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# **Report of the Secretary-General of UNCTAD to UNCTAD XIII**

**Development-led globalization: Towards sustainable and  
inclusive development paths**



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## Preface: The world turned upside down

1. In my report to UNCTAD XII (TD/413), I warned that, despite an unprecedented global boom over the previous five years, significant risks and vulnerabilities threatened growth prospects and could undermine moves towards a more equitable and effective global partnership for development. In particular, I argued that “putting liberalized markets and flexible prices at centre stage has proved to be insufficient in the light of the complex challenges that the new generation of globalization poses”.

2. At that time, I was swimming against the tide of conventional thinking. Even though there were clouds on the economic horizon, notably the housing market in the United States and (closely related) concerns about global imbalances, the consensus forecast was for fair economic weather sustained by strong market fundamentals. Indeed, at the time that I was writing, the International Monetary Fund (IMF) was raising its global growth projections.

3. With the benefit of hindsight, my report underestimated the seriousness of the global imbalances. Sharply rising food prices were an early indication that the world economy was out of kilter. The danger signs became apparent during the UNCTAD conference in Accra, when prices for cereals, soybeans and rice were all at historic highs. In the following months, further rises led to political unrest in several countries. There were also concerns about the price of oil, which had risen above \$100 per barrel, raising inflationary worries along with the possibility of geopolitical tensions.

4. Financial turbulence hit in August 2007, and the collapse of Northern Rock in February 2008 and Bear Stearns in March 2008 revealed serious stresses in the financial markets. Concerns over subprime lending in the United States housing markets intensified in the middle of 2008. But it was the bankruptcy of Lehman Brothers in September that triggered a crisis that few had anticipated or even imagined possible, exposing the full extent of global financial fragility. Credit markets froze and equity prices collapsed. Leading financial institutions failed, while many others turned to their governments for support. The speed of contagion was breathtaking, and the sense of panic in the financial markets and among policymakers was palpable.

5. The first lesson to draw from the crisis is that leaving markets to regulate themselves is both ineffectual and costly. Bailing out financial institutions has already run into trillions of dollars, and despite unprecedented fiscal and monetary responses, the global economy experienced its first contraction since the Great Depression. An estimated 10 per cent of global output was lost between 2008 and 2010, and tens of millions of jobs were destroyed; according to estimates by the International Labour Organization (ILO), 200 million people are currently unemployed worldwide. The impact was felt even in those communities that had seen few benefits during the boom years: due to the crisis, the number of people living in extreme poverty jumped by between 50 and 100 million.

6. A second lesson is that when a large number of economies collapse so dramatically, there must have been underlying weaknesses and fragilities missed or ignored by policymakers prior to the crisis. No one doubts the creative impulse of market forces, but the private pursuit of short-term gain can sometimes result in insufficient productive investment and concentrate the rewards with the favoured few. The risks are particularly pronounced when financial markets detach themselves from the real economy, tying wealth creation to the rapid accumulation of debt and rising asset prices rather than to steady productivity improvements and increasing incomes, and channelling innovation to financial engineering rather than to technological progress. Such a growth strategy is likely to be neither stable nor fair.

7. A third lesson is that when things do fall apart, the state remains the only institution capable of mobilizing the resources needed to confront large and systemic threats. The idea that the nation state had somehow outlived its usefulness in a borderless world was never very serious. Since the state is pivotal to establishing an inclusive social contract and strengthening participatory politics, it is both imprudent and unrealistic to reduce or bypass its role in managing economic development and change. The more worrying trend in recent years has been the growing influence of financial markets in bending public policy and resources to their own needs and interests – leading a former IMF chief economist to warn of “a quiet coup” – including in the post-crisis period.

8. Even as a tentative recovery has set in, the imbalances that arose during the previous boom, particularly in advanced countries, have proved very difficult to overcome. The private debt overhang remains a drag in many countries, while the combined effect of financial bailouts and recession has led to rising public deficits, triggering sovereign debt crises in some countries and stalling the recovery in others. Everywhere, employment creation has lagged behind, raising the threat of jobless growth and the spectre of protectionist responses. This provides a fourth lesson from the crisis, namely that in an interdependent world, countries cannot be expected to tackle destabilizing threats and imbalances on their own. And yet, to date, effective rebalancing strategies have not materialized at the multilateral level. The initial reaction to the food and financial crises was swift, with significant resources committed on both fronts, along with improved policy coordination; and protectionist responses have so far been kept in check. But the reforms required to prevent a repetition of the crisis have proved elusive. In the resulting interregnum, the burden of adjustment has been shifted onto overstretched public and household finances, with growing threats to the social peace and stability.

9. Neither IMF nor the World Bank, having abandoned their original *raison d’être* to the siren calls of unregulated financial markets, have been able to forge a vision of a post-crisis world economy consistent with changed economic and political realities. This failure points to a wider hiatus in global governance. The Doha Development Round is fast approaching its tenth anniversary, and its completion – as initially conceived – is still to happen. Progress on reducing greenhouse gas emissions has stalled following the failure to reach a comprehensive deal in Copenhagen. Finally, even before the latest crisis, keeping the Millennium Development Goals on track was a struggle: their achievement by 2015 is now only a distant possibility. It is telling that even a small proportion of the resources used to save financial institutions deemed “too big to fail” could never be found in better economic times for social and economic development, infrastructure-building and social welfare, or to address environmental challenges.

## **A. Goodbye finance-driven globalization**

10. It has become commonplace to view these developments as part of the inevitable stresses and strains of moving to a borderless world economy, and the price to be paid for the greater efficiency and dynamism of global market forces. Doing so requires a good deal of faith in the textbook logic of how markets work. In fact, the past 30 years have seen a persistent slowdown in global growth, weaker investment performance in many countries, and a sharp rise in income inequality almost everywhere. Moreover, describing the global economy as a natural system with a logic of its own ignores the policy choices underpinning it.

11. The extensive deregulation of the financial sector in the advanced countries, the dismantling of controls on cross-border financial activities, and the ensuing surge in capital flows marked a radical break with the post-war international policy framework. The rapid ascent of financial interests has eroded the checks and balances that had previously helped

channel market forces into the kind of creative and productive activities needed for long-term growth, and has instead encouraged short-term, and at times destructive, behaviour by banks, businesses, and households. Ideological support came from the efficient market hypothesis, which made the case for a hands-off policy approach applicable to all economic circumstances and challenges.

12. The crisis has put to rest the idea that there is a “one-size-fits-all” policy agenda. It has also been a considerable shock to the confidence of the developed world, and to the belief that economic disasters only occur in developing countries because of weak institutions, corruption and mismanagement. The former head of IMF, Dominique Strauss-Kahn, was right to conclude that events since 2008 have “devastated the intellectual foundations of the global economic order of the last twenty-five years” and have shattered confidence in simple policy fixes to complex development challenges.

13. Since the early 1990s, against the grain of conventional economic wisdom, UNCTAD has been arguing that the risks from the premature liberalization of trade and capital flows are significant, that the benefits are not simply there for the taking, and that a more pragmatic approach to development strategy is essential. In 1993 UNCTAD warned of an emerging financial crisis in Mexico, in 1995 we flagged the systemic risk from growing derivatives markets, and in 1997 we were not only alert to the dangers of rapid financial liberalization in East Asia but also suggested that a combination of repeated shocks and growing inequalities could produce a backlash against globalization. We have consistently argued that, in the face of large and unruly capital movements, neither fixed nor flexible exchange rates can provide the macroeconomic stability needed to secure strong growth, and that capital controls should be a permanent part of the policy toolkit. We have warned that an undue emphasis on inflation targeting would likely fuel damaging boom-and-bust cycles, particularly in developing countries, arguing instead for greater fiscal space and a more balanced approach to demand management. Throughout the past decades, we have been warning that the build-up of private and public sector debt was feeding unsustainable imbalances at the household, national and global level, and that “bailouts” were neither an effective nor a desirable solution. In 2008, we argued that the financialization of markets of strategic interest to developing countries had reached dangerous levels, and that it had become a more significant influence on trade and development than real economic fundamentals.

14. With all this in mind, I have chosen the term finance-driven globalization (FDG) to characterize the dominant pattern of international economic relations during the past three decades. This is intended to convey the idea that financial deregulation, concerted moves to open up the capital account, and rapidly rising international capital flows have been the main forces shaping global economic integration since the breakdown of the Bretton Woods system. Financial markets and institutions have become the masters rather than the servants of the real economy, distorting trade and investment, heightening levels of inequality, and posing a systemic threat to economic stability.

15. The latest crisis has served as a further reminder that FDG is a political project and is, therefore, the subject of legitimate discussion and debate. To date, the response has largely been one of muddling through, with ad hoc measures to mitigate the damage from economic shocks, informal partnerships to tackle global imbalances, and impromptu alliances to push for greater market transparency. There has been progress: the G20 has added a new and more focused layer of coordination in international economic matters, and has helped to nudge the multilateral financial institutions towards (marginally) more representative governance structures and (slightly) less dogmatic advice. However, divisions have emerged among the advanced economies on how to reform the international financial system, with alarming signs of a reversion to “business as usual”. Indeed, their financial sectors have already returned to many of the old practices, even as public finances

deteriorate and the recovery stalls. Austerity measures are back on the agenda, and resistance to financial regulation has begun in earnest.

## **B. The future is not what it used to be**

16. Money and finance have dominated policy discussions and grabbed the headlines. However, there are other important trends shaping development prospects. Soon after UNCTAD XII in Accra, the United Nations concluded that the planet was now truly urban, with over half the world's population living in cities. This figure is expected to rise to over 60 per cent by 2030. Urbanization has long been seen as a progressive trend, closely linked to a series of cumulative processes raising economic and social well-being. However the links are not automatic, and considerable challenges lie ahead. Rapid urbanization, premature deindustrialization and a degraded public sector have led to speculations about a "hollowing out" of the middle-class, and, more dramatically, a "planet of slums". Where these trends have collided with the ambitions of a youthful population, economic frustrations have spilled over into political unrest, as witnessed recently in North Africa.

17. It would be equally amiss to ignore environmental challenges, and, in particular, what the United Nations Human Settlements Programme (UN-HABITAT) has dubbed the "deadly collision" between urbanization and climate change. It is widely acknowledged that global warming is the unwelcome (and unpriced) result of successful development of today's advanced economies. But solving it will require a global policy response that brings about a new economic trajectory without compromising existing development goals. That will entail low-carbon, high-growth paths based around new technologies that can deliver an adequate supply of energy and rising incomes to a growing global population, with greatly reduced greenhouse gas emissions. A large investment push, with adequate financing and technology transfer from richer countries, is essential to this rebalancing challenge, and serves as a reminder of the interrelated nature of the challenges facing the international community. To date, the requisite economic incentives, degree of political will and appropriate partnerships have been noticeable by their absence.

18. The rise of new growth poles in the South also heralds a significant shift in the global economic and political landscape. China has already become the world's second-largest economy and its largest exporter. India has now posted two decades of strong growth and is steadily climbing the export ladder. Growth in other large developing countries, such as Brazil and Indonesia, picked up in the second half of the last decade. Since the Accra conference, the share of developing countries in world income has risen by more than 3 percentage points, to 30 per cent. Trade and investment patterns have shifted accordingly, and new political alliances and groupings have emerged, suggesting that a new world order is already taking shape.

19. The resilience to, and rebound from, the crisis in parts of the developing world certainly marks an important break with the past and has raised hopes of a prolonged period of convergence ahead. UNCTAD has always looked to an emerging South as being key to a more balanced global economy. However, a degree of caution is warranted. To date, this shift has been uneven, with large differences between developing regions and among individual countries; many of the least developed countries (LDCs) have seen the income gap between them and other countries widen further during the past two decades, suggesting that polarization pressures continue to shape global economic relations. Moreover, many emerging markets remain dependent on the leading economies and vulnerable to changes in policy and in economic conditions there. The impact of the Northern debt crisis on developing countries will need to be monitored carefully. The emerging South is still work in progress, and new forms of cooperation and partnership will be needed to consolidate recent gains and to meet the challenges ahead.

## C. Hello development-led globalization

20. Against a backdrop of economic imbalances and political tensions in interwar Europe, John Maynard Keynes called for “new policies and new instruments to adapt and control the working of economic forces, so that they do not intolerably interfere with contemporary ideas as to what is fit and proper in the interests of social stability and social justice”. A new deal did eventually emerge, but only after a push for “business as usual” had left a trail of currency disorders, wasted resources and shattered communities. Today’s global economic landscape bears some unnerving similarities to the interwar years; as then, neither muddling through nor a return to business as usual will get things back on track. The challenge is to rebalance economies in a way that is timely, sustainable and just.

21. This time around, rebalancing will need a global new deal that can “lifts all boats”, in developed and developing countries alike. It is a basic truth that people everywhere want much the same thing: a decent job, a secure home, a safe environment, a better future for their children and a government that listens and responds to their concerns. UNCTAD has consistently suggested a battery of policy measures and institutional reforms at the national and the international level to support rising living standards in developing countries, build their resilience to external shocks, and help them pursue a balanced integration with the global economy. The challenge, as I outlined in my report to UNCTAD XII, was less about “getting prices right” and more about “getting development right”, through a pragmatic, proactive and socially inclusive approach to macroeconomic, trade and industrial policies.

22. Finding the appropriate mixture of reflation, redistribution and regulatory measures to achieve these goals is now the urgent task of policymakers, at the international as much as the national level. I have chosen the term development-led globalization (DLG) to describe the principles, priorities and policies that need to be pursued to turn tentative recovery into an inclusive and sustainable future.

23. Reforming the financial system is the place to begin. Even before the crisis, it was clear that stable and inclusive development was incompatible with speculative market behaviour, boom-and-bust cycles, and the austerity programmes to which they invariably lead. It is telling that the emerging success stories from the South have, in large part, pursued policies that have avoided these dangers. Finance needs to get back to the business of providing security for people’s savings and mobilizing resources for productive investment. Reforms are also needed to replace unruly and procyclical capital flows with predictable and long-term development finance, to regain stability in currency markets and to support expansionary macroeconomic adjustments. Surveillance and regulation will need to be strengthened at all levels, and new institutional arrangements may need to be considered. Regional financial cooperation, despite the current difficulties in the eurozone, will, in particular, have a much larger role to play in a more balanced international architecture.

