multilateral norms or as the establishment of complementary regulations, regionalism – be it in trade, production, finance or the digital sphere – rests on negotiated agreements among a select group of (predominantly national) decision-makers who alter the rules and norms governing the economic activities in a particular space. Therefore, regional integration typically involves multiple layers of new regulations, with varying degrees of influence in national territories.

Whether the changes in rules and regulations have a positive effect on development is determined not only by the details of negotiated treaties, but also by the behaviour of large private actors – particularly

the MNEs – navigating the global treaty space. This chapter sets forth some of the key aspects of this corporate maneuvering between jurisdictional niches – a phenomenon known as corporate arbitrage.

The behaviour of MNEs is partly affected by the sets of rules and regulations of the jurisdictions in which they operate and partly by the capacities of the corporations themselves to anticipate, shape and accommodate regulatory shifts in the political and economic context. In recent decades, the power of these actors to influence outcomes and shape regulatory contexts has grown in relation to other economic agents; it has also been transformed and amplified, as mechanisms of corporate control have been reengineered by the wider forces of legal and financial innovations, or financialization.

The focus of this chapter is on two dimensions of the financialization of the corporate realm pertinent for the developmental outcomes at both national and regional levels. The analysis reveals the way the core group of actors in the global economy – leading MNEs – interacts with the global system of multiple regulations and does so by making an incision into the way MNEs navigate the global regulatory system when planning their investment strategies generally and particularly when investing in the developing countries. The latter are vulnerable to the two-fold problem of global financial and corporate governance.

First, at the level of global political economy, regulatory complexity has been conducive to the rise of the "fragmented firm." Second, the inner transformation of the corporation itself, or the "code of capital" (Pistor, 2019), paralleling the technological, financial and regulatory shifts in the global economy, has meant 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.

In the context of developing economies, when investing in these places, top multinationals tend to structure their FDI flows indirectly, taking ownership and control over the nature of investment (i.e. the type of economic activity, if any, associated with the investment), away from the host country and the purview of its regulatory institutions. Moreover, around a quarter of the subsidiaries of the top MNEs in the Global South present only balance sheets as evidence of their presence in a country, with no (or few) income statements reflecting real economic engagement. This has multiple implications for policymakers at national and regional levels and more crucially at the multilateral level.

The chapter is organized as follows. Section B features an explanation of the evolution of the linkages between the organization of production activities and the internationalization of MNEs and notes the role of financialization mechanisms in augmenting those links. Section C contains an analysis of the regulatory structure of the global economy that facilitates and determines the nature of international financial flows and investment. Importantly, notwithstanding recurring financial crises and reform attempts, including at the level of regional integration, the analysis indicates the system of global finance and investment is anchored in long-established regulatory niches and specific jurisdictions favouring financial capital, to the disadvantage of the developing countries seeking to attract long-term, productive investment.

Section D presents an empirical study of the investment activity of the top-100 non-financial MNEs globally. It is revelatory of a stark contrast between indirect ownership of subsidiaries of top MNEs and the type of their economic presence in the advanced vis-à-vis the developing countries. Section E contains a conclusion drawing lessons for the macro-financial regime governing global corporate behaviour, for the efforts of national governments seeking to attract foreign capital into their economies and for the efficacy of regional integration efforts, which are imperilled in the global regulatory topography exploited by the interests of global corporations and amplified by the structure of global finance.

# B. CORPORATE CONTROL, INVESTMENT AND THE EXPANSION OF MNES

## 1. Corporate strategy, international production and regional development

The spread of cross-border supply chains is not an altogether new feature of the global economy, but the emergence of GVCs, particularly in manufacturing sectors, has brought fundamental changes to the way international production is organized. Whereas firms previously expanded abroad by essentially cloning themselves in another location, today, separate activities are performed in different locations and valued according to how they contribute to the objectives of the firm as a whole, not simply based on their profitability in the host country. Moreover, as the universe of MNEs has expanded, inter-firm agreements, networks and alliances of various kinds have emerged alongside FDI, to coordinate dispersed activities and deal more effectively with the growing complexity and contestability of international markets (*WIR*, 2011, 2013).

There is broad agreement that the adoption of market-driven reforms, along with technological developments and greatly reduced transport, communication and coordination costs, has stimulated the expansion of FDI over the past two decades. There is no consensus, however, particularly given the uneven distribution of investment flows across developing countries, on why some countries have proven more attractive to international business than others, and what the developmental impact of a global corporate presence in a country is. Outside the macro discussions, there is considerable analytical confusion surrounding the decision of firms to expand their activities abroad.

International trade theory provides little guidance. Its assumptions of identical production functions and competitive markets are far removed from the world of international big business and cannot explain why significant cross-border flows of investment occur between countries with similar factor endowments. Instead, conventional explanations of why firms invest abroad focus on efficiency considerations, with the commitment to invest seen as reflecting the comparative costs of hierarchy and markets in managing intangible assets. Given the mix of factor endowments in the host and home countries, the presence of scale economies in production and the transaction costs arising from trade and setting up production abroad, cost efficiency will dictate whether investment abroad emerges as the optimal market outcome in industries where firm-specific assets are important. This argument downplays and may even ignore the significance of firm size and corporate control in maintaining and expanding profitability; simply stated, it fails to recognize the potential economic distortions that can accompany very large firms' rent-seeking behaviour (Hymer, 1979, p. 65; *TDR*, 2018).

Big firms can and do shape market outcomes. These firms tend to be the first to move into production abroad. Recognizing this means abandoning the fiction of price-taking firms in perfectly competitive markets and contemplating instead a global economy structured by hierarchical power relations, inherently imperfect markets and (private) rent-seeking behaviour. Including these features in the argument adds an historical dimension to the FDI story, both by recognizing the evolutionary progression of international production and by acknowledging first-mover advantages.

The creation of MNEs is, from this perspective, best understood as an extension of the processes which originally gave rise to national corporations (Hymer, 1960). In essence, national firms become internationalized because they possess specific assets – such as a superior production technology, a distinct product design, superior managerial and marketing skills and other intangible capital – and have sufficient economic size to undertake profitable investments and manage costs internationally, despite the higher risk and additional costs deriving from coordinating production activities over large geographical distances and across political borders.

The transfer of production abroad is, however, rarely an all-or-nothing affair, and certain functions often continue to be performed in the country of origin or to be registered in jurisdictions offering favourable conditions for this specific type of business activity. These include higher-level strategic functions, such as research and development (R&D) and financial and service operations, with only the more routine types of production located in the jurisdiction where the actual production takes place. There can be strong neighbourhood effects to the organization of FDI: within Western Europe, for example, the consolidation and expansion of the European Union via the internal market program has been a steady influence on the growth of intraregional FDI which, as a result of both mergers and acquisitions (M&As) and greenfield investment, has facilitated the formation of pan-European firms (Dicken, 2003), with a Europe-wide corporate bond market developing in the same direction (Plender, 2003).

This process is also quite advanced in North America, where the historically close relations between Canada and the United States were extended under the North American Free Trade Agreement (NAFTA), particularly in some key industries, such as automobiles, where regional production structures played a central role. In the 1980s, Japan also started to invest heavily in some of its neighbouring economies, with much of the investment going into manufacturing (UNCTAD, 1996). But because the development gap between Japan and its neighbours was still considerably wider than that within other advanced regions, this left an opening for firms from the first-tier newly industrialized countries (NIEs) to become an important source of FDI in the regional economy of East Asia.

Within these regional blocs, direct investment and trade are often complementary, reflecting the development of an internal division of labour within a firm, whereby plants in different countries of the bloc either collaborate in the creation of a single product or specialize in the production of different finished goods for export to the entire bloc or beyond.

An additional set of barriers to the developmental gains from corporate expansion comes from the financialization of the corporation itself. As the next section shows, financialization, understood as the workings of financial and legal innovation driving corporate arbitrage globally, is closely linked to the decreasing ability of national and regional host authorities to control the behaviour of global corporate groups investing into their regions. At the same time, the reorganization of GVCs is paralleled by finance-driven patterns of rent extraction, wherein developing countries remain at a structural disadvantage.

## 2. The financialization of the inner corporation

From the 1980s onwards, there has been growing evidence that MNEs are responding proactively to the changing regulatory regimes underpinning globalization and regionalization. During the 1980s, the global presence of MNEs in developing countries started to evolve from relatively simple and specialized cross-border structures, predominantly motivated by the search for natural resources and international markets, to more complex and integrated GVCs, built to exploit differences in labour costs and productivity (Zhang, 2021, p. 206). In the 1990s and into the 2000s, this process accelerated, and the two decades witnessed rapid growth in GVCs, a tenfold increase in the global stock of FDI and a fivefold increase in global trade.

More recently, the unbundling and geographical dispersion of MNEs' operational activities has come to affect those functions traditionally agglomerated in the global corporate headquarters of MNEs (Desai and Moel, 2008; McIvor, 2010). The offshoring of business support services has affected back-office and support operations, such as human resource management, legal services and accounting (Wilson, 1995), as well as front-office operations, such as customer support (Breathnach, 2000) and R&D activities (Dachs et al., 2014).

Together, these tasks are grouped in the category of corporate treasury and financing functions. Today, many of these functions tend to be separated from other headquarter functions and are performed by a separate subsidiary or set of subsidiaries. Furthermore, the groups of subsidiaries performing treasury functions tend to be located in specific jurisdictions providing an optimal institutional environment for

the performance of that specific function. Similarly, strategic management might be "offshored" to jurisdictions providing large pools of managerial talent and conveniently located in the proximity of major markets.

An important aspect of the way MNEs are investing is the legal framework underpinning every type of transaction they undertake. Economic and financial operations must be booked through the firm's subsidiaries and located in a jurisdiction – a sovereign country – for accounting purposes; they also have to be registered somewhere for legal reasons. Along with contracts that reflect the interests of business parties, economic transactions are subject to the laws of a particular jurisdiction where they are nominally located (or registered). The majority of modern multinationals deal with legal structures by decentring into separate legal persons, each of which is regulated by the rules and laws in the country where it is located (Blumberg, 1993; Ferran, 1999; Robé, 2011).[1]

Today's MNEs are organized, in effect, as a network of entities held directly or indirectly by the parent through equity ownership. The corollary of this separation is that legally the different subsidiaries must trade with one another "as if" they were separate companies involved in typical market transactions. This is called the "arms' length" principle, as mandated by the Organization for Economic Cooperation and Development (OECD). Estimations by UNCTAD (e.g., *WIR* 2015, 2016) and other organizations suggest between one-third and roughly two-thirds of global trade today is intrafirm – that is, trade between subsidiaries and affiliates of the same MNE that are located in different countries (Zhang, 2021, p. 207).