24. Stable monetary and financial arrangements are a precondition for making trade and investment work for inclusive growth and development. But rebalancing requires that financial and other resources be channelled towards the right kind of productive activities. Industrial development remains a priority for many developing countries because of the opportunities it provides to raise productivity and incomes, and to get the most from international trade. But a wider sectoral approach, including a focus on the primary sector in many LDCs, is needed in order to ensure that measures to diversify economic activity are consistent with job creation, the security of food and energy supplies, and effective responses to the climate challenge.

25. Talk of “picking winners” has been given an unexpected boost by the exigencies of the financial crisis, but the real challenge is to make sure that industrial policy, broadly conceived, is properly aligned with other measures needed to build inclusive development

paths. Since diversified economies are the building blocks of a dynamic trading system, it is essential that trade policies and rules – at all levels – support this agenda. Cutting through the Gordian knot of existing regional trade and investment agreements and building more productive forms of integration among neighbouring countries offers a way forward for developing countries. There is also a case for new global rules in areas of particular interest to developing countries, including for commodity markets and the effective transfer of technologies.

26. An inclusive development agenda cannot depend on economic policies alone. Under FDG, the stresses and burdens of unregulated markets have, all too often, been shifted to individuals and households and, in countries where social welfare systems exist, to government budgets. In many cases, unprecedented increases in income inequality have gone hand in hand with underfunded public services and rising levels of household indebtedness. The resulting cost to economic security and social cohesion has been enormous. Even when growth has accelerated, as it did in many developing countries between 2002 and 2008, too many people were left behind. A balanced economy depends on a strong social compact which, in turn, requires a range of universal and targeted social policies, tailored to specific circumstances, to ensure that the benefits of growth are widely enjoyed and its risks are shared fairly.

27. The crisis has confirmed UNCTAD's long-standing insistence on the importance of policy space. Its role in building new and more inclusive development paths cannot be understated. This is needed to allow governments – particularly but not only in developing countries – to correct market failures, promote collaboration among enterprises in areas of long-term investment, manage integration with the global economy, and ensure that the rewards from doing so are evenly shared. In order to do so, states must forge a coherent and inclusive developmental vision and build a strong compact with different interest groups to better manage the conflicts and trade-offs that change inevitably brings. Effectiveness also hinges on a more integrated approach to policymaking which not only links macroeconomic, sectoral, trade and financial policies in support of growth and development, but also brings together economic, environmental and social policies, leading to sustainable and inclusive outcomes. Accordingly, in this report, I will stress the critical role of the developmental state in building balanced growth paths in an economy where the mobilization and allocation of resources relies on market forces.

28. This should not be taken to imply that states never fail. Indeed, accountability, transparency and the rule of law are just as important for making states sufficiently representative as they are for making markets sufficiently stable. However, when we compare success stories from North America to Scandinavia to East Asia, we find that market economies can operate within a wide spectrum of social and political arrangements, and that, beyond a few core principles, there is no single model of state–market relations for others to emulate. Each country must be able to experiment and discover what configuration of institutions and governance works best in its circumstances and in line with the expectations of its population.

29. Responsibility for the choice of policies to secure a prosperous, fair and stable future remains to a large extent with national governments, institutions and constituencies. However, in our interdependent world, a more secure and inclusive global economy requires strong international leadership and carries collective responsibilities. There are hard questions to answer about whether current arrangements can help to build socially inclusive alternatives to FDG, and what governance structures might support DLG. UNCTAD XIII in Doha provides an opportunity for the international community to discuss these challenges in a frank, open and constructive manner.

30. This report is presented in three parts. The first sets out some of the main features of FDG and suggests that its outcomes have been much more uneven, unstable and unfair than



its proponents had claimed or expected. It also shows that there has been a systemic failure to create the economic environment needed to promote productive investment and employment. However, this raises the question of why some countries have been able to grow strongly over the past two or three decades. This section seeks to account for that, and to draw lessons from their success.

31. The second part outlines a rebalancing agenda which aims to deliver lasting and inclusive development gains. It sketches a three-pronged strategy focusing on (a) building developmental states that are able to mobilize domestic resources, strengthen productive capacities and share the gains in an equitable manner; (b) creating more robust multilateral structures capable of forging collective responses to the challenges that countries will face in the years ahead, including those required to tame finance and to promote investment-led responses to climate change; and (c) strengthening regional ties, including through South–South cooperation, in order to enhance stability and open new growth opportunities.

32. The final section will argue that rebalancing is not a narrow technocratic challenge. A true break with the fundamentalist thinking underlying FDG will involve a change of attitudes, morals and values. Accordingly, this report insists on the importance of a normative agenda as an integral part of the broad-based rebalancing involved in the shift towards DLG.

## I. Finance-driven globalization and its limits

### A. Introduction

33. Liberal political economy has long linked the spread of commerce to economic prosperity, personal liberty and the control of abusive state power. Its neoclassical offspring has provided a mathematically eloquent account of how unrestricted markets for goods, assets and factors of production can generate efficiency gains and bring macroeconomic stability by tying relative prices to global scarcities. Proponents of neo-liberal globalization have often claimed that these forces, in combination with advances in information and communication technology, have been propelling the global economy in the direction of a borderless world, and that policymakers, particularly in developing countries, should not resist this epochal shift: indeed, conventional economic logic suggests that developing countries will be the main winners in this “flatter world”.<sup>1</sup>

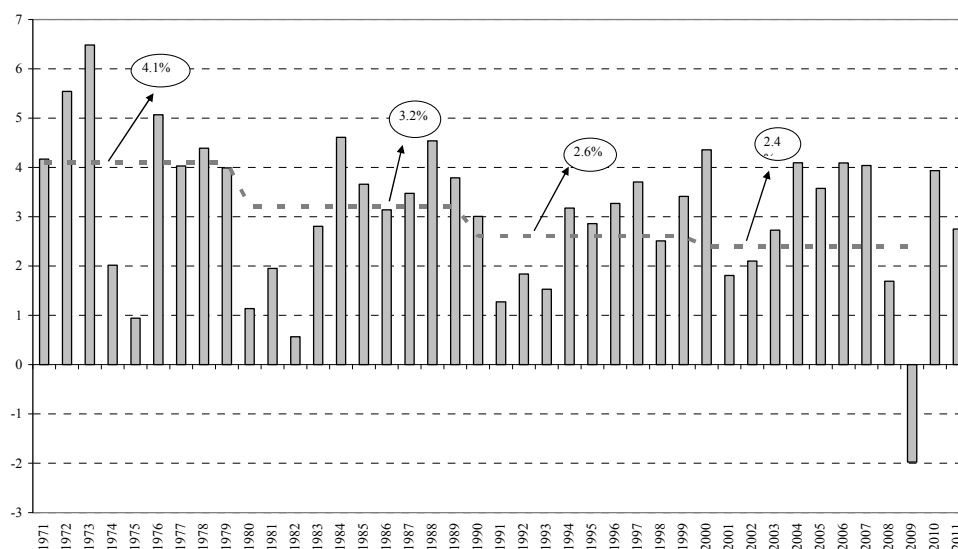
34. Expanding trade and advances in information and communication technology have certainly been important in connecting and shrinking the world over the past thirty years. However, these were also prominent features of the post-war era of regulated market capitalism. In contrast, the main drivers of recent economic transformations have been financial markets and a finance-friendly policy environment. Pressure for financial and capital account liberalization has been justified by the argument that this would raise domestic savings, improve resource allocation and spur productive investment, particularly in capital-scarce developing countries.<sup>2</sup> Despite these ambitious promises, the rewards from FDG for most countries and communities have fallen short of expectations. Global growth has slowed down in recent decades (fig. 1), become more unbalanced, and been frequently punctuated by crises. These crises have been particularly prevalent in the developing world (fig. 2), but they have been growing steadily larger in the advanced economies, culminating in the deepest economic collapse since the Great Depression.

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<sup>1</sup> In his keynote speech to the 2005 Labour Party conference, the then British Prime Minister Tony Blair summed up the conventional view of globalization when he chastised those wishing to debate it: “You might as well debate whether autumn should follow summer. They are not debating it in China and India. They are seizing its possibilities in a way that will transform their lives and ours ... In the era of rapid globalization, there is no mystery about what works – an open liberal economy prepared constantly to remain competitive. The new world rewards those who are open to it.” Full text of speech available at [http://news.bbc.co.uk/2/hi/uk\\_news/politics/4287370.stm](http://news.bbc.co.uk/2/hi/uk_news/politics/4287370.stm). On a more technical level, the globalization debate involves the links between economic convergence and openness; see TDR (1997) and Rodrik (2011b).

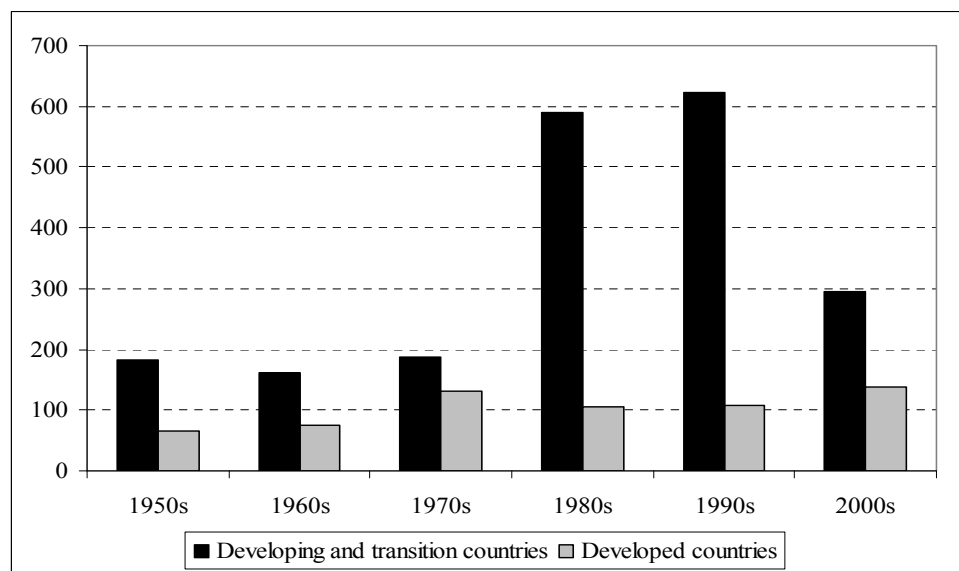
<sup>2</sup> See Mishkin (2006) for a standard account. In what follows, domestic financial liberalization includes the removal of controls on interest rates, the elimination of credit controls and restrictions on foreign currency deposits, and the liberalization of the stock market to allow foreign investors to buy, earn income from and sell equities without restriction. Capital account liberalization describes the unification of the exchange rate and the removal of regulations on capital outflows and offshore borrowing by financial institutions and non-financial corporations.

Figure 1  
**The slowdown in global economic growth, 1971–2011**  
 (annual and decadal average, percentages)



Source: UNCTAD secretariat, based on UNCTADStat. For 2011, forecast by UNCTAD.

Figure 2  
**Number of financial crises, 1950–2009**



Source: UNCTAD secretariat. Based on Reinhart and Rogoff (2011).

Note: Financial crises include banking crises, currency crashes, domestic default (or restructuring), external default (or restructuring), and stock market crashes.

35. This first part of the report examines the rise of FDG and its two-fold legacy. On the one hand, it has fostered imbalances, instabilities and inequalities which have damaged development prospects. These must be systematically tackled at all levels to allow more inclusive development paths to emerge. On the other hand, new growth poles have emerged in the South which have proved resilient in the face of the crisis. Paradoxically, that is because they have been able to resist many of the policies and principles of FDG.

## **B. Development matters**

36. After the Second World War, advanced-country governments concluded that balanced and coordinated expansionary policies, increased provision of public goods and services and appropriately designed multilateral arrangements in trade and finance offered the best way to secure domestic stability and prevent the return of the waste and destruction of the interwar years (*Trade and Development Report (TDR)*, 2004). The consensus allowed for a range of instruments to achieve these goals, from indicative planning to aggregate demand management to steady trade liberalization and relatively strict capital controls. These tools allowed the authorities to manage government finances counter-cyclically, to target industrial support, and to direct credit according to domestic policy goals, while international agreements permitted measured adjustments to balance-of-payments difficulties and guarded against the build-up of systemic risks. The outcome was a period of unprecedented growth driven by investment and rapid technological progress, often linked to strong export demand, and underpinned by full employment and rising wages.

37. This proved a favourable environment for growth and development in poorer countries, many of which achieved political independence during these years. However, developing countries faced additional challenges during this period due to their low incomes, limited productive capacities, import dependence, technological backwardness and institutional handicaps – in many cases inherited from the colonial period. These challenges had been neglected in the original design of the post-war trade and financial system, and existing international arrangements were unable to close these countries' widening gaps with the advanced economies. In particular, no global institution was tasked with the stabilization of primary commodity prices while the promotion of development cooperation had been added to the objectives of the International Bank for Reconstruction and Development as an afterthought.<sup>3</sup>

38. Even so many developing countries were able to adopt "big push" strategies in an attempt to trigger rapid economic growth and growth accelerated across the developing world (table 1). In some cases (e.g. the East Asian "tiger" economies) these strategies had a strong export orientation while, in others (such as in Latin America and in most of the newly independent African countries) they were linked to import-substitution industrialization or to Soviet-type planning. Despite differences in their initial conditions, the common constraints on catch-up growth in developing countries helped focus the early policy debates on international measures to support faster growth by providing long-term

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<sup>3</sup> While the original charter for an International Trade Organization contained a more ambitious mandate linking trade, macroeconomic and financial policy issues, the rules-based system of trade negotiations to eliminate discriminatory bilateral agreements through the application of unconditional most favoured treatment was all that survived in the form of the General Agreement on Tariffs and Trade (GATT). At the same time, the Marshall Plan offered an ambitious approach to development cooperation. But this did not survive the recovery of Western Europe.

finance and foreign exchange.<sup>4</sup> Looking back from the vantage point of the last three decades, it is clear that, despite their flaws and limitations, the achievements associated with these strategies were often impressive.<sup>5</sup>

Table 1

**Average annual per capita growth, by region, 1950–2010 (PPP)**

	World	Developed countries	Developing countries	South Asia	East Asia	South-East Asia	Latin America	Middle East	Sub-Saharan Africa	Transition countries
1951–1959	2.6	3.3	2.7	1.3	4.8	2.5	2.1	2.8	1.7	3.1
1960–1969	3.4	4.7	2.6	2.0	1.5	2.1	2.7	4.4	2.0	4.1
1970–1979	2.4	3.1	3.6	0.7	5.3	4.6	3.6	4.8	0.9	2.7
1980–1989	1.6	2.5	2.2	3.8	6.6	3.1	-0.4	-1.3	-1.2	0.8
1990–1999	1.9	2.0	3.2	3.9	6.0	3.6	1.3	1.6	-0.7	-4.2
2000–2009	2.9	1.1	5.8	5.6	10.2	4.2	2.0	2.8	3.4	6.0
2010	4.1	2.0	6.3	6.0	9.0	5.6	4.4	3.1	2.9	3.8
<b>MEMO</b>										
2000–2008	3.3	1.7	6.1	5.7	10.6	4.7	2.6	3.2	3.7	7.5

Source: The Conference Board (2011). *Total Economy Database*. January. See <http://www.conference-board.org/data/economydatabase/>.