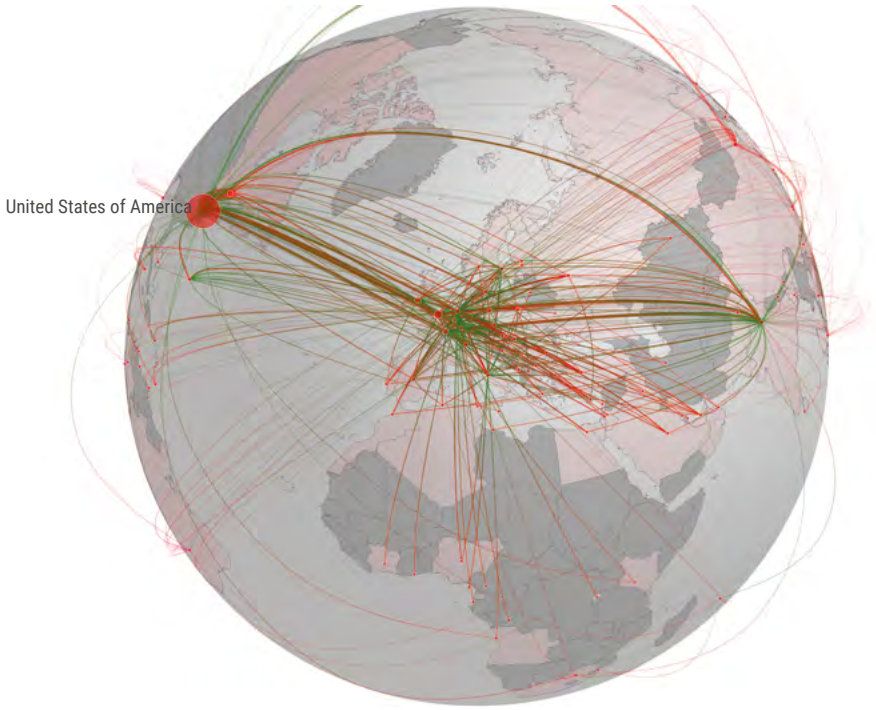
The implication of this chain of legal ownership is that when multinationals invest abroad, they tend to set up a subsidiary or a joint-venture company in the host country. The subsidiary will be controlled directly by a parent company or indirectly by one or more subsidiaries held by the parent, but for all intents and purposes is considered an independent legal person (Palan et al., 2021; Robé, 2011; *WIR*, 2015, 2016).

A multinational firm can opt for different arrangements of chains of ownership. A multinational whose parent holding company and headquarters are located in the United States can invest directly in Argentina by setting up an Argentinian subsidiary held directly by the United States parent. Alternatively, the firm may opt to invest indirectly in Argentina by routing the investment through subsidiaries in a third country – a transit country. While the multinational firm in the United States remains the ultimate owner of the investment in Argentina, the subsidiary in the transit country becomes the immediate owner (Bertz et al., 2021, p. 759; *WIR,* 2016).

Figure 7.1 visualizes the corporate structure of a major United States non-financial corporation. As it shows, nearly all interactions between the parent company in the United States and its subsidiaries in the developing countries are mediated through the group's United Kingdom subsidiaries. According to Phillips and colleagues (2021), among the largest 100 non-financial MNEs in the world, direct ownership of subsidiaries in developing countries is a rare event. In this figure, there is practically no direct relationship between the United States and the developing country where the corporate entity invests. A comparison of global corporate presence of major MNEs by home countries is presented later in this chapter in figure 7.8.

[1] Many legal scholars argue the independence of corporate subsidiaries is a fiction (Greenfield, 2008), but courts treat each corporate subsidiary as an independent corporate entity. On rare occasions, courts accept that the subsidiary is acting on behalf of the parent company or on behalf of another subsidiary and thus is not acting as an independent corporate entity. This is often referred to as "lifting the corporate veil."

**Figure 7.1** Global structure of a United States non-financial corporation




*Source:* UNCTAD Secretariat visualization on the basis of Orbis corporate filings.
*Note:* All interactions between the parent company in the United States and its subsidiaries in the developing countries go through the United Kingdom. There is no direct relationship between the United States and the developing country where the corporation invests. This pattern is similar for all major corporations (not just those in the United States).

Until recently, the central assumption of economic theory and policymaking has been that these corporate layers are merely functional elements of efficiency: they establish an allocation of ownership stakes across countries but need not affect or reflect the firm's productive operations. However, academic research increasingly recognizes that the form and nature of corporate ownership entail macroeconomic and macro-financial consequences.

First, indirect forms of investment create a distinction between the ultimate and the immediate owners of assets and, as a result, can present a major challenge to governments attempting to reassert control over the investment regime (Bertz et al., 2021, pp. 760-768; Robé, 2020; *WIR*, 2016).

Second, while for a company run as a single entity, the separation between form and function is less obvious, the corporate form is increasingly used to partition assets of the same firm into select pools; as a result, one firm may be comprised of hundreds of legal shells used for entity shielding, loss shifting and possible immortality (Pistor, 2019, pp. 52-55).

Third, in terms of the relationship between the nature of corporate holdings and control over investment, UNCTAD's earlier work on corporate complexity and investor nationality shows that while in the internal ownership structure of MNEs, control generally coincides with (direct or indirect) majority ownership, MNEs can exercise control over affiliates, even when they have a minority stake (*WIR*, 2016, ch. 4).

Fourth, 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 anomalies and double counting in FDI statistics (Zucman, 2013). Because 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 risks associated with investment – for home and host countries alike. For example, beginning in 2019, Bahamas and Bermuda both overtook the Republic of Cyprus as a lead FDI investor in the Russian Federation,[2] while Hong Kong, Cayman Island and the British Virgin Islands (BVI) are the top three FDI investors in the People's Republic of China.[3]

Last but not least, by using intermediary subsidiaries in the third country, the owners and managers of an entity or 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 particularly important for a number of reasons.

## 3. Intermediary subsidiaries

One known purpose of such intermediaries is the tax-efficient channelling of the value created by operating subsidiaries to the parent company (Eicke, 2009; Lewellen and Robinson, 2013; Palan et al., 2021; Phillips et al., 2021). To achieve this, the debt or equity investments of the parent company are not made directly into a foreign subsidiary but indirectly through an intermediate holding company. Returns on those investments are then channelled back to the parent company through the conduit entity in the form of interest or dividend payments. Intermediate holdings or other entities in the group may also be used to channel royalty payments. Such "royalty conduits" may receive royalty payments because they are the legal owners of an intellectual property (IP) asset itself or because they own the economic rights to the royalty income generated by the asset because of a licensing agreement with the group entity who legally owns the asset (Maine and Nguyen, 2017).

The payments they receive are usually deductible expenses for the operating company and are generally taxed at a favourable rate in the country where the holder of the IP is located. The above-described dividend, interest and royalty conduit functions may also be combined in a single intermediate holding company (Garcia-Bernardo and Reurink, 2019). These techniques involve intermediary subsidiaries who serve as mere "conduit" entities (Garcia-Bernardo et al., 2017; Mintz, 2004). A recent International Monetary Fund (IMF) study called them "phantom investments" and suggested they are conducted purely for tax purposes (Damgaard et al., 2019; Garcia-Bernardo et al., 2017).

As most large multinational corporations are located in OECD countries, the phenomenon of phantom investment is often seen to affect tax receipt from corporate taxation in those home countries (Clausing, 2016; Hines, 1988; Zucman, 2013; *WIR,* 2016). Yet Cobham and Janský (2018, 2019) demonstrated a deleterious effect on developing countries as well, and others have suggested those corporate structures also accelerate capital flight from developing countries. As a recent OECD study argued, rerouting investments through less-regulated environments may raise risks of illicit financial flows (IFFs) (Nesvetailova et al., 2020). This argument, in turn, sparked debate on whether those conduits which are typically located in offshore financial centres (OFCs) are used for tax avoidance or serve as corporate treasury centres

According to Goldman Sachs, corporate treasury plays a central role in the firm's overall strategy, with the specific task of providing appropriate funding to support all firmwide activity while maximizing net interest income. The division allocates financial resources, raises funding and capital to support firm activity and dynamically manages the firm's asset liability risk and liquidity portfolio.[4] Corporate treasury actively engages in public markets and with businesses across the firm, investors, ratings agencies and regulators. At times, corporate treasury functions as an in-house bank (KPMG, 2016).

[2] See Inward Direct Investment in Newly Issued Shares of Banks and Other Sectors by Geographical Allocation. Data from Central Bank of Russia.

[3] Data from Republic of China Ministry of Commerce (MOFCOM).

[4] https://www.goldmansachs.com/careers/divisions/corporate-treasury/

Importantly, the use of corporate treasuries is not confined to companies in the financial sector but is standard across non-financial corporations (see box 7.1). In reality, they can function in both. According to Bertz and colleagues, the use of such intermediaries goes beyond accounting: it has implications for multilateral dialogue and reform because of the effects of shared investor nationality on economic diplomacy, the consequences of existing investment ties and regulations for military conflict and risks of illicit financial flows (Bertz et al., 2021, p. 786).

### Box 7.1 The rise of corporate treasury operations

Before the advent of financial innovation, treasury operations in a corporate organization tended to centre on cash and very specific hedging operations serving investments. For a number of reasons – mainly but not only associated with financialization – these treasury tasks have, on the one hand, expanded in scope internally (within the corporate structure), but on the other, become dependent on being located in specialized intermediary subsidiaries typically registered in OFCs (Polak, 2010; Polak and Roslan, 2009).

Today, these types of subsidiaries perform many tasks, including hedging, investment, use of derivatives and compliance techniques, as well as capital market, accounting and tax arbitrage and, in some cases, in-house banking. With the expansion of these corporate treasury centres, many of the most value-added tasks of the organization have been shifted to corporate treasury units. The phenomenon is noted as the extraction of value in the literature on GVCs, where it is apparent that primary production of raw materials or basic agriculture goods constitutes only a fraction of the price paid by the consumer. This means much of the value added is absorbed within the corporate groups themselves or through transactions between groups along those value chains. The use of intermediary subsidiaries in third countries may be used, therefore, not simply for tax avoidance functions, also for treasury operations, along with the absorption of value, or earnings stripping (Robé, 2020, ch. 8).

As Haberly and Wojcik (2022) recently explained, the financialization of the inner corporation takes the form of larger portions of tasks and revenue assigned to these treasury operations and is intimately linked to broader trends in the global financial topography. Top companies in banking, insurance, real estate, investment management and other financial services, as well as in law, accounting and business consulting, drive the process of financial innovation at the macroeconomic level, with new financial products and services arising from the interactions between the sector and its consumers in both private and public realms.

In the emergent financial business services complex, the activities of many “non-financial” firms are just as impactful as those of the financial institutions. Law firms, for example, in addition to their key role in the economy of contracts, play an indispensable role in the structuring of assets and liabilities into investable funds and securities. Meanwhile, the concept of “value” in finance is often vague and thus frequently manipulated by accounting firms (Haberly and Wojcik, 2022).

Schwartz (2021) recently gave an empirical illustration of the social construction of value by pure financial vis-à-vis intellectual property rights (IPR) companies in the United States. He found a notable convergence in the business models of high-profit finance and IPR-based firms, particularly tech firms, as the latter become increasingly co-dependent at the level of business models and production processes. This concerns the way firms capture profit and what they do with that profit. The four homologies noted in his study involve: splitting standardized goods into an IP component firms control and a generic good or service, with low barriers to entry spun off to someone else; the salience of patenting (and state-sanctioned monopoly more generally) in creating a tollbooth around that IP; the nature of production processes; and reliance on proprietary data collection and manipulation (Schwartz, 2021, p. 10).

From the perspective of developing countries, these changes in the inner structure of MNEs mean the use of intermediaries can be very significant and entail serious macroeconomic consequences.

First, their use highlights the limitations of traditional FDI data for macroeconomic strategy, illustrating that a country's ability to attract large FDI flows into the economy does not necessary translate into national fiscal revenue. Second, corporate conduits are used for tax avoidance purposes and raise risks of illicit finance (Nesvetailova et al., 2020). Third, if used as corporate treasury centres, the jurisdictional location of these entities is important, especially for developing countries, because the operations they perform are very lucrative. If investments are mediated through foreign intermediaries, and these intermediaries serve as corporate treasury centres, a considerable portion of the high-value activities is clearly taking place elsewhere.

# C. REGULATORY COMPLEXITY AND THE FRAGMENTATION OF THE FIRM

The lack of harmonious regulation governing international trade and investment is widely cited as a by-product of the regional integration initiatives that have increased during the last three decades. At a broad level, this is the result of the historical layering of regional integration initiatives that originated in the creation of trading blocks in the post-war years. More specifically, it is also an outcome of the changes in the very nature of regional agreements – in scope, depth, type of participation and coverage. Finally, the regulatory governance of regional integration is affected by the global politico-economic context.

## 1. Regulatory complexity as a by-product of regulatory layering

As a result of regulatory layering, most regional and bilateral initiatives across trade and investment have tended to expand in a manner not controlled by the multilateral regulatory framework. From the perspective of large MNEs, the global economy has become a complex and uneven set of what Douglass North called "the rules of the game of society." These are national rules shaped by particular states, their own macro-financial regimes and competition priorities, combined with a multilateral or regional layer of rules and regulations superimposed on the national rules.

Figure 7.2 visualizes the complexity of the global regulatory landscape governing international investment flows – known as the international investments agreement (IIA) regime. It shows all currently active IIAs, pointing to the centrality of Europe as a global hub for international investment structures and the key connecting role of OFCs, as well as the comparatively weaker presence of "attractor states" in the developing South.

The multilateral investment regime is known to have many problems related to complexity and lack of coherence, with treaties often exposing gaps and overlaps. In this respect, as noted by UNCTAD, regionalization initiatives represent a rare opportunity to rationalize the regime and create a more coherent, manageable and development-oriented set of investment policies. In reality, however, regionalism has moved in the opposite direction, leading to a multiplication of treaty layers over time (figure 7.3), making the network of international investment obligations even more complex and prone to overlap and inconsistency (*WIR*, 2013). In effect, more than half a century after the first bilateral investment treaty was concluded (between Germany and the Islamic Republic of Pakistan in 1959), the multilateral investment regime has evolved from a system originally developed to foster legal predictability in investment relations between countries to become a source of legal uncertainty, debate and controversy (UNCTAD, 2020, p. 117).

**Figure 7.2** International investment agreements, 2022

*Source:* UNCTAD Secretariat visualization based on UNCTAD investment agreements data.
*Note:* Only agreements that entered into force are represented.

Attracting FDI is now a key reason for developing countries to seek regional trade agreements (RTAs), especially with the developed countries, as a way to join GVCs.[5] Theoretically, one would expect continued support for a multilateral regime governing investment – that is, a set of rules to protect the rights of the corporation – among leading MNEs. However, because of the layering and multiplication of treaties, the largest MNEs tend to already have access to investment treaties for most of their target markets or can get such access with relative ease.

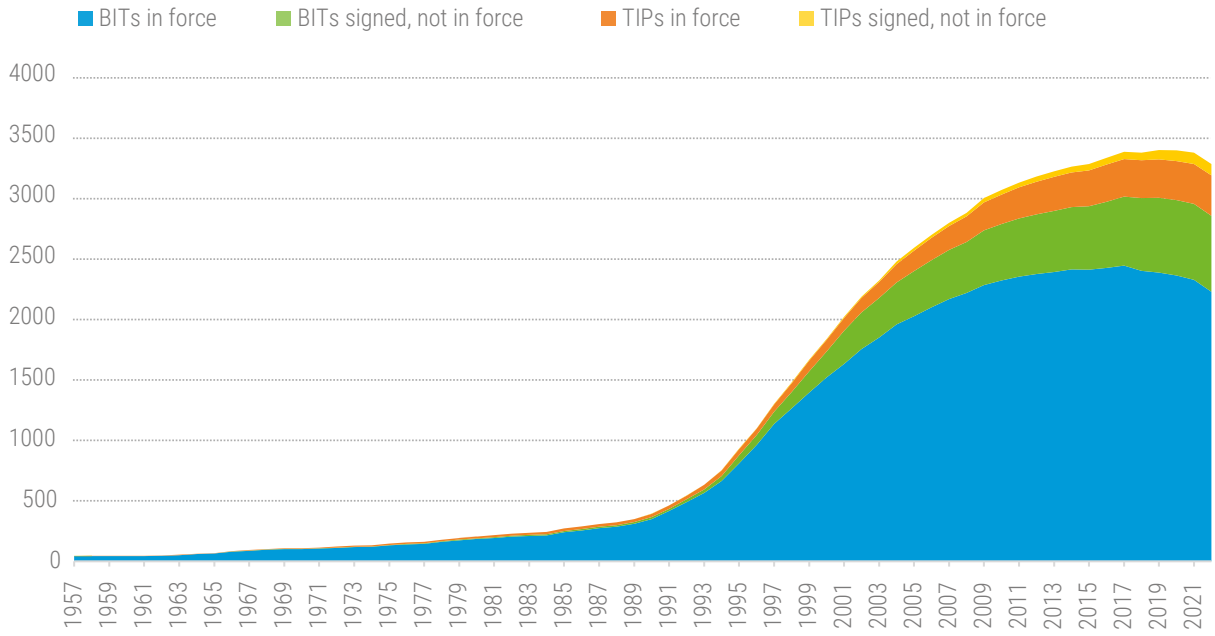
As illustrated by figures 7.2 and 7.3, Europe and OFC states serve as key hubs or conduit spaces in providing such access. This might explain both the lack of corporate support for a multilateral investment regime after its failure in the 1990s and the slow-down in the creation of new investment treaties, as illustrated by figures 7.3 and 7.4 (Jandhyala et al., 2011). Unsurprisingly given the market reach endowed in bilateral investment treaties, large MNEs tend to be less supportive of (and may even oppose) a multilateral regime than they would have been without an existing bilateral investment regime. This echoes arguments about preferential trade agreements, which similarly create opposition to multilateral liberalization among beneficiaries (Mansfield and Milner, 1999; Bertz et al., 2021, p. 786).

[5] Balassa conceived his typology in the 1960s when the roles of FDI and cross-border production networks were less important. The motives for reginal integration have been extended from the traditional area of trade into new areas, such as investment and regional trade, both of which relate to deep integration (Kang, 2016).

**Figure 7.3** The evolution of international investment agreements, 1957–2022


*Source:* UNCTAD Secretariat visualization based on UNCTAD investment agreements data.
*Note:* The figure periodizes all active IIAs based on when the agreements came into force. The three periods captures agreements in force pre 1995; agreements that entered into force between 1995 and 2008; agreements that entered into force post 2008.

**Figure 7.4** International investment agreements by type, 1957–2022




*Source:* UNCTAD secretariat calculations, based on UNCTAD, Investment Policy Hub, International Investment Agreements Navigator.
*Note:* International investment agreements (IIAs) are divided into two types: bilateral investment treaties (BIT) and treaties with investment provisions (TIP). BIT is an agreement between two countries regarding promotion and protection of investments made by investors from respective countries in each other's territory. TIP brings together various types of investment treaties that are not BITs.

By default, the visualizations presented in figures 7.2, 7.3 and 7.5 offer only a snapshot of the scope of regional agreements and do not reflect the specifics of each deal and type of partnership. Yet they do give a clue about the political geography of international trade and investment governance. While RTAs (figure 7.5) broadly correspond to major zones of market integration and trade, as reflected by the established regional blocs and wider participation of the developing countries, the network of IIAs points to the central role of the European hub and OFCs as central nodes in the regulatory landscape governing the corporate intermediation of FDI flows.

The outcome of this layering is the increasing regulatory complexity of the global economy; this tends to disadvantage the developing countries seeking to establish new regional integration projects and governance institutions (Kang, 2016, p. 243). For instance, bilateral investment treaties include a dispute settlement clause that allows investors to sue host states, typically bypassing domestic courts and allowing investors to bring international arbitration proceedings directly, most often at the International Centre for Settlement of Investment Disputes or under the United Nations Commission on International Trade Law arbitration rules. Originally based on a system of ad hoc confidential commercial arbitration between private parties, the legitimacy of the investor–state dispute settlement system is now challenged (*TDR*, 2018). By mid-2019, investors had brought more than 1190 investor-state dispute settlement cases against 130 countries, including 117 cases against at least 30 African countries (*EDA*, 2020, p. 117; *WIR,* 2022, p. 73). The interplay between the legal infrastructure of asset creation at the level of the corporations and the international financial system poses a set of challenges not only to national and regional regulators, but also to the strategies of developmental regionalism more generally (see box 7.2).