39. These experiences have contributed to the emergence of a vast literature contrasting country experiences and searching for general lessons of growth and development.<sup>6</sup> A series of empirical regularities or “stylized facts” have been identified across countries and over time, which help to frame the development policy challenge. First, the process of development draws on underutilized labour and capital to transform the pattern and composition of economic activity and achieve a rapid rise in productivity, which is a sine qua non for cumulative improvements in living standards. Sustaining the transformation requires large-scale coordinated investment to create a more complex and diversified output matrix, including a steadily more sophisticated range of tradable goods and services.

40. Second, these structural transformations are associated with a shift of the population from rural to urban areas and a constant reallocation of labour within the urban economy to higher-productivity activities. Agricultural employment declines as mechanization spreads into the primary sector, while mutually reinforcing links between output growth and

<sup>4</sup> In the discussions of the ITO, the difference was clearly recognized between financing required to meet imbalances created by long-term development needs, and the provision of liquidity needed to meet shorter-term cyclical international payments imbalances. The thread was picked up a decade later around the debate on a Special United Nations Fund for Economic Development (SUNFED), but a softer lending window was eventually added to the World Bank through the International Development Association (IDA). However, the first comprehensive agenda was set out by Raúl Prebisch in his report to UNCTAD I entitled “Towards a new trade policy for development”, in which it was recognized that trade and finance had to be approached as “interdependent elements” managed through an integrated policy framework supporting growth and structural change, and backed by appropriate international cooperation. See Toye and Toye (2004) for a useful discussion of the intellectual and political origins of the UNCTAD agenda and its evolution.

<sup>5</sup> According to UNDESA (2006: 11), in the 1960s and 1970s, 50 of 106 developing countries included in UNDESA’s analysis experienced sustained expansion, defined as four consecutive five-year moving average periods with income growth above 2 per cent per capita. See also Maddison (2001) for a useful comparative assessment of how the different developing regions performed during this “golden age”.

<sup>6</sup> See Ocampo et al. (2009). Kenny and Williams (2001) provide an overview of the growth regression literature; they note that well over 100 variables have been subjected to millions of regressions with what they call “disappointing results”.

productivity growth help the manufacturing sector to absorb an expanding labour force before industrial employment begins to decline at higher income levels. Complementarities between services and manufacturing ensure a steady rise in employment and output in transportation, energy, finance and the provision of public goods.

41. Third, the evolving pattern of production is influenced by geographical location, resource endowments, market size and institutional conditions, with some combinations being more conducive than others to structural transformation and rising incomes. Successful countries tend to have high savings rates, a large share of manufacturing output in gross domestic product (GDP) and a high profit share in manufacturing. These mutually supporting features point to the importance of the strong profit–investment nexus in establishing a sustainable development path.

42. Fourth, technological learning and upgrading help to raise productivity and build dynamic trading advantages. The challenge for most developing countries is to adapt existing technologies to local conditions as much as making major technological breakthroughs. Because the market underinvests in knowledge and because the technological gap between early and late developers tends to widen over time, active public support is usually needed to strengthen local learning and research capacities, build human capital, and create a more collaborative environment in support of innovation.

43. Fifth, sustained prosperity depends on rising per capita income and on improvements in social welfare which, in turn, require appropriate social policies. Since markets tend to misprice the returns from investment in public goods, for example health and education, inclusive development requires extensive state intervention and public sector investment. These policies help to turn a national development strategy into a broader social consensus. The required policies and institutional support do not exist in the abstract, but are rooted in local conditions and preferences. Nor are they fixed in time, but must adapt and evolve in line with changing economic and political circumstances.

44. Putting these elements together requires a coherent strategy which can help policymakers, at the national and international level, to see development as “a movement upward of a whole system of interdependent conditions” (Myrdal, 1970) and to strengthen the linkages required to trigger circular and cumulative growth and development circles. The importance of institutions and policies necessarily ties the effectiveness of these development strategies to domestic resource mobilization and capacity-building. However, the fact that this search must take place against the backdrop of an interdependent world economy necessarily complicates policy choices. Indeed, correcting the biases and asymmetries that continue to structure that world remains key to whether or not policymakers in developing countries can deliver inclusive and sustainable growth and development.

### **C. The emergence of finance-driven globalization**

45. Weaknesses in the post-war growth model emerged in the late 1960s through distributional struggles, energy crises, inflationary pressures and balance-of-payments difficulties that, eventually, triggered policy responses which reinforced a sharp cyclical downturn in the late 1970s. Efforts to circumvent some of the controls put in place in the post-war period began with the emergence of a Eurodollar market in the 1960s through the overseas expansion of United States financial institutions. In 1964, this market had gross deposits of \$19 billion; these reached \$86 billion in 1970, and \$1.5 trillion by 1980 (Panic,

1996: 65).<sup>7</sup> However, it was the collapse of the Bretton Woods system in 1973 that opened the way to the global dominance of financial markets. From the mid-1970s, the advanced countries began to deregulate their financial systems and reduce capital controls, in part to help finance the rising United States current account deficit and, increasingly, believing that unregulated financial markets would improve the mobilization and allocation of savings, extinguish inflationary pressures, and stimulate economic growth.<sup>8</sup>

46. The shocks that hit developed countries during the 1970s had significant implications for developing economies, including a first boom in private capital flows.<sup>9</sup> However, in the late 1970s, restrictive macroeconomic policies in the advanced countries exposed significant fragilities in developing economies that had failed to address consistently their problems of domestic resource mobilization and balance-of-payments sustainability.<sup>10</sup> Growth stalled, particularly in Latin America and sub-Saharan Africa, and several economies collapsed after the lending freeze following Mexico's default, in August 1982.

47. The collapse of these earlier growth strategies opened the way for a very different policy agenda, beginning in the advanced countries, that attributed macroeconomic and balance-of-payments difficulties to price and other market distortions, financial repression, trade protection, overvalued exchange rates, and "overly generous" social policies. This diagnosis was worked into ambitious reform packages for developing countries to "roll back the state" and "liberate" markets by means of privatizations, trade and exchange-rate liberalization, fiscal discipline, tax cuts, tight monetary policy and labour-market flexibility.

## 1. Financialization

48. The initial case for unleashing global market forces was strongly tied to the perceived benefits of trade liberalization and global market competition. In essence, what was being offered was the realization of a self-regulating market order. The Bretton Woods institutions were in the forefront of efforts to promote this vision among developing countries – an approach that was subsequently labelled the "Washington Consensus".<sup>11</sup> However, trade openness was never the strongest basis for advancing this programme, if only because the advanced countries did not themselves follow the advice consistently.

<sup>7</sup> This explosive growth was indicative of the later proliferation, growth and global interpenetration of private financial institutions, often trading novel assets in new markets. Just as telling of things to come, already in the late 1960s the United States economy witnessed the first wild ride of hedge funds, a wave of M&As, a stock market boom, and ballooning credit card and instalment debt. See Phillips (2008: 33).

<sup>8</sup> For a discussion of the economic and political pressures behind financialization in the United States, see Krippner (2011).

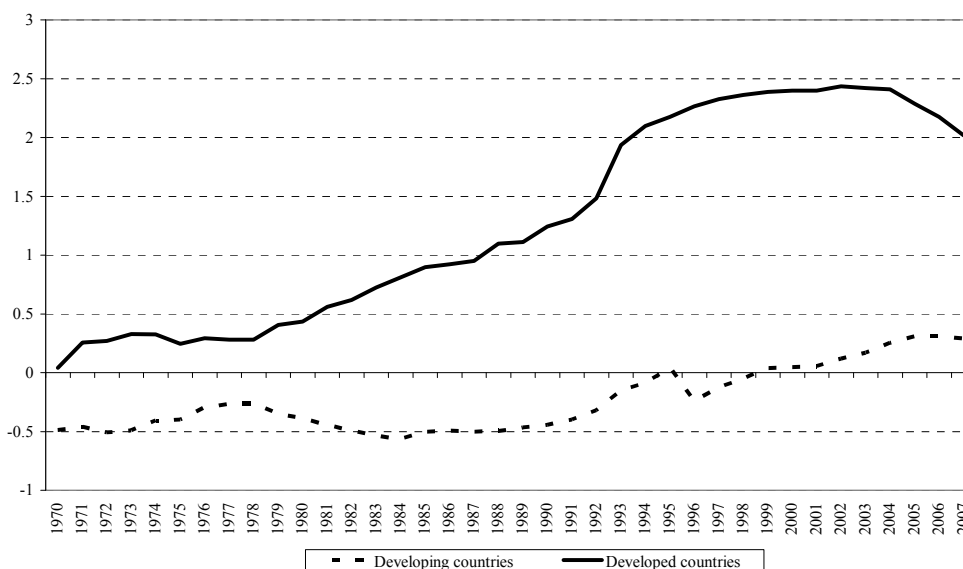
<sup>9</sup> This boom was associated with recycled oil surpluses, the first round of financial deregulation, and booming eurodollar markets. Excess liquidity was recycled in the form of dollar-denominated syndicated bank credits at variable but, for a time, low or even negative real interest rates. Latin America was the main recipient of these currency flows. See TDR (1985) for a detailed discussion.

<sup>10</sup> On the breakdown, see TDR (2004) and Glyn (2006, chs. 1 and 2).

<sup>11</sup> There had been a growing body of research inside the Bretton Woods institutions from the late 1960s which focused on the market-distorting impact of policy interventions in the areas of agriculture, trade and finance; this was associated with the work of Schultz, Little, Scitovsky and Scott, McKinnon and Shaw, Krueger and others. The tenor of this work was to promote the view that government failures are always a greater obstacle to development than market failures; see Krueger (1990). The nature and impact of the resulting adjustment packages have been extensively discussed in the volumes published by UNCTAD and the G-24 in the *International Monetary and Financial Policy Issues for the 1990s* collection and in the subsequent G-24 *Discussion Papers* series.

Instead, attention quickly turned to financial liberalization and capital account openness.<sup>12</sup> These policies spread quickly across the developed countries and, with the strong backing of the international financial institutions, in the developing world too (fig. 3).

Figure 3  
**Evolution of de jure capital account openness in developing and developed countries, 1970–2007 (simple average)**



Source: UNCTAD secretariat. Based on the index proposed by Chinn, Menzie and Ito (2008) in the paper entitled “A new measure of financial openness”. *Journal of Comparative Policy Analysis*. 10 (3): 309–322. September. This measure of de jure capital account openness is an index ranging from -1.83 to 2.5.

49. The increasing significance of finance in shaping the global economy can be gauged from a comparison with the evolution of trade flows. In 1970, the average trade openness (exports plus imports divided by GDP) of the developed economies was around 0.5, and by 2007 it had increased, by 60 per cent, to 0.8 (fig. 4). During the same period, these countries’ average financial globalization (total foreign assets plus total foreign liabilities divided by GDP) rose by 800 per cent, from 0.5 to 4.8. In the developing countries, trade openness and financial globalization also started at similar levels, with indices of approximately 0.4. During the same period, the index of trade openness rose by 100 per cent, while financial globalization increased by 250 per cent.<sup>13</sup>

50. This worldwide policy shift has been accompanied by an explosion in cross-border financial flows. While in net terms the scale of flows is not unprecedented, the extent of gross flows has no historical parallels. Daily foreign exchange transactions rose from \$80 billion in 1980 to \$600 billion in 1989, and to almost \$4 trillion in 2010. The ratio of global capital inflows to global GDP rose from 3 per cent in the early 1980s to over 20 per cent in

<sup>12</sup> Many of the more ardent supporters of trade openness have been sceptical about liberalizing finance in developing countries, calling for a careful “sequencing” of the reform agenda which would discriminate between good and bad capital flows. However, in terms of textbook logic, “the principles of international factor movement do not differ in their essentials from those underlying international trade in goods” (Krugman and Obstfeld, 1997: 159).