**Figure 7.5** Regional trade agreements, 2022

*Source:* UNCTAD Secretariat visualization based on World Trade Organization data.
*Note:* Only agreements that entered into force are represented.

The introduction of IP laws in international trade and investment agreements has added further complexity to such agreements in recent decades, largely to the detriment of the needs and interests of the developing countries. The adoption of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) by the World Trade Organization (WTO) in 1995 established binding multilateral minimum standards on all WTO member states for granting and protecting the use of IP (i.e. patents, copyrights and trademarks) in foreign markets.

The negative impact of these IP protection measures on the developing countries, particularly with respect to the healthcare and pharmaceutical industries, resulted in the Doha Declaration in 2001; the developing countries' rights to use flexibilities and safeguards were reaffirmed in the Declaration and clarified at the WTO Ministerial Meeting. However, despite these supposed safeguards, in practice, the bilateral, regional and plurilateral agreements signed in recent years have included IP protection provisions that are far more stringent than those envisaged in TRIPS. Such provisions, often referred to as TRIPS-PLUS, include the expansion of existing obligations under the TRIPS Agreement (e.g., patent term extensions[6]), restrictions on the use of safeguards or flexibilities (e.g., compulsory licenses,[7] parallel imports[8]), and the introduction of new provisions not even addressed by TRIPS (e.g., data exclusivity[9]) (Correa, 2017). These provisions are often imposed on the developing countries as a necessary component of international trade and investment agreements.

[6] These are provisions to extend the duration of a patent beyond the 20 years required by TRIPS.

[7] This provision gives the government the authority to grant permission to another party to produce a patented product or process without the consent of the patent owner.

[8] This provision refers to the purchasing of patented goods in a foreign market for their resale in the domestic market.

[9] This provision means that for a specified period of time the regulatory authorities cannot rely on the originator's safety and efficacy data for the registration of generic versions of a drug.

### Box 7.2 Investment protection and climate change

One aspect of investment treaties subject to intensified scrutiny in recent years is the legal protection of investments.[10] The investor-state dispute settlement (ISDS) mechanism included in thousands of investment treaties allows investors to sue governments for any action they claim violates their legitimate expectations of profits. These cases can run into billions of dollars, often involving claims against future profits: in July 2019, the Australian subsidiary of Tethyan Copper Company was awarded $5.8 billion against the government of the Islamic Republic of Pakistan, more than 25 times the $220 million the company invested in the project and 16 per cent of the entire Pakistan budget for 2018-2019 (Bonnitcha and Brewin, 2020).

Cases are often initiated in response to public interest policies, such as financial regulation, public health, land use, environment and social protection policies (Thrasher, 2021). Risk of exorbitant penalties curtails governments' right to regulate, causing a regulatory chill. Climate and environmental regulations are the most common, most lucrative and fastest-growing trigger for claims (Salvatore, 2021). The fossil fuel sector has been the most litigious, initiating 20 per cent of total investor-state disputes so far and winning almost three-quarters of them (Salvatore, 2021).[11]

A recent study estimated the costs of possible legal claims from oil and gas investors in response to government-led transitions in line with International Energy Agency's 1.5°C scenario (IEA, 2021). It found claims could reach $340 billion (Tienhaara et al., 2022). As a consequence of treaty shopping, this is an underestimate of the true extent of protection of 1.5°C – incompatible oil and gas assets, with law firms already advising investors to adjust corporate structures to avail themselves of ISDS benefits from climate claims (Jones Day, 2022). Considering the total public climate finance in 2020 was less than this at $321 billion, these protections pose a significant financial risk, draining resources from necessary mitigation and adaptation efforts.

The Energy Charter Treaty (ECT) which protects energy investments is the most commonly used ISDS mechanism in the world. There is increasing awareness of the threat the ECT poses to a just energy transition, with governments facing liability for a range of net zero actions, such as cancelling pipeline developments and denying drilling permits. As a consequence, ECT members recently agreed to a process of "modernization" to "align the ECT with the Paris Agreement and our environmental objectives." However, the "agreement in principle" did not go so far as to remove fossil fuels and other carbon-intensive energy sources from protection and did not alter the basic mechanics of the Treaty to shield corporate power from public policy decisions (European Commission, 2022).

As many more countries in Africa and the Middle East, Asia and Latin America are in the process of joining the Treaty, litigation will drive up the bill for global transition, posing a barrier to sustainable and climate-resilient development. Given the obvious threat to public interest and the failure of such investment protections to deliver promised levels of productive FDI, governments should terminate their existing Treaty (Moehlecke and Wellhausen, 2021).

[10] For UNCTAD's work on this, please see: https://investmentpolicy.unctad.org/publications/1269/the-international-investment-treaty-regime-and-climate-action and https://investmentpolicy.unctad.org/publications/1270/treaty-based-investor-state-dispute-settlement-cases-and-climate-action

[11] For breakdown see: https://investmentpolicy.unctad.org/investment-dispute-settlement

Although a central argument justifying the adoption of these IP protections is that they promote the transfer and dissemination of technology, recent evidence suggests IP protections do not have a positive impact on technology transfer to the developing countries (Kirchherr and Urban, 2018). Rather, the inclusion of so-called TRIPS-PLUS provisions in international agreements is largely a result of intense lobbying by large corporations seeking to leverage technological leadership to enhance market power, set a barrier to market entry and create a source of super-profits (*TDR*, 2020).

Consequently, the IP provisions and frameworks in international agreements have shown an increasing bias towards the excessive protection of private investor interests, often at the expense of wider public interests (*TDR*, 2017). This is particularly the case when international agreements are signed between developed and developing countries, evidenced by the fact that North-South agreements contain a larger number of TRIPS-PLUS provisions than either North-North or South-South agreements (*TDR*, 2014; WTO, 2011).

The next section focuses on the fragmented corporation in the political economy of development to reveal the role of control in global corporate groups. The analysis of the configuration of corporate ownership structures offers important lessons for development, including through regional arrangements, because when analysed in a systemic framework, they point to where value and earnings stripping occur.

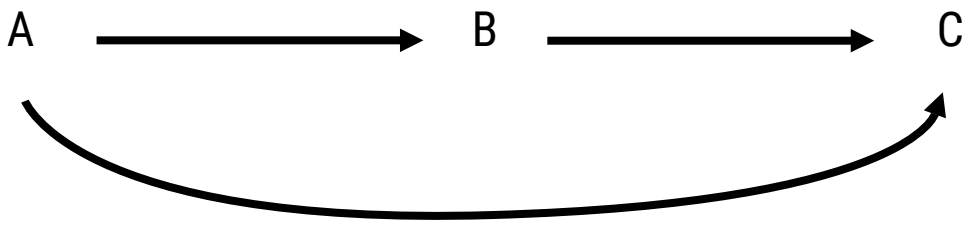
## 2. Legal implications of the use of subsidiaries

Section B included a description of the potential uses of intermediary subsidiaries of MNEs. The importance of diverging functions of such intermediaries within corporate groups becomes clearer in the context of the rules of incorporation and transaction. As mentioned above, each subsidiary is subject to the rules of its country of registration.

Figure 7.6 presents a scheme of direct and indirect holding. In a direct holding, A→C, the investment is subject to the rules and regulation of country A and country C, to the bilateral trade and investment treaties between the two countries and to multilateral treaties in which they participate. In an indirect investment, A → B → C, the investment is subject to a much more complicated set of rules. The investment takes the form of A→B and is subject to the rules and regulations of country A and country B and the bilateral and multilateral agreements between them, and between country B and country C and the bilateral and multilateral agreements between them.

Indirect investment through intermediaries is more complicated, but it may have the advantage of redirecting the rules under which the investment takes place. An MNC may react to a more favourable environment presented by a regional trading agreement by locating an intermediary in the most favourable jurisdiction in that agreement and direct most activities to that intermediary, thus denying much of the coveted advantage of FDI to other countries in the region.

**Figure 7.6** Direct and indirect ownership patterns




*Source:* Phillips et al. (2021).

In a more sophisticated scenario, an MNC can use two intermediaries. One is located in a country that is not part of a regional agreement but shares a bilateral agreement with one of the countries in a regional agreement. The upper intermediary is then accessing the regional trading or investment agreement through the lower subsidiary, whereas much of the actual activity is moving to the upper subsidiary located in a country that is not part of the regional agreement. An even more sophisticated scenario can involve three intermediaries in three different countries. These techniques of setting up an intermediary can ensure that every regional agreement is "arbitraged."

In a yet more sophisticated scheme known as a "put out" option, the corporation may move business out of an entity via an apparently innocuous contract:

1. Company A in Country B has a business of producing widgets sold to distributors. It has a turnover of 100 and makes a margin.
2. Company A is indirectly controlled by Company Z in the Global North.
3. Company Z prefers Company A's business to be located in Country B.
4. Subsidiary B signs a contract with Company A. It will supply components to A; A will produce the same widgets with these components and will deliver the finished widgets to B for the price of manufacturing the widgets.
5. Company B sells the widgets to distributors.
6. End result: Company A gets enough to pay local production costs (mainly employees' salaries but nothing more); Company B now owns the business (it has the clients) and earns the margin.

In sum, the corporate world, particularly large MNEs, often manoeuvres the changing regulatory environment at two main levels. First, while regional trade and investment agreements may well encourage investment into the region, the way the investment is structured through subsidiaries is crucial for the economic nature of the investment. The default assumption in FDI research is that all investment is structured as a set of directly held subsidiaries, and those subsidiaries perform operational activities (as above).

Second, MNEs can and, as shown below, do structure those investments indirectly through intermediaries and ensure a considerable portion of operational activities takes place elsewhere. They may do so because certain countries offer a better regulatory environment, lower taxation and other advantages – as reflected in the phenomenon of the competition state. As detailed in box 7.3, there is strong evidence to suggest countries have chosen to participate in the global economy by competing over lucrative segments of corporate "parts." Due to statistical anomalies discussed above, none of these outcomes is picked up in FDI statistics.