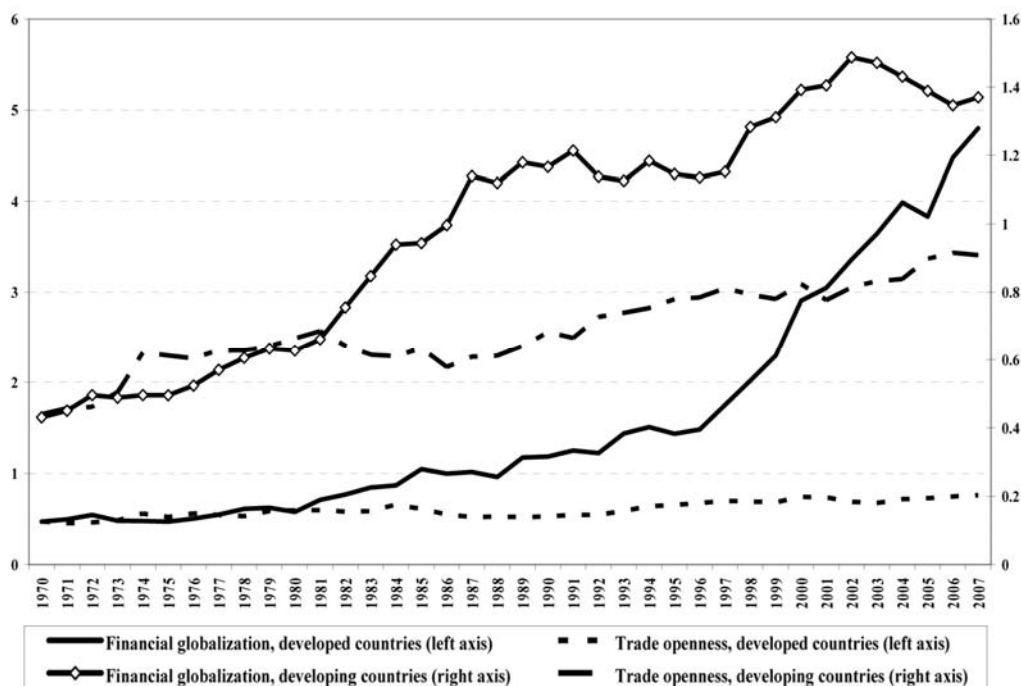
<sup>13</sup> The same also holds when comparing financial globalization with foreign direct investment, although the latter rose faster over the first decade of the new millennium.



2007. In 2006, the value of global financial assets was almost three-and-a-half times global GDP; while advanced countries dominated, the share of emerging markets had more than doubled since 1995, to 14 per cent. Finally, cross-border mergers and acquisitions (M&As) rose from \$98 billion in 1990 to \$1 trillion in 2007, especially in banking, insurance and other financial services.

Figure 4

**Financial globalization and trade openness in developing and developed countries, 1970–2007 (simple average)**



Source: UNCTAD secretariat, based on Lane and Milesi-Ferretti (2006) and on the World Bank's *World Development Indicators*.

Note: Financial globalization is the ratio between the stock of foreign assets and liabilities and each region's GDP; trade openness is trade flow (exports plus imports) divided by the region's GDP.

51. The growing influence of financial markets and institutions has been called "financialization". This describes a structural shift in the organization of economic activity along with changes to economic, political and cultural behaviour, which together have altered profoundly the way in which wealth is produced and distributed. These include:

- (a) The increasing proportion of national income accruing to the financial sector, including the rapid growth of the remuneration of high-ranking financiers. In the United States and the United Kingdom, the financial sector accounts for one third of total activity, compared with one fifth or less in the late 1970s, with the average for the Organization for Economic Cooperation and Development (OECD) countries being in the high twenties.<sup>14</sup>

<sup>14</sup> The OECD classification includes financial intermediation, real estate, renting and business activities; for a discussion of measures of financialization, see Freeman (2010).

- (b) The growth, complexity and increasingly speculative nature of the activities mediating between savers and investors, accompanied by an explosive build-up of debt both on a global and personal level. Rising financial sector leverage has been supported by the proliferation of esoteric financial products and corresponding markets, and the emergence of “shadow” financial institutions. By the middle of 2007, the systemically important European banks had a leverage ratio of 45 to 1, while for United States banks it was about 34 to 1.<sup>15</sup>
- (c) The channelling of entrepreneurial energies into devising new financial products and processes to manage the risks accompanying increasing levels of indebtedness; financial innovation has come to dominate technological innovation as the way to transform growth prospects by expanding consumer choice and boosting the efficiency of capital.<sup>16</sup>
- (d) The growing claim that the rights of the owners of financial assets are beyond social accountability, the imposition of shareholder value as the principal gauge of corporate performance, and the extension of financial market calculations into expanding areas of economic and social life, including pensions, education, healthcare, infrastructure provision and food supply.
- (e) The validation of economic policies by reference to financial market interests, measured by performance indicators devised, managed and endorsed by the financial institutions themselves, including the strength of stock markets, returns from real estate investments, the scale of M&As etc. As finance has expanded its command over global resources and tightened its grip upon policymaking, the measures of economic “success” have become increasingly disconnected from the drawn-out pressures of making productive investments, raising productivity levels and creating jobs.

52. The uneven impact of these trends on growth and development will be examined in greater detail below. However, a near-universal feature accompanying FDG has been a sharp rise in income and wealth inequality. This is important because, in addition to its moral implications, growing inequality can damage social well-being, threaten economic stability and undermine political cohesion (Wilkinson and Pickett, 2009). Textbook economics usually describes a trade-off between growth and equality. In examining this trade-off, economists have paid a good deal of attention to whether it is trade or technology that has been the principal link between globalization and rising income inequality, and whether the general (efficiency) gains outweigh local costs (in terms of income or employment losses), and if so, how best to compensate the “losers”. The discussion has not proved conclusive, however, in part because this trade-off is difficult to reconcile with the wide experience across countries in terms of the timing and scale of these different aspects of globalization (TDR, 1995; Jaumotte et al., 2008), along with familiar methodological

<sup>15</sup> “Another way of looking at these ratios is to say that they represent the amount of the bank’s assets which have to go bad for the bank to be insolvent. In the United States, on average, if one thirty-fifth of the bank’s assets went bad, the bank is bust ... This is obviously a highly precarious position. It was also no accident, because those risks were also the reason why the banks had a boom period” (Lanchester, 2010: 25–26).

<sup>16</sup> See Greenspan (1998). For a different assessment of the impact of financialization on entrepreneurship in the United States, see Kedrosky and Stangler (2011) and Lazonic (2011).

problems in measuring global inequality.<sup>17</sup>

53. Understanding the rise of inequality under FDG needs instead to look more carefully at functional income dynamics, and in particular the divergence between wage and productivity growth, the imperatives of shareholder value and executive compensation in shaping corporate behaviour, and the regressive turn in taxation. Unfortunately, consistent cross-country and time series data are quite difficult to obtain. However, the wage share has declined in 17 out of 24 countries with data going back to the early 1980s (ILO, 2011), and in some systemically important countries, the concentration of income and the share of profits have returned to levels last seen in the 1920s (TDR, 2010; Galbraith, 2011). Across most countries, the top income strata (in some cases just the top 1 per cent of the population) have seen the biggest (and in some cases the only) gains from boom conditions, capturing higher rentier incomes through capital gains and interest payments than would have been possible under more regulated financial structures, or even conceivable barely a generation ago (Davies et al., 2006). Capital mobility has made it harder to tax, reducing the bargaining power of labour and increasing the state's reliance upon regressive taxes and bond markets, further amplifying the adverse distributive impact of FDG (Jayadev, 2007). A growing body of research has begun to tie the scale of the current crisis to these inequalities, pointing to their skewed impact on the composition of demand, incentives that promote paper over real investments, and, above all, their links to an increasingly fragile debt-driven growth model.<sup>18</sup> Milanovic (2011: 196) summarizes the destructive logic:

The root cause of the crisis is not to be found in hedge funds and bankers who simply behaved with the greed to which they are accustomed (and for which economists used to praise them). The real cause of the crisis lies in huge inequalities in income distribution that generated much larger investible funds than could be profitably employed. The political problem of insufficient economic growth was "solved" by opening the floodgate to cheap credit. And the opening of the credit floodgate, to placate the middle class, was needed because in a democratic system an excessively unequal model of development cannot exist with political stability.

## 2. Debt-driven growth

54. In countries pursuing strong adjustment policies or otherwise committed to FDG, inflation has declined, trade and capital inflows have risen, and firms have become more competitive, giving rise by some accounts to a "great moderation" of steady and sustainable growth. However, even before the recent crisis hit, this did not adequately describe the reality of FDG which, over the last thirty years, has given rise to uneven and unstable growth in both developed and developing economies, around a slowing global trend, severe macroeconomic imbalances including sluggish investment, periodic consumption booms, declining savings rates, exchange rate misalignments and current account imbalances.

55. The feature holding these developments together, while adding to the systemic fragility of FDG, has been mounting levels of debt, especially in the more heavily financialized advanced economies. Average debt-to-GDP ratios in the leading industrial economies increased by 50 per cent between 1995 and 2008, to over 300 per cent, with spectacular rises in such countries as Iceland and Ireland. This trend has been registered

<sup>17</sup> It is widely assumed that wealth is even more unevenly distributed than income (WIDER, 2006). The global pattern of inequality since 1980 is a composite and complex combination of the trend within countries, the divergence in country mean incomes, and growth and distribution dynamics in the world's two most populous countries of China and India. For a discussion of how these factors have contributed to the global pattern of inequality over the past 30 years, see Milanovic (2011).

<sup>18</sup> See, for example, Kumhoff and Ranciere (2010).

across all sectors, however the build-up has been concentrated in households and financial institutions, as typified by the figures for the United States (table 2).<sup>19</sup> The trend, as suggested earlier, has been closely linked to rising levels of inequality (and particularly a falling wage share).

56. The fragility accompanying the accumulation of trillions of dollars in debt has been compounded by an even larger volume of financial bets through derivatives and other complex instruments, justified by arguments that these would minimize systemic risk, and supported by the idea that efficient markets do not make mistakes. On the basis of this lending activity, not only did the profitability of financial institutions rise sharply but non-financial firms also became increasingly dependent on financial activities for their revenue flows, including lending to governments whose own revenue flows were being squeezed, in many countries, by a combination of slow wage growth and tax cuts.

Table 2

**United States: credit market debt outstanding, by sector (billions of dollars)**

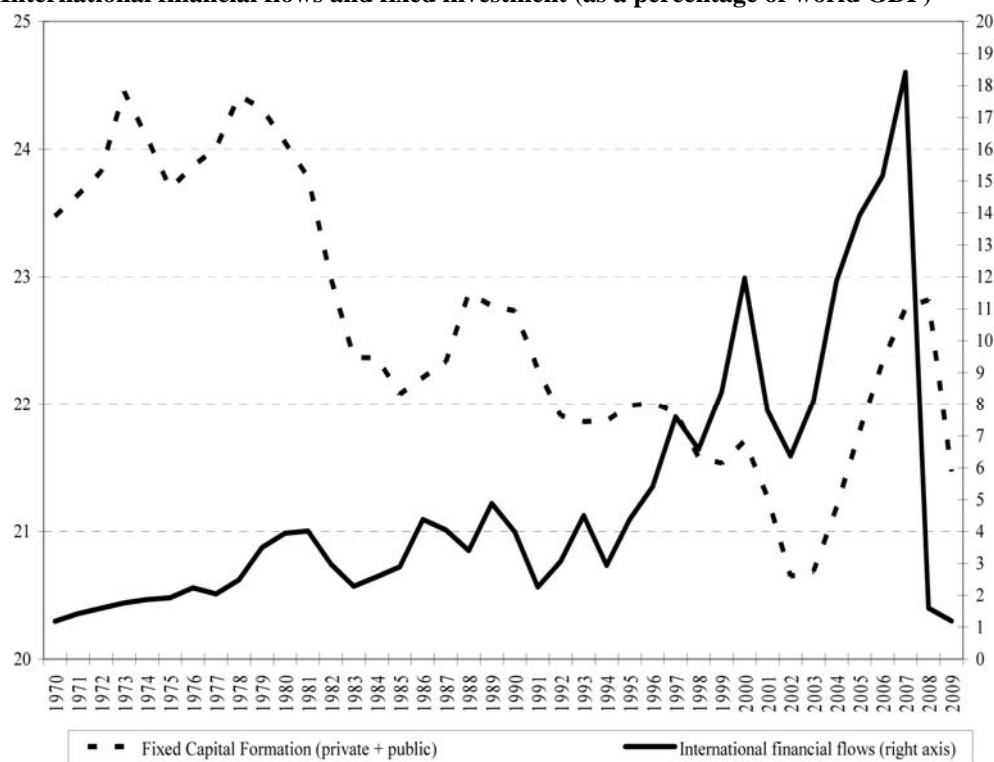
	1974	1984	1994	2004	2010
Domestic financial	258	1 052	3 791	11 936	14 171
Foreign financial	81	233	443	1 439	2 115
Total non-financial business	821	2 315	3 842	7 791	10 876
Total household	680	1 944	4 532	10 576	13 386
Federal government	358	1 364	3 492	4 395	9 386
State and local government	208	514	1 107	1 683	2 465
Total United States financial and non-financial debt	2 406	7 422	17 207	37 820	52 399

Source: United States Federal Reserve (2011). *Flow of Funds*. D3. 9 June.

57. In this new growth model, the codependence between finance and the real economy and between the state and the market, which characterized successful post-war models, has given way to one in which unchecked financial markets and mounting financial leverage drive the real economy. This shift has led to a change of consumption behaviour, which has become tied to rising asset prices and access to credit, and, at the firm level, to the channelling of rising profits towards short-term investments. Indeed, the mushrooming of mostly short-term cross-border capital flows over the past two decades has done little to help get worldwide capital formation back to the levels of the 1970s (fig. 5). The inconsistency of the model is particularly clear with the accumulation of debt in the public sector, which has often been associated with a sharp slowdown in public investment. Much of the debt has been contracted to finance current spending and transfer, including interest payments. The combination of increased public debt and reduced investment suggests that the debt does not correspond to an equivalent build-up of productive capacity capable of producing additional revenues for its servicing. At the same time, the distinction between public and private debt has often been blurred, as states have stepped in to salvage financial institutions that were judged too big to fail (Reinhart and Rogoff, 2011).

<sup>19</sup> Household debt is difficult to measure, and international comparisons suffer from data deficiencies. However, all advanced countries saw rising debt ratios from the 1990s onwards; the countries that saw a 50 per cent or more rise between 1995 and 2005 (in terms of percentage of disposable income) include Ireland, Italy, the Netherlands, Spain and the United Kingdom. See Stockhammer (2008).

Figure 5  
**International financial flows and fixed investment (as a percentage of world GDP)**



Source: United Nations Department of Economic and Social Affairs (UNDESA). Based on the *National Accounts Main Aggregates* database (United Nations Statistics Division) and *International Financial Statistics* (International Monetary Fund).

58. The financialization trends that had been building up after the collapse of Bretton Woods moved up a gear at the start of the current century. In response to the destruction of trillions of dollars in equity values during the dotcom crisis, the United States and other advanced countries loosened up their monetary policies, fuelling an unprecedented debt-driven boom. Consumption expanded, particularly in the United States, on a wave of (more or less shady) financial trading predicated upon permanently rising houses prices (TDR, 2006). At the same time, several emerging developing countries, especially in East Asia, which had already experienced the downside of FDG, were gearing up to accumulate substantial foreign currency reserves to protect themselves against future shocks. Global growth picked up through this combination of factors, notably in developing countries, but the underlying macroeconomic imbalances widened rapidly. The resulting leveraging and maturity mismatches set the global financial system onto the path to unsustainable financial fragility.

59. By 2005, the value of global financial assets had reached \$140 trillion, three times the size of global output; growth rates – ultimately the basis for servicing the underlying debt – had failed to keep pace, especially in the more financialized economies. Instead, increasing leverage, accompanied by a plethora of new financial instruments, encouraged the acquisition of more debt to cover existing commitments. In several systemically important countries, the monetary authorities found themselves compelled to support implausibly high (and continually rising) asset prices in order to maintain household solvency and financial stability. In the process, central banks lost control of global liquidity

and the ability to use interest rates to influence either the pace of debt accumulation or the rhythm of capital formation (Krippner, 2011: ch. 5).

60. An early sign of the problems with this growth model was the rising “global imbalances” between surplus (largely the United States) and deficit (more dispersed but led by China, Germany and Japan) countries, which emerged in the mid-1990s and escalated dramatically in the new millennium. This has been much discussed with an eye to parcelling out blame, but the rather obvious truth is that in a world where one group of countries produces more than it can absorb and the other generates global demand and absorbs more than it produces, then both sides depend on each other (Priewe, 2010). The global picture was further complicated by the special status of the dollar, which disguised the recycling of domestic credit creation in the United States through rising imports, the channelling of international reserves into United States financial markets, and the perpetuation of asset price bubbles. In Western Europe, distinct national patterns of debt accumulation were observed, involving variations in domestic demand expansion and diverse combinations of public and private sector debt. Nevertheless, an equally unbalanced recycling process revolved around strong productivity, sluggish wages and domestic demand, and strong export growth, in Germany, together with slower productivity growth and rising absorption elsewhere (TDR, 2010).

61. The financial arrangements linking uneven demand growth, debt and capital flows are now weighing heavily on growth prospects in the advanced economies, as the battle between borrowers and creditors becomes “the defining struggle of the next generation” (*The Economist*, 24 June 2010). The threat of a deflationary spiral, in which falling incomes and asset prices add to the burden of debt while the expectation of further price declines discourages spending and leads to further economic contraction, continues to haunt policymakers. There is growing concern that an entire decade may be lost to deflation and stagnation, much like Japan’s experience in the 1990s.

62. Debt-driven growth in advanced countries shares some similarities with earlier external debt-led growth episodes in developing countries.<sup>20</sup> By contrast, robust output and export growth in developing countries since 2001 has reduced their debt-to-GDP, debt-to-export and debt service ratios.<sup>21</sup> At the same time, private capital flows to developing countries have undergone important changes regarding destination, size and composition. They are now more synchronized across countries than in the past, and the amounts involved are much higher and include significant resident outflows as well as increased South-South flows. Finally, the composition of inflows has shifted towards domestic currency-denominated financial instruments, including government bonds, equities, and carry trade-style borrowing, lending and investment.<sup>22</sup>

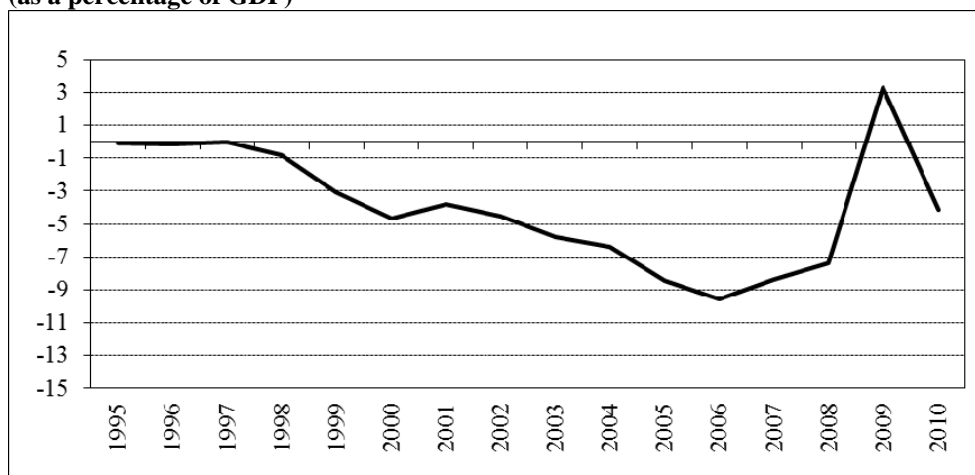
63. The growing denomination of external liabilities in their own currencies changes the nature of the risks associated with borrowing from non-residents, and in particular lessens the danger of currency mismatches in balance sheets, which played a key role in previous crises. However, these same developments could allow domestic financial markets to dictate growth patterns in these countries, and increases the risk of exposure to international contagion, while the use of developing-country current account surpluses to fund overconsumption in advanced countries can only be detrimental to long-term balanced growth (fig. 6).

<sup>20</sup> UNCTAD first described this growth model in the context of financial liberalization in developing countries (TDR, 1997), however it became even more prominent in advanced countries following the dotcom crisis.

<sup>21</sup> Developing countries’ external debt levels in terms of share of exports and GDP peaked in the late 1990s. Servicing ratios to exports and output peaked in 1999 and 2002, respectively.

<sup>22</sup> For an estimate and discussion of just how far this shift has gone, see Hausmann and Panizza (2011).

Figure 6  
**Net transfer of financial resources to developing countries, 1995–2010**  
 (as a percentage of GDP)



Sources: UNCTAD secretariat calculations, based on UNCTADStat and on UNDESA data on net transfers (*World Economic Situation and Prospects*, various issues).

Note: Net transfers are the sum of net capital flows, income payments, and changes in official reserves. The term “negative net transfers” means that exports of goods and services exceed imports, resulting in a transfer of the excess abroad by way of financial flows (debt servicing, profit remittances, foreign reserve accumulation, capital outflows, or withdrawal of foreign investors).

64. Financialization has also added new threats and vulnerabilities to growth prospects in developing countries, at three levels. First, the concentration of the commanding heights of finance in a few global hubs has magnified the impact of the policy and regulatory decisions taken in those economies, leaving other countries badly exposed. Second, countries borrowing to keep reserves, as self-insurance, risk heavy losses through the widely expected long-term devaluation of the dollar due to the protracted economic difficulties in the United States and its reliance on aggressively expansionary monetary policies to try to revive the economy. Third, finance has also penetrated global commodity and food markets, directly affecting the livelihoods of hundreds of millions of poor citizens in many developing economies (box 1).

#### **Box 1. The financialization of commodity markets**

Trends in commodity prices are a long-standing UNCTAD concern. In recent years, the focus has shifted away from adverse movements over long periods of time and towards the damaging consequences of price fluctuations. Long-term comparisons show that recent price volatility is not unprecedented for individual commodities; for example, the oil price volatility in 2008, while remarkable, remained well below its price spike in the early 1970s. Nevertheless, the speed and amplitude of the recent price swings for a broad range of commodities clearly distinguishes them from earlier ones. The magnitude of the most recent price upswing was above historical averages for food and metals, while the magnitude of the price rebound for oil was similar to historical averages but occurred at a higher speed.

Although it is difficult to fully assess the financialization of commodity trading due to the lack of comprehensive data, several indicators suggest that it is becoming an increasingly important driver of commodity prices. The value of commodity-related assets under management by financial investors

rose fivefold between 2005 and 2010, and has increased very rapidly since mid-2010, reaching a historic high of \$410 billion by March 2011. Similarly, the number of futures and options contracts outstanding on commodity exchanges started increasing rapidly in 2004, then dipped during the collapse of commodity prices in the first half of 2008, but then continued to increase at a rapid pace. By mid-2010, the number of these futures and options contracts had reached about five times their pre-2004 level.

It is also difficult to assess the impact on prices of the financialization of commodity trading, because it became influential roughly at the same time as the demand for commodities from the large emerging economies started increasing rapidly and when a growing interest in biofuels shifted the demand for some agricultural commodities from food to fuel. However, recent analysis shows that variables reflecting financialization remain statistically significant even after controlling for the influence of changing fundamentals, refuting the claim that growing demand from the emerging economies was the only driver of the commodity price hike in 2006–2008.

It is sometimes argued that the price impact of index investments is spurious because similar hikes could be observed for the prices of commodities that are not included in the main indexes. However, research shows that the co-movement between the prices of different commodities increased after 2003–04, and that for the commodities included in the major indices, this increase was significantly more pronounced than for those not included.

Information emanating from financial markets can lead to resource misallocation, because it contaminates the price discovery mechanism in the commodity markets and generates misleading signals for consumers and producers. Two arguments are traditionally put forward to defend the influence of financial markets on commodity price formation: that they help price discovery and that they provide liquidity. Neither of them is tenable where herd behaviour is pervasive. In this case, the price found by financial investors may be unrelated to supply and demand, and it is often the wrong price in view of the market fundamentals. Similarly, the provision of liquidity may also be invalid in markets that are subject to herding, that is, where many and powerful participants share the same information. If the participants have the same views and dispositions, price swings can be large, in response to simultaneous changes in the participants' views. Market distortions such as these, which are induced by the financialization of commodity trading, call for active policies to stabilize commodity prices (see box 14), and for a healthy scepticism about the purported "benefits" of financialization more generally.

For additional details, see UNCTAD (2011a).

### 3. Cycles, shocks and crises

65. The potential instability accompanying FDG was already exposed by the first "modern" financial crisis, which hit the Southern Cone of Latin America (Argentina, Chile and Uruguay) just a few years after the collapse of the Bretton Woods system. In a story that would subsequently become familiar, hasty liberalization of finance, trade and the capital account led to a massive build-up of foreign exchange liabilities by private financial and non-financial institutions, followed by financial and balance-of-payments collapse. The ensuing rescue operations involved state bailouts, bank nationalizations and the



socialization of private external debts. In a perceptive article, Carlos Díaz-Alejandro (1985) waved goodbye to a world of financial repression and said hello to one of (contagious) financial crashes, which would include the United States savings and loans crisis; financial collapses in Scandinavia; the 1987 stock market crash; the Japanese crisis; the emerging market crises of the 1990s, beginning in Mexico and rolling through East Asia to Latin America; the dotcom bubble; and the housing and financial bubble which exploded catastrophically in 2008.<sup>23</sup>

66. In retrospect, growth in financialized economies has often consisted of episodes of feverish speculation between crises. This has been fuelled by the combination of tight fiscal and monetary policies, and trade, financial and capital account liberalization. The ensuing current account deficits were normally financed with foreign capital inflows (foreign direct investment, privatizations and portfolio investment). These processes have, in some cases, been destabilizing, because they perpetuate currency misalignments regardless of the exchange rate regime, render potentially viable industries uncompetitive, destroy the established employment patterns, and fuel a succession of domestic credit and asset bubbles. As it unfolds, the cycle raises the economy's external vulnerability even as its "fundamentals" appear to improve. Mounting fragility often quickly turns to disaster through a sudden shift in capital flows and market expectations, leading to a collapse of the balance of payments and the exchange rate, followed by the insolvency of domestic banks, corporate bankruptcies, and rising unemployment. These crises have further worsened the distributive impact of FDG, since wages and employment drop sharply and poverty levels rise when crises hit (ILO, 2004). Recoveries under FDG often fail to make up these losses, especially where policymakers seek to return to business as usual by adopting austerity measures which reproduce rather than address the imbalances that arose during boom conditions.

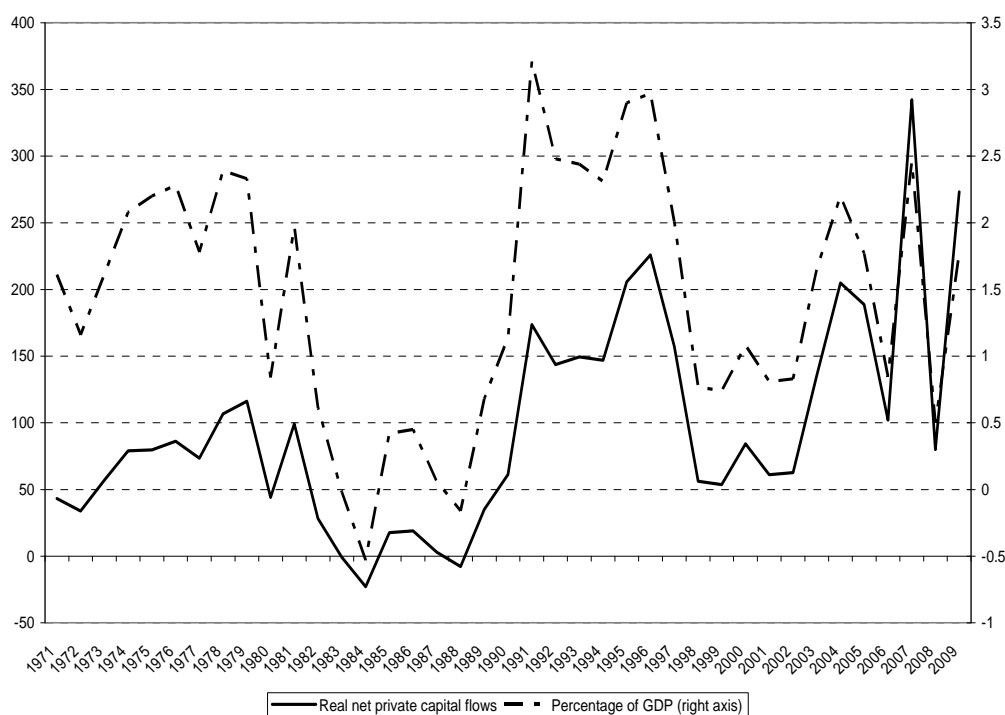
67. The developing world has experienced three full cycles of capital flows and crisis during the past thirty years, and is currently into the fourth (fig. 7). Each cycle has been closely tied to policy events in the major reserve-issuing countries, and defined by a specific type of capital flow which fostered particular vulnerabilities (TDR, 2001; TDR, 2009; and Akyüz, 2011). They illustrate the procyclical bias of the global financial system and the propensity of unregulated financialized markets to move in tandem, suggesting that asset prices are driven less by improved prospects of productivity or income gains than by potentially self-reinforcing expectations of price changes.