The internal organization of corporate groups and the way subsidiaries relate to parent companies and to each other are now recognized to play major roles in enabling corporate access to international arbitration. The techniques can also come into conflict with national governments, especially in the context of developing countries, where corporate groups arbitrage national rules through access to investment treaties. Consequently, analysing the specific role of corporate subsidiaries in host economies and mapping their linkages to their parent may point to a central way in which value and earnings are being created (and stripped) in the process of international business.

### Box 7.3 The competition State and OFCs

The neoliberal reforms of the 1980s gave rise to a development that remains at the centre of globalization, including regionalization processes. With the hollowing out of post-war models of welfare states and the rise of global markets, states became increasingly engaged in a peculiar competitive game, wherein "they are competing for world market shares as the surest means to greater wealth and greater economic security" (Strange, 1987, p. 564).

The phenomenon is known as the rise of a competition state – a process where key institutions and policies of the state are adapted to the new conditions of the global market, and where the very concept of the national interest is expanding to embrace the transnational dimension: the so-called competition state is itself obliged by the imperatives of global competition to expand transnationalization (Cerny, 1994, p. 225). One major implication of the transformation, as maintained in the Washington Consensus, is that rather than directly controlling the economy, in order to compete for a share in the global marketplace, the state is better off providing the conditions for generating growth (Palan and Abbot, 1996, p. 4).

The transformation has unfolded globally in the era of what Philip Cerny has referred to as "embedded financial orthodoxy" – an extended phase of crisis marked by unstable cycles of boom and slump. In the context of heightened fragility, the policy instruments available to the state have changed from tools of fine-tuning to more blunt options, such as interest rates, while the central concern of financial stability is to ensure a contagion-free environment conducive to further and deeper financialization (Cerny, 1993, p. 158). In parallel, economic policymaking has shifted from predominantly demand-side measures of the Fordist era and the immediate post-Second World War decades to supply-side measures.

The broad principle of deploying state rules and regulations as a developmental strategy has achieved its extreme form in some of the very small states in the world, particularly island economies in the Caribbean and small states of Europe, who historically found it difficult to develop a strategy of competition based on diversification of economic sectors. They learned to commercialize their sovereignty by offering a free and liberal regulatory environment of low or zero taxation, secrecy and light regulation. By the early 1990s, with over 40 states offering a variety of facilities for tax havens and offshore banking, the tax haven model was, at least numerically, one of the most popular state strategies.

In effect, the strategy drew a new political and economic map, with each of the major and minor trading blocs now surrounded by an archipelago of small tax havens (Palan and Abbott, 1996, p. 167). While many of these states were initially accused of becoming tax havens, over time, their models of the competition state became more sophisticated and targeted, and many established themselves as more diverse OFCs (Haberly and Wojcik, 2022).

In Europe, with the creation of the European market and the concept of subsidiarity, states were given free hand to determine their fiscal structure. Some began to compete to become the gateway for investment into Europe (early 1990s). Some states targeted real investments, while others became conduits for financial presence of chiefly United States companies, accommodating, in part, the hosting of corporate treasury centres (Garcia-Bernardo and Reurik, 2019). Over time, these European attractor states drew not only United States capital, but also European and Asian corporations. The effect of this structure is that the services aspects of the investment value – the highest value-added of the value-creating components – are being located in very specific jurisdictions, led by the Netherlands, Ireland, Luxemburg, the United Kingdom and Switzerland. As a result, FDI into developing countries is rerouted through these territories (Garcia-Bernardo and Reurik, 2019).

As Haberly and Wojcik (2022) recently noted, the institutional and historic legacy of European legal frameworks looms large over the global web of not only offshore financial havens but also the global financial system. Laws and institutions that once served the extraction of wealth now prove useful for jurisdictional arbitrage (Haberly and Wojcik, 2022; Palan et al., 2010; Eden and Kudrle, 2005; Shaxson, 2011). The role of these tailored jurisdictional niches is key to the global pathways of FDI and the flows of international finance as mediated by MNEs. These historical jurisdictional niches constrain the national policy space available to governments when regulating the economy and pose a challenge to multilateral attempts at economic governance (Robé, 2020).

As a result, the structural impact of the global architecture built by early regionalization initiatives is the creation of regulatory layering: the regionalization initiatives are being layered onto each other, amplifying complexity in the process. In this increasingly complex global economy, where the very process of value creation and extraction proceeds in many stages across several economic and legal spheres, typically involving multiple agents in many jurisdictions, financialization, including its legal and corporate underpinnings, is the main channel that not only connects capital and regions, but also sustains the value-creating operations of MNEs at the transnational level. Both dimensions of financialization pose a spectrum of challenges for development in general and for the outcomes of regional integration in particular.

# D. CORPORATE ARBITRAGE AND DEVELOPMENT: MAPPING CORPORATE EQUITY CHAINS

It is clear that an understanding of whether or not regional arrangements can accommodate a strong development dimension must address the issue of changing corporate structures, especially the growing ability of large international firms to circumvent regulations and policies. Doing so requires a more granular approach to FDI and includes the analysis of corporate organization and intrafirm trade, of the sort pioneered by UNCTAD (*WIR*, 2015, 2016). The challenge that has so far impeded the advancement of the analysis of corporate intermediaries and groups is two-fold.

First, the number of subsidiaries and groups has tended to multiply over the past few decades, making it difficult to have an overview of the corporate organization at the aggregate level. Second, some subsidiaries, especially indirectly held subsidiaries, do not acknowledge in their annual report their relationship to the group or the parent of the group. Phillips et al. (2021) relied on the Orbis database to chart the visual maps of the groups as whole (these were called *equity maps*). More specifically, the authors innovated an algorithm linking subsidiaries to the overall group, even when this relationship is not formally declared. As a result, the technology visualizes all subsidiaries and affiliates.

With the authors' permission and having access to their original database and the algorithm, the following box combines the spatial mapping technique with the analysis of subsidiary accounting data to gauge the degree to which investment in developing countries follows the phantom FDI pattern. The more general goal is to establish to what extent jurisdictional arbitrage-seeking is a key feature of the foreign investment patterns of multinationals.

### Box 7.4 The CORPLINK study and its limitations for development research

The Corplink study examined the way the largest 100 publicly traded non-financial MNEs in the world structure their investment in the Global South and around the world. It should be noted that many of the largest companies from the developing economies are state-owned or partly state-owned, and the Orbis database does not record any of the largest Global South MNEs in its top 100. As a result, there is a bias of composition in the sample of companies: the top 100 largest non-financial MNEs tend to be companies from the advanced economies. Importantly, however, the present analysis focuses on the location and organization of subsidiaries, not on the flow of funds.

By definition, not all entities may have or report financial statements (they can be dormant, for instance). Furthermore, countries' record collection practices and filing requirements may influence whether records exist in the Orbis dataset; companies, in turn, may seek out specific jurisdictions for secrecy reasons. Indeed, the financial management practices of multinationals can mean economic activities are "booked" in certain entities and not in others. All of this means it is normal for only a fraction of MNE subsidiaries and affiliates to have visible financial reporting data; consequently, research should be taken as indicative, not definitive.

## 1. Mapping corporate equity chains

The approach taken in this Report comprises a two-stage analysis:

**Stage 1.** Estimate the significance (if any) of indirect investment via third-party jurisdictions, as opposed to a simpler form of investing directly, in the structure of investment between the parent company and its subsidiary undertaking in a developing country.

To do this, we first identify all the corporate entities where equity ownership is traceable to the parent multinational (i.e. the global ultimate owner or GUO). The "group subsidiaries" considered here represent two types of equity holdings underpinning the foreign investment activities of a multinational:

i) Those entities where the estimated weight across an observed chain of equity holdings is greater than 50 per cent. These entities are estimated to be "owned" and "controlled" by the GUO; thus, their financial activities are most likely to be attributed to that GUO entity as part of its consolidated accounting and financial reporting.

ii) Those entities with a discrete estimated equity value below 50 per cent and either directly owned by a subsidiary as defined in (i) above or by the parent GUO itself. These entities represent the "affiliates" of a group. All other sub-holdings of these entities are excluded from analysis, as they pertain to investments relative to some other GUO outside the present research focus.

With this set of group subsidiaries defined, we focus on foreign incorporated holdings (relative to the parent company) and differentiate these entities along two dimensions:

i) Foreign holdings incorporated in the Global North versus those incorporated in the Global South.

ii) Foreign entities identified in terms of their direct versus indirect ownership structure. Direct holdings are those where the GUO entity is the sole immediate owner and/or where all other

entities in a chain of intermediate shareholding to a foreign entity are incorporated in the same jurisdiction as the parent. In contrast, indirect holdings are situations where a foreign subsidiary is held via a known entity incorporated in a third-party jurisdiction (or jurisdictions) different from both the GUO and the jurisdiction of the foreign holding in question. The results of this stage of the study are presented in figures 7.7 and 7.8.

**Stage 2.** Differentiating between operational and asset-based subsidiaries.

We differentiate between subsidiaries presenting an income statement and those providing only a balance sheet.[12] We introduce an additional nuance to this classification by acknowledging income statements can be "thin" presentations of only financial transactions and non-operating expenses. In addition, some subsidiaries' income statements may be dwarfed by large balance sheets, signalling a stronger likelihood of the subsidiary being an investment vehicle.

We resolve this by making an additional quantitative assessment of the proportion of the two types of activities in a given entity. We then define our categorization of MNE investments as "asset dominant" when the income statement is less than 1 per cent. We take the mean average of all reported balance sheet items and compare this to the mean average of all income statement items to determine whether a subsidiary is likely to serve operational or merely financial purposes.[13] The results are displayed in figure 7.7.

All entities with financial reporting fall into two basic groups: those with income statement information plus balance sheet reporting and those with only balance sheet data. Entities only reporting balance sheet information are treated here as pure investment vehicles, because available evidence suggests their role is primarily to manage some underlying asset.[14] The presence of additional income statement reporting requires further consideration, as this information does necessarily signify the presence of substantive operations or "real FDI." For instance, income statement reporting may only be a description of relatively small administration costs of an enterprise managing a larger pool of financial assets.