68. Cross-market linkages have appeared with a large variety of currencies, stocks and commodity derivatives, reinforcing herding behaviour across multiple asset classes. Hedge funds are widely believed to contribute to this process through the sharing of investment ideas and by using the same macroeconomic indicators to formulate their trades (Büyüksahin, Haigh and Robe, 2010). When information collected in one market or for the economy as a whole is used to form expectations about other markets and economies the danger of contagion adds to other systemic risks. This has been compounded by bank borrowing abroad to fund the expansion of domestic credit, derivatives trading and carry trade-style off-balance sheet short-term foreign exchange operations (see TDR, 2010).

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<sup>23</sup> The privatization of returns and the socialization of the costs of boom-and-bust cycles have been noted by various commentators; see Lanchester (2010) and Krugman and Wells (2011).

Figure 7  
**Real net private capital flows to developing countries (in billions of 2005 dollars and as a percentage of GDP, 1971–2009)**



Source: UNCTAD secretariat, based on Akyüz (2011).

Note: Real flows are nominal flows adjusted for changes in the United States GDP deflator. Developing countries does not include Central and Eastern Europe or the Commonwealth of Independent States.

69. As suggested earlier, rapid swings in asset prices, property values and exchange rates are likely to increase investment uncertainty, shorten planning horizons and promote defensive and speculative strategies which can influence adversely the pace and direction of economic growth and employment creation. This is particularly true in sectors that are susceptible to herding behaviour, such as residential and commercial real estate investment, although it can also happen in productive sectors, as was the case in South-East Asia in the run-up to the 1997 crisis (see TDR, 1996). UNCTAD has consistently argued that FDG and, specifically, trade and investment agreements, aid dependence and the conditionalities attached to international lending have increased the vulnerability of developing countries to shocks, crises and contagion, reduced their ability to respond to these challenges, and prevented the design and implementation of policies tailored to local needs and aspirations.<sup>24</sup>

70. These destabilizing trends have coexisted, albeit uneasily, with more promising developments driven by the large current account surpluses of the developing countries as a group. Even those countries running current account deficits have found it easier to attract capital inflows, although in some cases these have triggered a new form of Dutch disease, distorting their exchange rates and frustrating efforts to develop manufacturing industry and diversify domestic production and exports (TDR, 2011). Primarily for these reasons, the threat of “sudden stops” in capital flows has eased, especially in those developing countries

<sup>24</sup> See, for example, TDR (1998), TDR (2006), and LDCR (2009).

that have accumulated large reserves or that have been able to borrow in their own currencies. Nevertheless, in many countries, underlying structural weaknesses still continue to limit diversification, restrain productivity growth, restrict gains from trade, and hamper efforts to alleviate poverty.

#### **D. Trade, technology and TNCs**

71. In the early post-war era, trade was considered the most reliable and productive way of integrating into the global economy. From the point of view of developing countries, access to world markets could open a “vent for surplus”, permitting the employment of underutilized land and labour to produce primary and labour-intensive goods for export, easing their balance-of-payments constraint, and introducing dynamic gains through specialization and scale economies. Although these gains from trade can be important, particularly in the early stages of development, UNCTAD, along with others, has argued that calls to “free trade” can lock countries in to an established pattern of production that – even if it makes efficient use of a country’s resource endowments – may not generate the more dynamic productivity gains that drive catch-up growth. These depend on a variety of macroeconomic, structural and technological factors that need to be in place for a strong investment–export nexus to emerge, including in the context of global value chains, and to support a more diversified economic structure.<sup>25</sup>

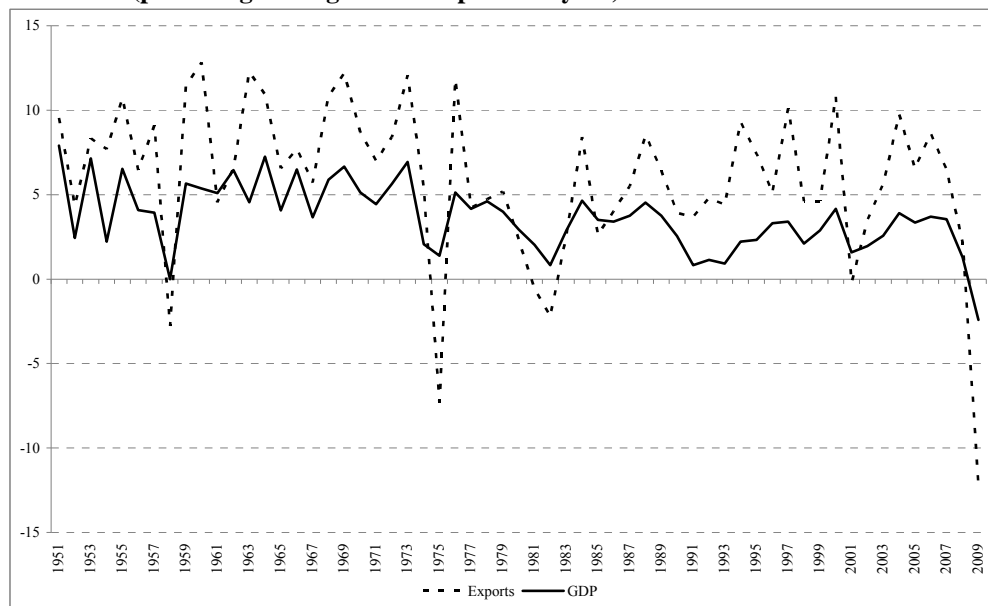
72. A flexible rules-based trading system created under the General Agreement on Tariffs and Trade (GATT), accompanied by controls on finance and capital flows, helped secure a stable investment climate and proved conducive to a dynamic trading system. Of particular importance during the Bretton Woods era was the strong correlation between trade and output growth. The mutually supporting links between output, investment and export growth were an important feature of the successful growth model established during these years. With the creation of a steadily more complex international division of labour, trade has expanded faster than global output since the end of the Second World War, albeit unevenly both geographically and over time (fig. 8).<sup>26</sup>

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<sup>25</sup> Emphasizing the investment–export nexus is one way around the futile discussion of whether or not trade is an “engine of growth”, for which there is little historical evidence; see, for example, Bairoch (1998): 136–38. While economists differ widely on the role of trade policies, there is broad agreement that investment is critical to trade performance; see TDR (1996), (1999), (2003) and (2006), as well as Bhagwati (1998), Bhagwati and Srinivasan (1999), Rodrik (1999) and Winters (2004).

<sup>26</sup> It was, of course, a key contention of UNCTAD that these links were particularly weak or even perverse for commodity producers and exporters.

Figure 8  
**Changes in the volume of world merchandise exports compared to changes in GDP, 1951–2009 (percentage change over the previous year)**



Source: World Trade Organization (WTO). *International Trade Statistics*. Various issues.

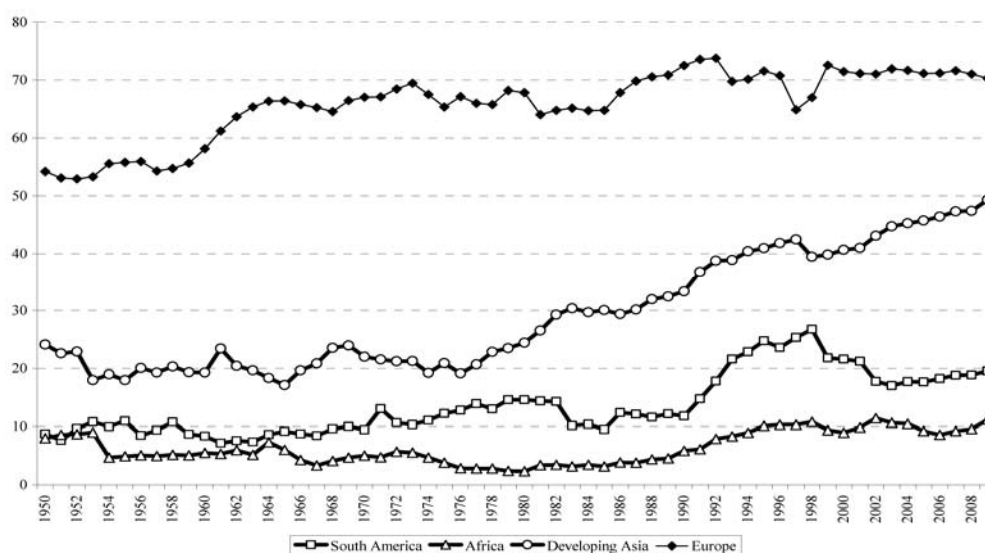
73. For much of this period, the elements that helped to integrate trade into virtuous growth and development circles found their most supportive environment at a regional level. For example, the share of intra-European trade in world trade increased from 18.3 per cent in 1953 to 31.2 per cent in 1973. This expansion was driven by intra-industry trade in manufactures based on the reduction of quotas and their tariffication, followed by tariff reductions through a series of trade rounds (Rayment, 1983). The next strong investment–export nexus emerged in East Asia, beginning in Japan and followed by the first-tier newly industrialized economies (NIEs) of Hong Kong, the Republic of Korea, Singapore and Taiwan Province of China. The pace of investment growth in these economies was unprecedented by historical standards; it allowed these five economies to increase their share of world trade from just 7 per cent in 1963 to 17 per cent in 1993. However, beginning in the early 1970s, the investment–export nexus also acquired a distinct dimension through intraregional flows of foreign direct investment (FDI) (fig. 9).

74. The first-tier NIEs had used TNC involvement strategically to strengthen their investment–export nexus, including through licensing (Republic of Korea) and subcontracting (Taiwan Province of China).<sup>27</sup> Moreover, FDI inflows became much more important to a second tier of neighbouring countries in South-East Asia. In terms of the sequencing of FDI among sectors and countries, a distinct regional pattern emerged consistent with the “flying geese paradigm” (TDR, 1996): the upgrading of economic activity from resource-based and labour-intensive industries to more sophisticated manufactures in leading economies opened up the opportunity for the relocation of production to less developed neighbours (Malaysia, Thailand, and other economies) through trade and FDI, and in response to shifts in competitiveness. Thus, while the ratio of FDI inflows to gross fixed capital formation was between 1 and 3 per cent in the Republic of Korea and in Taiwan Province of China in 1970s and 1980s, it was between 4 and 25 per cent in the second-tier NIEs in the 1980s and 1990s (see TDR, 1996: ch. 2; WIR, 2002; and

<sup>27</sup> In particular, non-equity modes of operation were important in the Republic of Korea (especially licensing) and Taiwan Province of China (especially subcontracting).

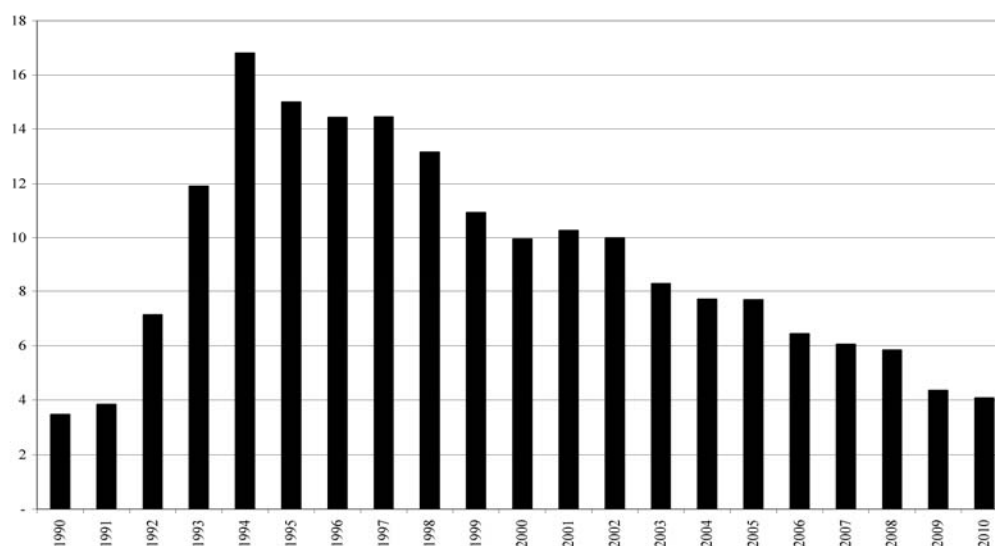
Petri, 2010). Finally, China began to attract large-scale FDI in the context of regional networks in the early 1990s (fig. 10), but did so as part of its own strategic shift from a consumption-led and employment-intensive growth regime to an investment-led and high-productivity regime, with active policies that ensured that FDI was complementary to domestic resource mobilization and supported the upgrading of local productive capacities (see various editions of *World Investment Report* (WIR); TDR, 2006; and Lo and Zhang, 2010).

Figure 9  
Intra-trade of regional groups as a percentage of total trade, 1950–2009



Source: UNCTAD secretariat, from UNCTAD GlobStat.

Figure 10  
China: FDI inflows as a percentage of gross fixed capital formation, 1990–2010



Source: UNCTAD secretariat, from UNCTAD FDI/TNC database.