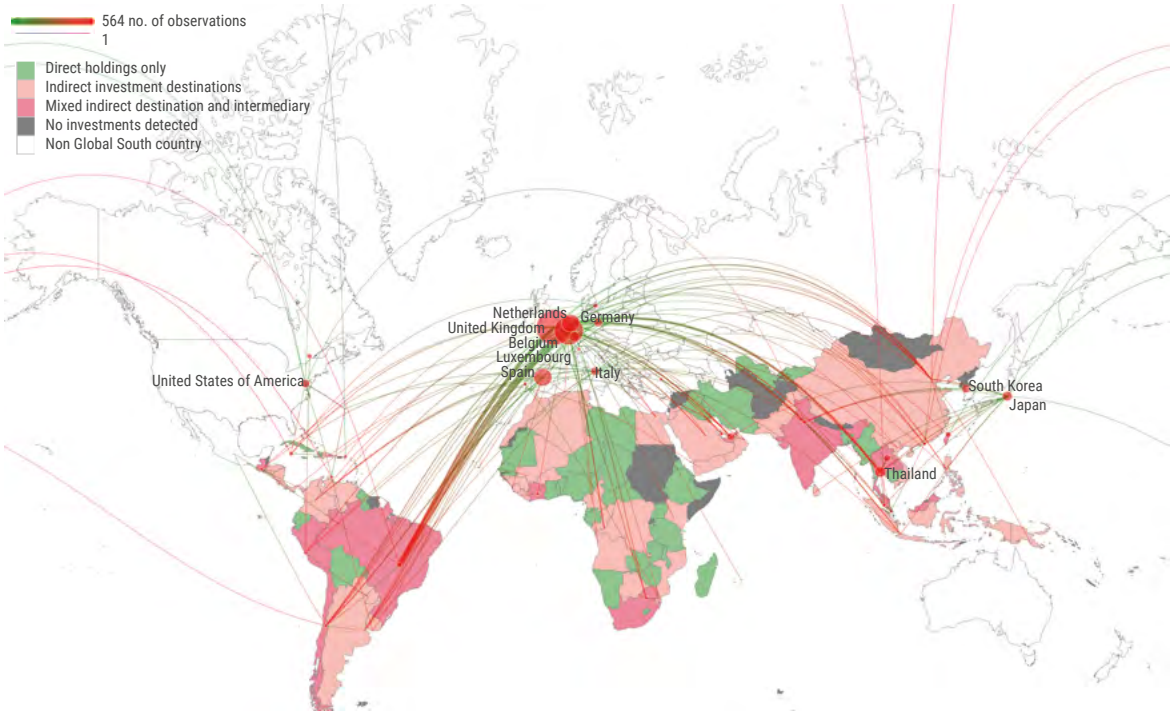
To discriminate between operational and asset-based subsidiaries when both forms of financial reporting are available, we compare a three-year weighed average of two indicative variables taken from both areas of reporting. From the balance sheet, capital and total fixed assets are used as comparative measures, with operating revenues and net income evaluated from the income statement reports. We use a weighted average estimate for the latest three fiscal years. As the data were collected in mid-2018 and reflect the state of available information in Orbis at that time, the three-year period covered here is 2015 to 2017. Cases where the weighted average of the balance sheet is greater than the weighted average of the income statement are classified as "asset dominant" situations, more likely to be financial investments or phantom FDI cases than substantive operational investments of the MNC itself. The results of this analysis are summarized in figure 7.9.

[12] There are two forms of financial reporting at the level of a private subsidiary in Orbis: (1) balance sheet reporting and (2) income statement reporting. We identify several key components from both, if available, and compare them. If no financial reporting is associated with an entity, the case is not part of the equity maps. If there are both balance sheets and income statements, we use their comparative weight to gauge the type of economic activity associated with the reporting entity.

[13] For an explanation, see box 7.4.

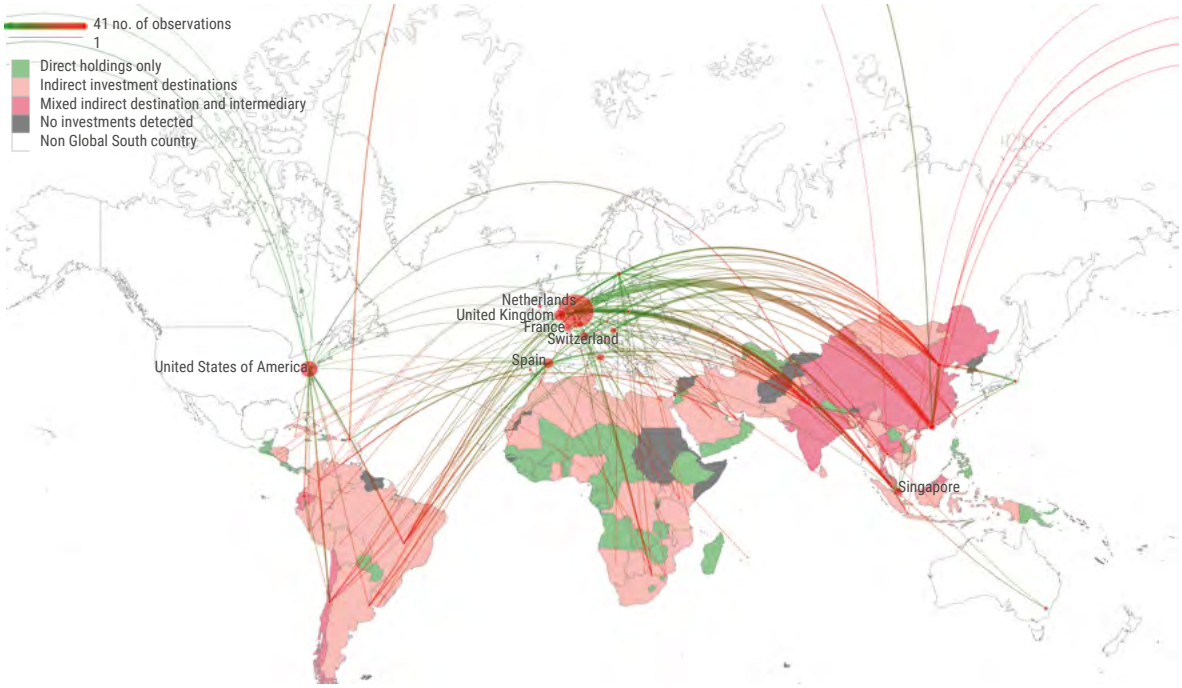
[14] Under English law, such companies are defined as dormant: these companies had no "significant" transactions in the financial year (https://www.gov.uk/dormant-company/dormant-for-companies-house)

**Figure 7.7.A** France indirect investment in the Global South



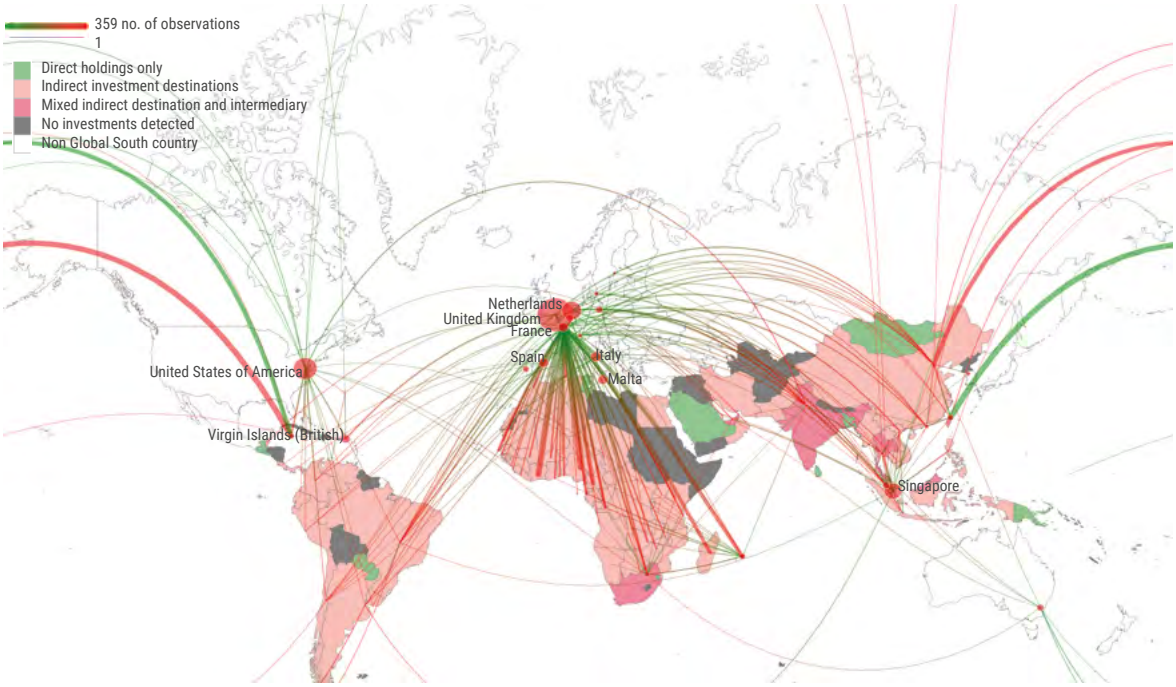

*Note:* Number of corporate groups with FR GUO: 9; total holdings of FR GUO: 12,204; total foreign holdings: 7,414; total holdings in the Global South (GS): 1,858; total GS holdings held by third party country: 809.

**Figure 7.7.B** Germany indirect investment in the Global South




*Note:* Number of corporate groups with DE GUO: 16; total holdings of DE GUO: 14,840; total foreign holdings: 10,552; total holdings in the Global South (GS): 2,141; total GS holdings held by third party country: 631.