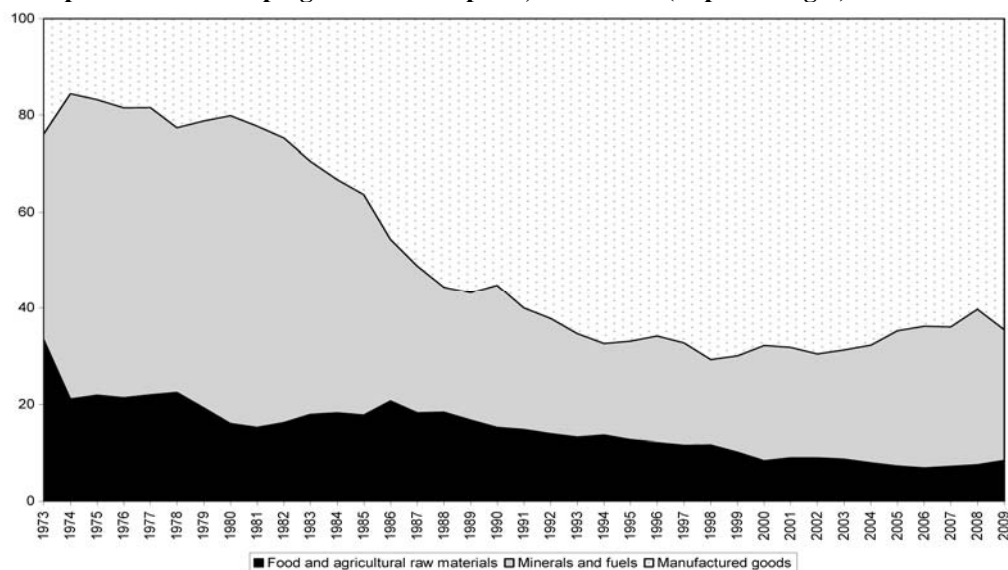
75. Another important feature shared by these dynamic regional trading experiences was their increasing technological sophistication, reflected in the higher value added of the

tradable goods sector. In the case of Western Europe, this was linked to a backlog of technologies that had been developed before the Second World War and were then embodied in a broad range of medium- and high-technology goods that found expanding markets across the region as incomes began to rise (Fagerberg, 1996). In the case of East Asia, technological upgrading was acquired from abroad through a mixture of imports and FDI and was adapted to local conditions by “reverse engineering” and supported by deliberate policy intervention which enabled these economies to move up the “world production frontier”.<sup>28</sup>

76. Beginning in the early 1980s, the links between output growth and trade have weakened.<sup>29</sup> Global trade has been driven more by policies of rapid liberalization (often introduced through structural adjustment programmes, and as a signal of commitment to FDG), by the addition of new markets following the collapse of communism and by the spread of global production networks. This has coincided with a sharp shift in the composition of developing-country trade towards manufacturing exports (fig. 11), and with growth rates far exceeding those in the developed countries. This pattern of trade intensified after the Uruguay Round, which reduced tariff barriers, opened negotiations in new (trade-related) issues, and imposed a more uniform set of obligations across all WTO members. The “grand bargain” struck in Marrakesh was that the developing countries would adopt a single undertaking including significant commitments in such new areas as intellectual property, while the developed countries would open up in areas of interest to developing countries such as agriculture, clothing and textiles (TDR, 1995; Ostry, 2000). Despite the lack of implementation of the developed countries’ side of the bargain, particularly in agriculture, a new round of negotiations was launched in 2001 in Doha.

Figure 11

**Composition of developing countries’ exports, 1973–2009 (as percentages)**



Source: UNCTADStat.

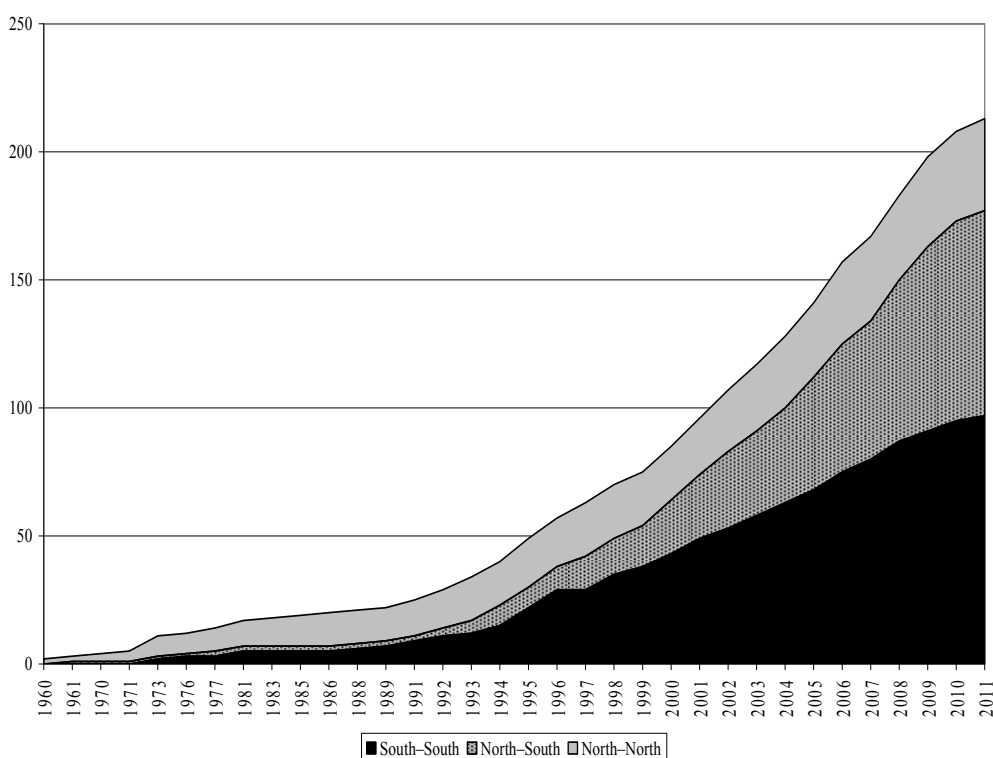
Note: SITC-2 data from 1973 to 1994 and SITC-3 data from 1995 onwards.

<sup>28</sup> See Allen (2011), who makes it clear that in late-industrializing economies, technological progress, capital formation and an export orientation are very closely related. See also TDR (2003) on this point.

<sup>29</sup> Indeed, taking average decadal growth rates for trade and output, there was a positive correlation between 1950 and 1980, however since 1980 the correlation has actually been negative.

77. The broadening of multilateral trade negotiations has coincided with a shift towards regional and bilateral trade agreements which, increasingly, include intellectual property provisions with potentially adverse implications for technological learning in developing countries (fig. 12). These developments have fuelled a debate about whether regional trade is likely to support or hinder a more open global trading system. Much of this debate continues to rely on a stylized vision of a borderless world as the ideal environment for international trade, along with an emphasis on static efficiency gains. Such an approach fails to register changes in the global economy linked to the rise of international finance – including the consequences of boom-and-bust cycles, the declining share of wages in national income, and an overall slowdown in global growth, and the impact of these factors on international trade.

Figure 12  
**Regional and bilateral trade agreements (cumulative number)**



Source: WTO.

Note: Regional trade agreements notified to GATT/WTO and in force (by date of entry in force).

78. Changes in wider macroeconomic conditions have coincided with a switch in the business models of many firms to a focus on “shareholder value”, short-term profitability, and M&As. Under these conditions, outsourcing (the contracting out of a particular activity) and offshoring (the relocation of an activity overseas) have become increasingly important to corporate strategy.

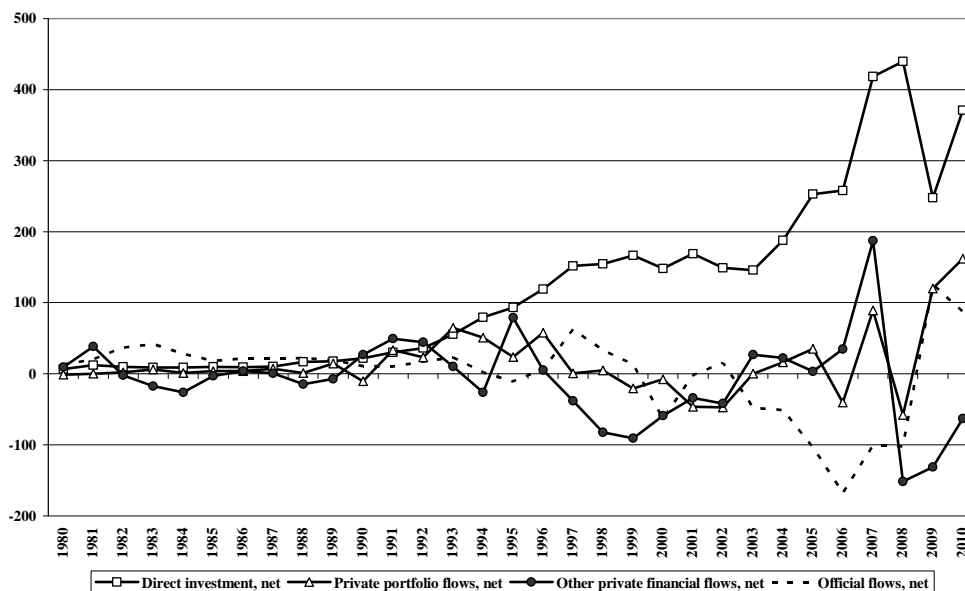
79. The competitive dynamics of global value chains have led to an increasing use of non-equity modes (NEMs) of operation by transnational corporations (TNCs) (WIR, 2011), such as international outsourcing of production, licensing of knowledge to host-country companies, management contracts, and franchising. For example, outsourcing combined with offshoring has become increasingly important to corporate strategy. Inasmuch as NEMs require the participation of domestic enterprises with significant productive capacity,

they recall the strategic opportunities successfully used by the first-tier NIEs to make their relations with TNCs work for development. TNCs initially sliced up the value chain in specific sectors such as textiles, clothing and electronics, parcelling out steps to different locations prior to final assembly. By the early 1990s, this model of vertical disintegration (usually with a leading firm based in an advanced economy) had expanded to other industries and service activities, engaging suppliers across an increasing number of developing countries. A well-known example is Nike, which outsources all of its production of sports goods to subcontractors in China, Indonesia, the Republic of Korea, Thailand and Viet Nam. Already in 1996, a Nike shoe contained 52 different components produced by subcontractors in five countries.<sup>30</sup> This process has given rise to the idea that an FDI–export nexus, driven by the liberalization of trade, and drawing on the marketing skills and technological know-how of TNCs, can allow developing countries to leapfrog into more sophisticated areas of production, and, in the process, avoid the perceived policy mistakes associated with the infant industry stages of development. “Getting production right” by attracting FDI seemed to transform the Washington Consensus mantra of “getting prices right” into a more complete development strategy, by enabling developing countries to trade and invest their way out of poverty (Stiglitz, 2002: 67). The idea that FDI did not carry debt obligations to the host country and was free of speculative and herd mentalities reinforced its appeal as an instrument for promoting development under FDG.

80. These expectations have been realized only in part. FDI to developing countries has risen sharply since the early 1990s, in some cases becoming the dominant modality of capital inflow (fig. 13). Correspondingly, inward FDI stocks grew from 7 per cent of world GDP in 1980 to around 30 per cent in 2009 (fig. 14). Although rising FDI flows are often assumed to correspond to a rise in gross fixed capital formation worldwide, this is only the case if those flows take the form of greenfield investments and expansion of the productive capacity of existing affiliates.

Figure 13

**Composition of net capital flows to developing countries, 1980–2010 (in billions of dollars)**

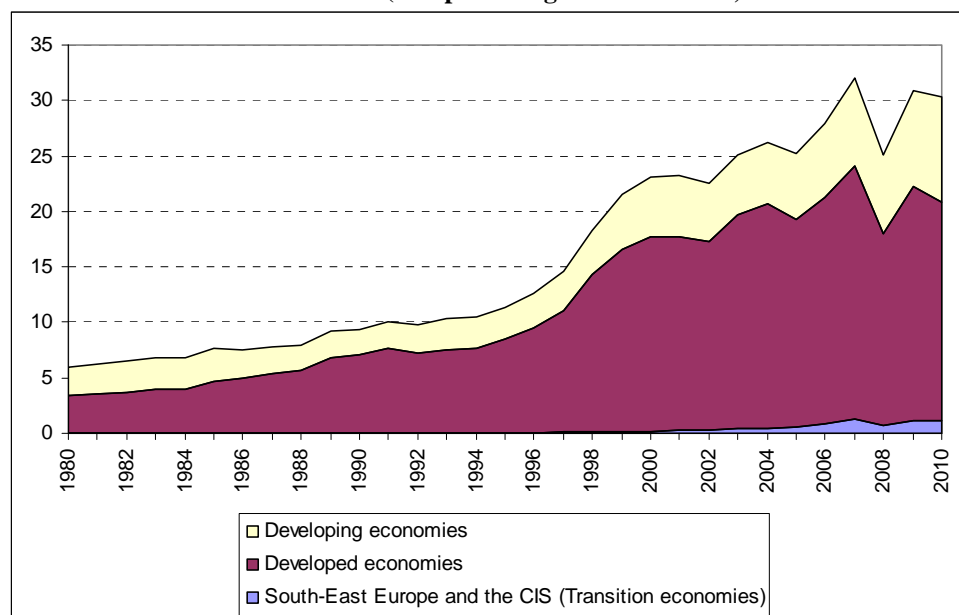


Source: IMF, *World Economic Outlook* (various).

<sup>30</sup> For a discussion of the organization and the evolution of these production networks, see WIR (2002) and TDR (2002).