**Figure 7.7.C** Japan indirect investment in the Global South

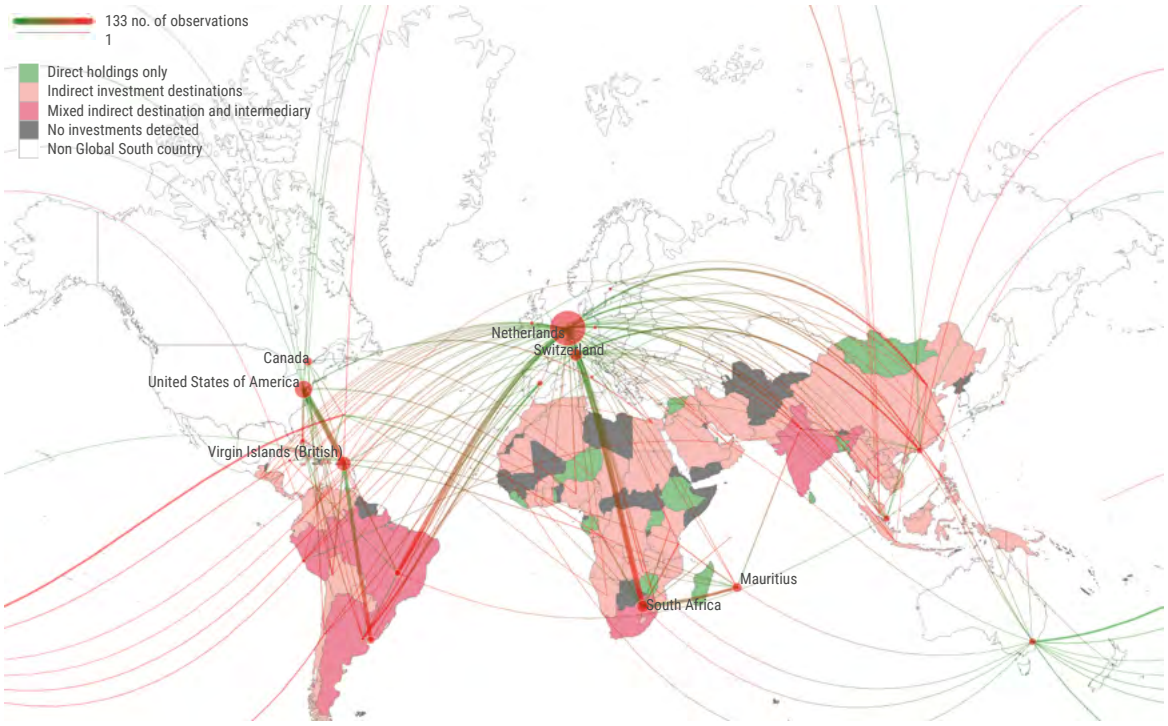



*Note:* Number of corporate groups with JP GUO: 9; total holdings of JP GUO: 11,939; total foreign holdings: 9,240; total holdings in the Global South (GS): 3,102; total GS holdings held by third party country: 1,285.

**Figure 7.7.D** Republic of Korea indirect investment in the Global South


*Note:* Number of corporate groups with KR GUO: 6; total holdings of KR GUO: 2,057; total foreign holdings: 1,611; total holdings in the Global South (GS): 623; total GS holdings held by third party country: 209.

**Figure 7.7.E** United Kingdom indirect investment in the Global South




*Note:* Number of corporate groups with GB GUO: 6; total holdings of GB GUO: 6,057; total foreign holdings: 5,004; total holdings in the Global South (GS): 1,241; total GS holdings held by third party country: 614.

**Figure 7.7.F** United States indirect investment in the Global South


*Source:* UNCTAD calculation and visualization of equity holdings (2018), based on Orbis data as compiled by Corplink in Phillips et al. (2021).
*Note:* Number of corporate groups with US GUO: 40; total holdings of US GUO: 34,893; total foreign holdings: 12,249; total holdings in the Global South (GS): 3,130; total GS holdings held by third party country: 1,269.

## 2. Interpreting the results

Two key patterns emerge from our analysis. First, our examination of the top 100 MNEs shows large MNEs tend to structure their FDI investments through intermediary subsidiaries, and those are typically located in a developed country. Within this general pattern, there is a divide in the type of relationship between the parent company and its subsidiaries in developed and developing countries: between 65 per cent and 80 per cent of subsidiaries in the Global North are held indirectly; the figure rises to between 70 per cent and 95 per cent for investment in the Global South.

In other words, companies from every developed country that make it into the top 100 MNEs by revenue hold a larger proportion of their Global South subsidiaries indirectly through intermediaries compared to their holdings in the Global North.

The second pattern that emerges from the analysis is that those intermediaries tend to be located in Europe, with very little in the way of investments flowing between the regional blocs. Figure 7.7 shows the multinationals from all the GUO jurisdictions analyzed in our sample structure, with the majority of their foreign equity investments using indirect holding structures. Moreover, the general tendency across our sample (MNEs from Japan and Republic of Korea are exceptions) is that investments into the Global South have a greater tendency to be structured indirectly than respective investments into the Global North.

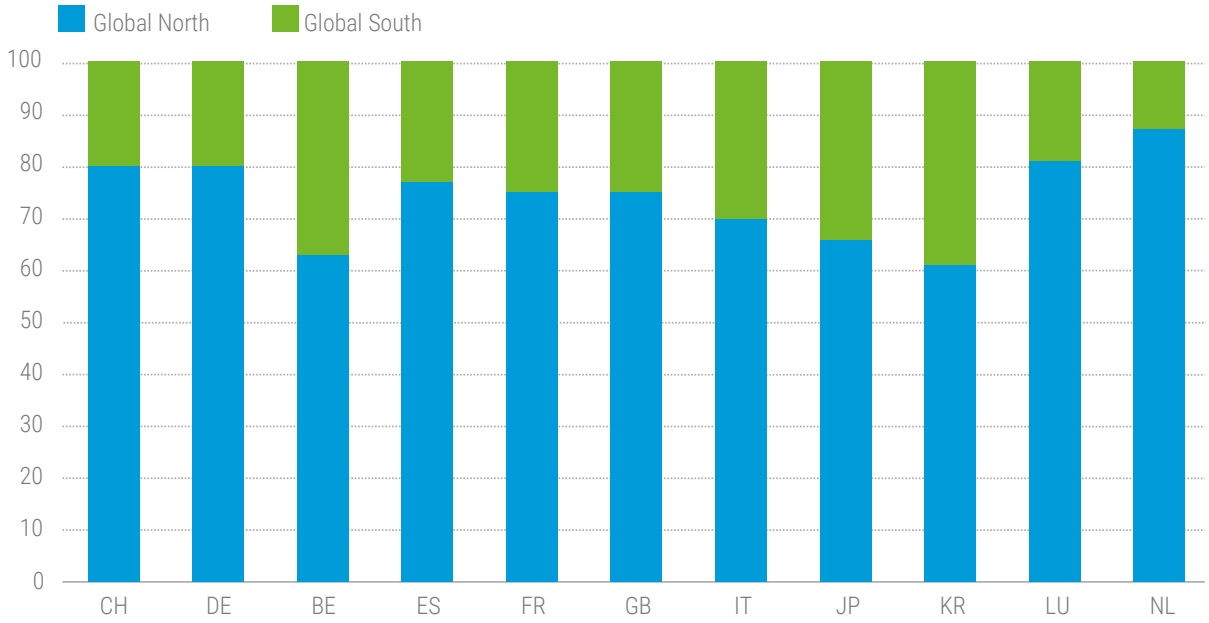
There are some important nuances in the data worth highlighting. Figure 7.7 provides a visual summation of how the largest multinationals from six major economies structure their indirect investments in the Global South. With around 35,000 equity investments, United States multinationals dominate the top 100 companies in the world (there are 40 United States multinationals in our sample).

However, United States multinationals have noticeably fewer investments going into the Global South than corporations from other countries. For instance, less than 9 per cent of United States investments are entities incorporated in the Global South. In contrast, Germany, France, Japan, Republic of Korea and United Kingdom multinationals have, on average, 19 per cent of their investments located in the Global South. As can be observed across the different exhibits in figure 7.7, subtle differences aside, the largest multinationals share a tendency to structure their investment into developing countries through intermediary subsidiaries located primarily in those advanced countries that serve as OFCs.

Unlike indirectly structured investments into developed economies, the overwhelming majority of direct equity investments into the Global North are cases where the value of income statement reporting is typically greater than balance sheet reporting (figure 7.9). This stark discrepancy is a further illustration of how the substance and function of intragroup corporate financing are linked to the form of legal structures managing those foreign investments. This difference is a managed one, likely to reflect the reality that a differential regulatory pressure is exerted on subsidiaries in the Global North.

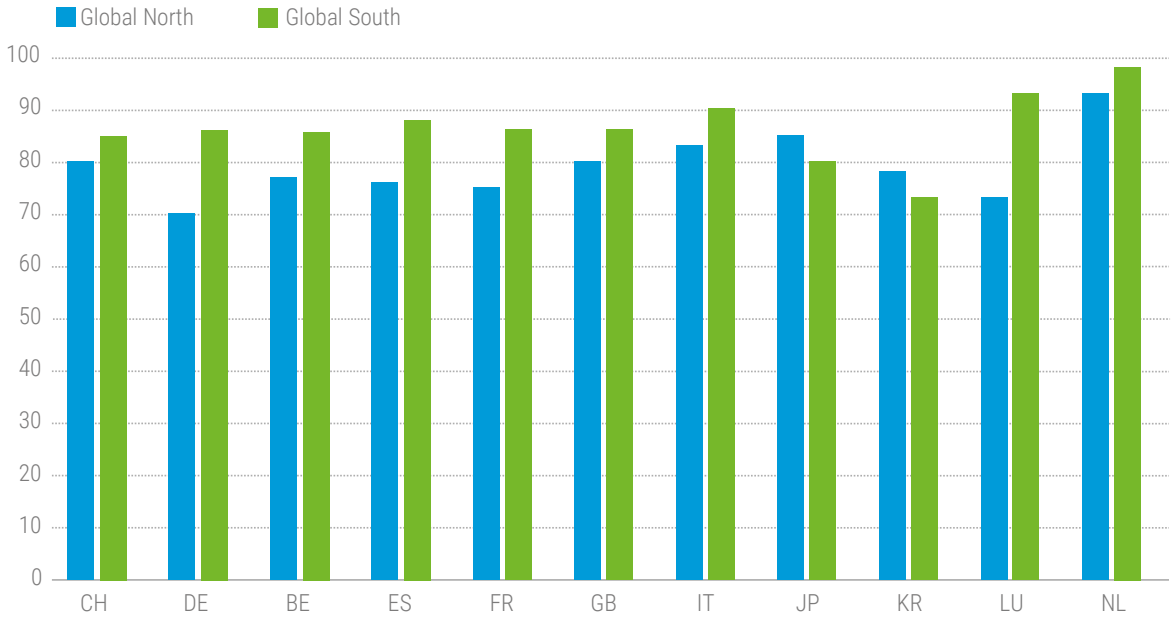
In contrast, both directly and indirectly structured equity investments into the Global South exhibit a nearly equivalent distribution of phantom cases where, in our method of detection, the balance sheet dominates the income statement (figure 7.8). Not only are these rates of incidence nearly identical for each GUO country group, but they are also very similar to what MNEs are pursuing by making indirect investments into the Global North. This consistency suggests that despite differing degrees to which multinationals use phantom foreign investments (this range typically falls between 20 per cent and 40 per cent of cases), multinationals all have a “normal” level of demand for constructing foreign investments in a phantom form.

**Figure 7.8.A** Shares of foreign equity holdings in corporate groups, by region and by jurisdiction of global ultimate owner, 2018 *(percentage of all holdings)*



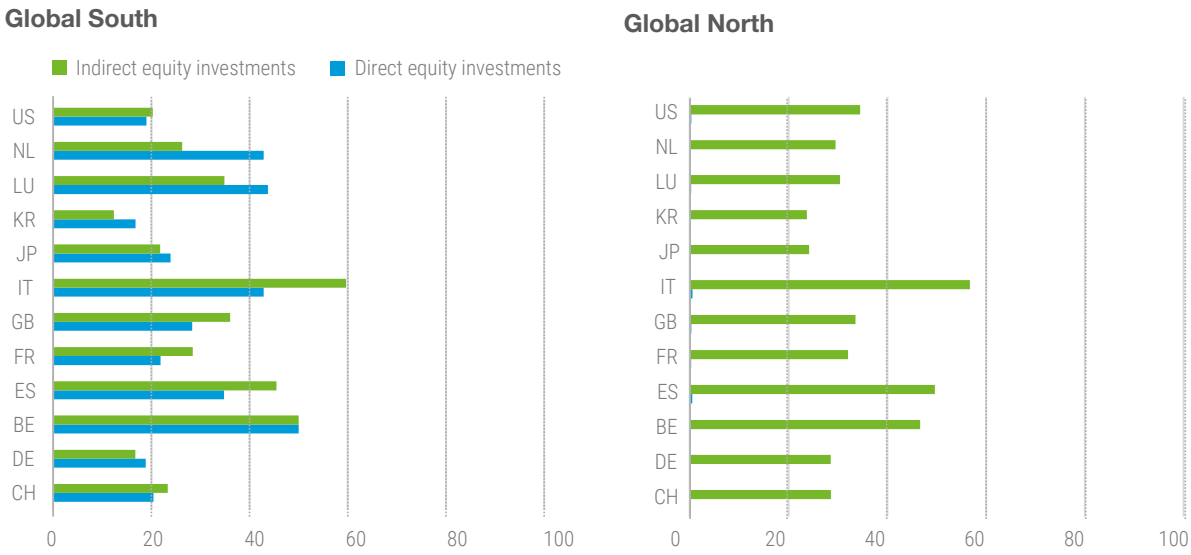

*Source:* UNCTAD Secretariat calculations based on Orbis corporate filings using CORPLINK algorithm.

**Figure 7.8.B** Shares of foreign equity holdings held indirectly through third-party jurisdictions, by region and by jurisdiction of global ultimate owner, 2018 *(percentage of holdings in the region)*




*Source:* UNCTAD Secretariat calculations based on Orbis corporate filings using CORPLINK algorithm.

**Figure 7.9** Shares of direct and indirect equity investment amounting to "phantom FDI" within top 100 MNEs, by region and by jurisdiction of global ultimate owner, 2018 *(percentage)*




*Source:* UNCTAD Secretariat calculations based on Orbis corporate filings using CORPLINK algorithm.
*Note:* A "phantom FDI" is defined as a foreign investment into an equity holding, where the balance sheet dominates the income statement.

Table 7.1. presents the summary of the results. Our study of corporate equity chains reveals that 26 per cent of indirect subsidiaries of top MNEs in the Global South present only a balance sheet as evidence of their presence in a country, with no (or few) income statements that would reflect real economic engagement with the host economy. The ratio of balance sheet dominant entities in the Global South that are held directly by the country of the GUO is 22 per cent. In contrast, the proportion of directly held subsidiaries of top 100 MNEs in the Global North that are balance sheet entities is less than 1 per cent. Interestingly, in case of indirectly held subsidiaries in the Global North the ratio of balance sheet only entities is 32 per cent.

These differences may simply reflect the fact that the more stringent regulatory pressures of the developed economies do not apply to entities located in the Global South. Nonetheless, the empirical point remains: the Global South has more cases where foreign investments take on a phantom form. In other words, a considerable portion of large multinational subsidiaries in the developing countries only maintain assets and perform very few operational tasks.

**Table 7.1** Distribution of phantom FDI cases, by region and type of equity invesment arrangement, 2018 *(percentage)*

| | Global North | Global South |
|---|---|---|
| Directly held subsidiaries | <1 | 22 |
| Indirectly held subsidiaries | 32 | 26 |
| **Total** | **23** | **24** |

*Note:* See note of figure 7.9.
*Source:* UNCTAD Secretariat calculations based on Orbis corporate filings using CORPLINK algorithm.

The pattern is indirectly confirmed by other UNCTAD research. More specifically, UNCTAD found that in 2021, the profitability of the largest MNEs doubled, reaching 8.2 per cent. The developed economies saw the biggest rise in FDI inflows, reaching $746 billion – more than double the exceptionally low level in 2020. In Europe, FDI rose in most countries, although half of the increase was caused by large fluctuations in major conduit economies (UNCTAD, 2022, p. 10).

Our results suggest there is a North-South divide in the registration of value creation in the global economy, with corporate players mostly relying on the financial, accounting and regulatory infrastructure offered to them by competition states (e.g., the Netherlands, Luxemburg, OFC islands). The majority of the developing economies, despite their efforts, remain structurally disadvantaged in the global competition for capital, and there is a structural divide across two major spheres of the global economy: corporate control and international investment. This divide is accentuated by the regulatory architecture governing finance and the activities of the corporate sector itself. Until these structural issues are adequately addressed, regionalization projects will not achieve their full developmental potential.

# E. CONCLUSION AND POLICY LESSONS

This chapter has featured an examination of the role of corporate arbitrage broadly and the function of corporate equity chains specifically, across two dimensions.

First, at the level of global political economy, it appears that the inner financialization of the corporate structure can serve as a tool for value extraction and earning stripping. In addition to corporate groups themselves, the beneficiaries of this phenomenon tend to be the advanced countries, especially global financial and corporate hubs located predominantly in Europe and the OFC islands.

Second, at the level of the multinational corporate investment activity, the transformation of the inner corporation paralleling technological, financial and regulatory shifts in the global economy (often referred to as the fragmentation of the firm) has meant that notwithstanding the macro-financial data on FDI flows, the economic substance of international investment, including in the developing countries, is often structured much like a variant of asset management.

In other words, a fifth of directly held subsidiaries of top 100 non-financial MNEs in the developing countries only maintain assets and perform few operational tasks. In the Global North, in contrast, the ratio of such subsidiaries in the corporate structure examined in our sample is less than 1 per cent. This stark contrast between the type of corporate activity in the Global North and the Global South warrants further research and policy attention.

Some lessons from the study relate to two aspects of corporate behaviour attracting increasing attention: tax arbitrage and profit shifting. Success in attracting FDI is not, in and of itself, conducive to making incoming foreign capital work for the host economy by, for example, helping it to 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 in the form of inexpensive labour, natural resources and so on, while other subsidiaries in the corporate group located in other jurisdictions contribute to and benefit from the 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. These countries face an additional disadvantage in the long term: their cost of borrowing is higher, usually several times higher, than that of the advanced economies (Garcia-Bernardo et al., 2022).

Against this global context, the structural asymmetries described above pose challenges to the developmental impact of regionalization efforts. As shown in the chapter, the global corporate-financial regulatory architecture favours private corporate and financial interests and is often guarded by the policies of advanced states. In the absence of a developed set of multilateral regulatory standards and a systemic framework of regulation, the developing countries need to build the relevant financial, accounting, legal and data expertise, with a view to enhancing the visibility of corporate behaviour at the global level. Earlier work by UNCTAD suggested policymakers in some countries have started to develop a range of mechanisms to safeguard the effectiveness of foreign ownership rules, including anti-dummy laws, general anti-abuse rules to prevent foreign control and disclosure requirements aimed at monitoring ownership-based and non-ownership-based control (*WIR*, 2016).

But these initiatives remain in their early stages and are selective. The central role of legal and financial infrastructure in corporate arbitrage and value extraction poses a particular challenge to developmental regionalism and regional institution-building. Therefore, an attempt to consolidate available resources at the regional regulatory level could be an important first step towards harmonizing regulatory policies and curbing – at least at the regional level – opportunities for corporate arbitrage.

In this instance, while many recent efforts by international organizations take a major step towards global tax justice and corporate transparency, these efforts have evolved separately. A more integrated approach towards a systemic multilateral system of measures of corporate and financial regulation is needed to address the power and economic asymmetries dividing developed and developing countries.

The development of such an integrated approach can start on the basis of the initiatives already undertaken at the international and regional levels. For instance, it is clear from the study discussed above that reform measures aimed at tracing tax arbitrage by corporations have to be connected with closer policy attention to advancing FDI statistics. Similarly, corporate accountability measures implemented in the developed countries need to take a closer look at the role and type of corporate subsidiaries and the nature of their de facto (as opposed to de jure) economic activity. The availability of reliable data on corporate financial behaviour, professional expertise and dedicated regulatory mandates at national levels can play a key role here. In light of the results of the study, the regulatory solution to corporate rent-seeking needs to start from the Global North.

In this respect, it is encouraging that the European Union is the first regional power to seriously consider making it mandatory for large companies operating in the region to spell out the details of their group of subsidiaries in corporate registers. This is an important step towards public control over corporate behaviour at the regional level (Foroohar, 2022). Although it is being challenged by countries' concerns about potential revenue losses from data sharing, if implemented and integrated with similar efforts in financial regulation, it can represent the first step towards a wider set of multilateral systemic measures.

And while the phenomenon of corporate and financial arbitrage and rent extraction is by definition multi-faceted, United Nations agencies, especially UNCTAD, are in a unique position to lead a program of reform, capitalizing on the relevant expertise of the organization. UNCTAD's earlier work on the multilateral investment regime focused on treaty shopping and international corporate complexity. Today, the broader goal would be to formulate a multilateral and multi-layered strategy representing the interests of the developing countries and addressing the negative consequences of corporate rent-seeking and financial arbitrage in a systemic manner.

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