Figure 14  
**Distribution of inward FDI stock (as a percentage of world GDP)**

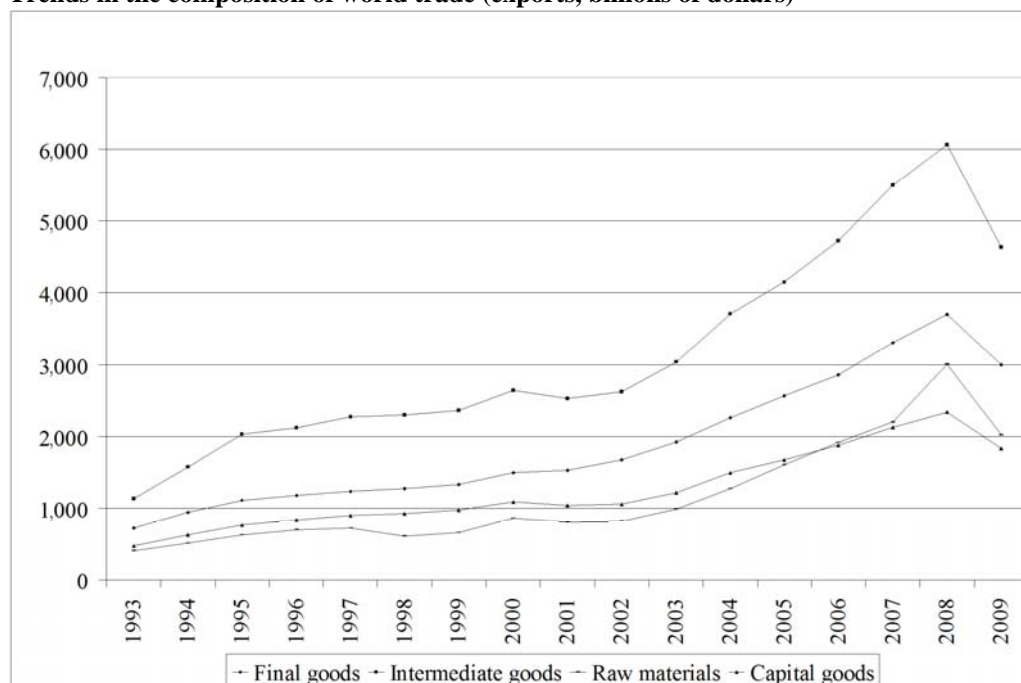


Source: UNCTAD secretariat, from the UNCTAD FDI/TNC database.

81. Still, as a result of the spread of international production networks, global trade has been boosted, as goods travel across several locations before reaching final consumers. For example, trade in intermediates has reached 30 per cent of world trade, between 40 and 60 per cent of the merchandise imports of OECD countries, and close to 75 per cent of the imports of such large developing countries as China (fig. 15 and table 3). Some of the most successful emerging markets have, in recent years, successfully linked their development efforts to these international production networks. However, the growth of trade accompanying the participation in these networks may not always be matched by comparable increases in value added or in real wages, thereby breaking the links between exports, productivity growth and rising living standards, which, for example, characterized the East Asian growth model (TDR, 2002 and 2003). Indeed, the combination of flexible labour markets and standardized components trade tending to oversupply in highly competitive markets has raised concerns about the possibility that production networks will replicate the trade imbalances previously associated with primary commodity exports, including the possibility of “fallacies of composition”, “enclave economies”, and even “immiserizing growth” (TDR, 2002; Kaplinsky et al., 2002).<sup>31</sup>

<sup>31</sup> The idea that many developing countries could be trading more but earning less from doing so was introduced in TDR (2002). Similar findings were reported in a study of 127 developed and developing countries by Dowrick and Golley (2004), who found that increased trade by developing countries had supported faster productivity growth between 1960 and 1980 than was the case in the developed countries, but that that link had weakened in the period from 1980 to 2000, favouring richer countries.

Figure 15  
Trends in the composition of world trade (exports, billions of dollars)



Source: UNCTAD secretariat calculation, based on World Integrated Trade Solution (WITS) databases.

Table 3  
Exports of intermediate products, by income groups and regions (percentages)

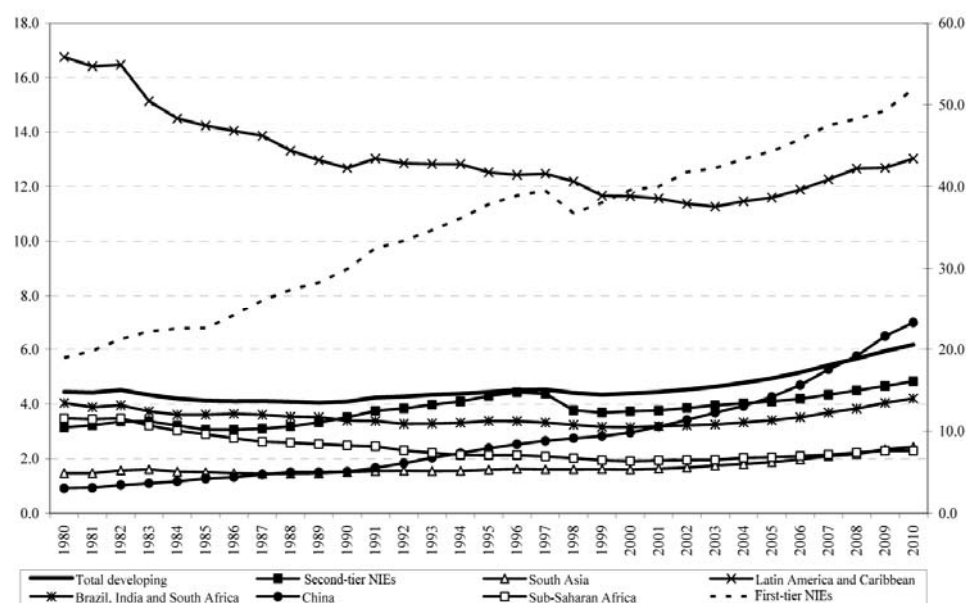
	Average for 1993 and 1994	Average for 2008 and 2009	2009	Annual growth rate
<i>Income groups</i>				
Developed economies	76.6	62.4	61.5	8.7
Developing economies	18.0	29.0	32.0	13.7
Transition economies	4.0	7.0	5.0	15.7
LDCs	2.1	3.5	3.2	14.0
Total	100	100	100	10.2
<i>Developing-country regions</i>				
East and South-East Asia	14.2	23.2	25.2	13.8
Eastern Europe	3.0	6.4	5.4	15.9
Latin America	4.3	4.8	5.2	11.0
Middle East/North Africa	0.3	0.6	0.6	15.8
South Asia	0.7	1.3	1.2	14.5
Sub-Saharan Africa	0.9	1.2	1.1	12.0

Source: UNCTAD staff calculations, based on COMTRADE-WITS.

## E. Development interrupted

82. The institutional, behavioural and policy changes promoted by FDG have failed to trigger virtuous development circles for most communities. Under FDG, only the relatively reluctant reformers, including the East Asian NIEs, China and India, have managed to reduce significantly their income gap with the advanced countries. Most other countries, including the “strong adjusters” in Latin America and sub-Saharan Africa, have failed to converge; indeed, despite the broadly shared strong growth performance after 2002, growth spurts have become much less frequent in developing countries since the early 1980s (UNDESA, 2006: 11), and many countries are as far behind the richest countries in terms of per capita income as they were 30 years ago, with only East Asian countries posting strong and sustained gains (fig. 16).<sup>32</sup>

Figure 16  
Real per capita GDP relative to the United States, 1980–2010



Source: UNCTAD secretariat, based on UNCTADStat.

Note: First-tier NIEs in the right-hand axis; all other economies in the left-hand axis. First-tier NIEs includes Hong Kong (China), the Republic of Korea, Taiwan Province of China, and Singapore. Second-tier NIEs includes Indonesia, Malaysia, the Philippines and Thailand.

83. The first failure of development strategies harnessed to FDG concerns their weakness in mobilizing sufficient resources to build productive capacities. In most developing countries, investment rates tumbled in the 1980s, and they have failed to return to their previous levels (fig. 17). The retrenchment of public sector investment has been especially pronounced, and in most cases, private (domestic as well as foreign) investment has failed to fill the gap (TDR, 2003).

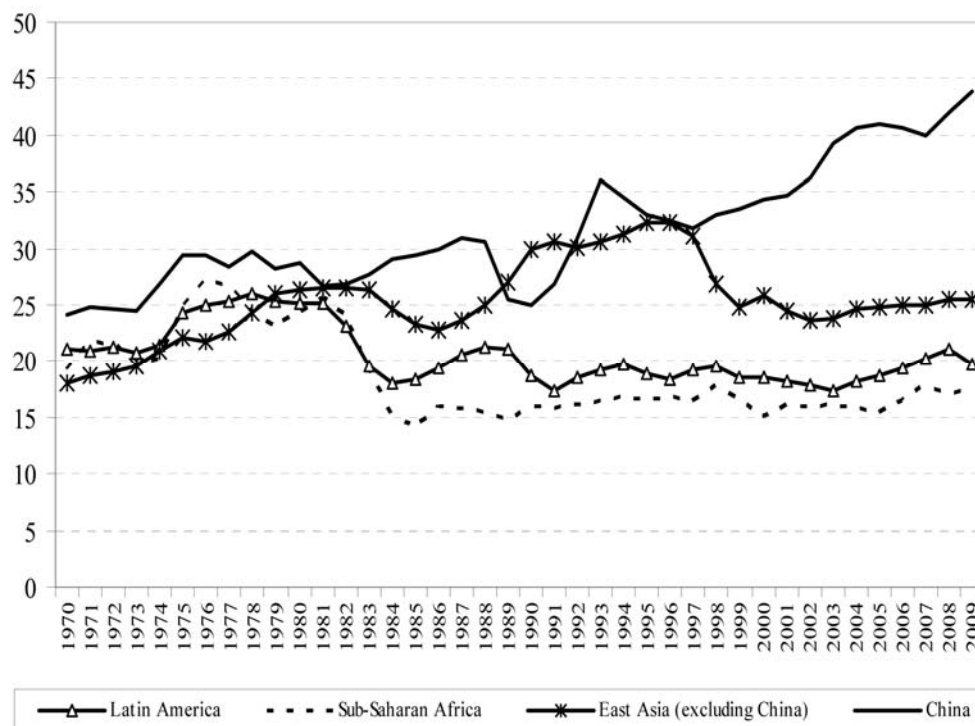
84. This failure is partly due to the fact that FDG has had an adverse impact on household savings at three levels: (a) wage incomes have been squeezed; (b) banks have

<sup>32</sup> UNCTAD’s assessment of the performance of the different developing regions can be found in its Trade and Development Reports, Least Developed Countries Reports, and Economic Development in Africa Reports.

moved away from the business of protecting household savings and funding long-term investment projects, and have instead become heavily involved in lending to consumers and governments; and (c) trade and financial liberalization (together with closely related cultural and behavioural changes) have raised the propensity to consume, especially luxury goods, and have fuelled speculative purchases of real estate. However, for reasons discussed earlier, financialization has also had a damaging impact on the profit–investment nexus, by channelling retained profits into less productive uses.<sup>33</sup>

Figure 17

**Gross fixed capital formation, 1970–2009 (as a percentage of GDP, current prices)**

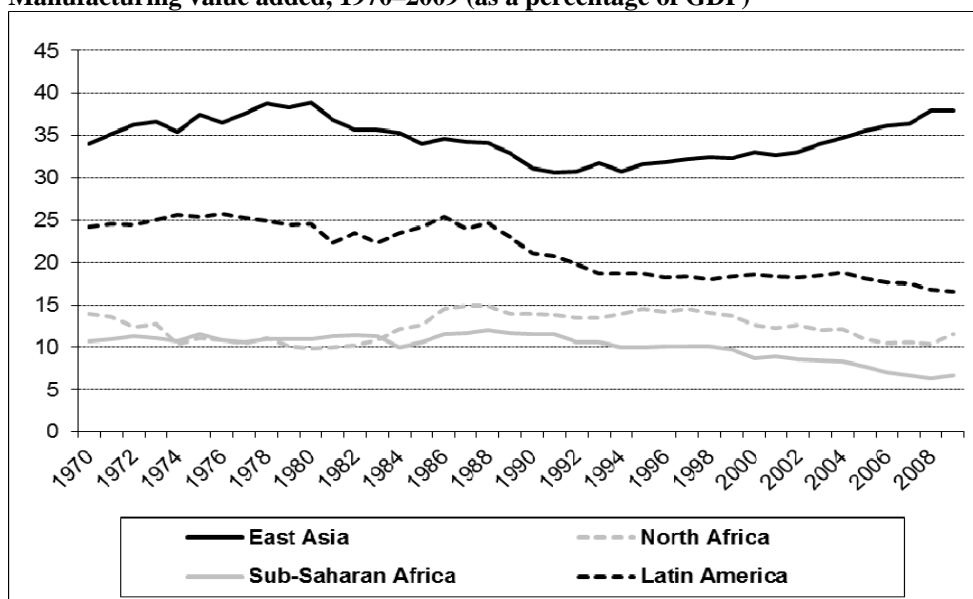


Source: UNCTAD secretariat, based on UNCTADStat.

85. A second danger is locking countries in to a narrow pattern of international specialization with limited growth prospects. UNCTAD research has identified a process of “premature deindustrialization” in a number of developing countries over the past thirty years, whereby the share of manufacturing in employment and output starts to decline at a level of income well below that associated with the trajectory of successful economies – both developed and developing (fig. 18). In these cases, it becomes increasingly difficult to produce more sophisticated goods for export and to sustain high levels of domestic demand and employment creation (TDR, 2003; *Least Developed Countries Report (LDCR)*, 2009).

<sup>33</sup> See also Arestis (2004 and 2005). One extensive survey of the impact of financial liberalization has concluded that there is little evidence to support the idea that financial integration has helped developing countries increase the resources available to bolster productive investment and support growth (Prasad et al., 2004: 11).

Figure 18  
**Manufacturing value added, 1970–2009 (as a percentage of GDP)**



Source: UNCTAD secretariat, based on UNCTADStat.

86. Third, and closely related, FDG has often failed to support technological upgrading (TDR, 2003; LDCR, 2007). In most developing countries, technological progress is more about adapting and improving existing technologies to achieve higher productivity than about pushing out the technological frontier. However – and regardless of whether the technology is imported or developed locally – this still depends on high levels of productive investment (as most technologies are embodied in capital goods), adequate levels of spending on research and development (R&D), and a range of appropriate technology support services. Measuring technological capacity remains a difficult task, particularly as there is good deal of tacit knowledge and skill involved, however recent trends have tended to follow much the same pattern as has already been seen in the areas of investment and industrialization, with several East Asian countries performing strongly, many middle-income developing countries struggling to keep up, and most LDCs dropping further behind (table 4). Efforts to correct these weaknesses by attracting FDI have been only partially successful. While affiliates tend to exhibit higher output and productivity than comparable local firms, the evidence for technological spillovers from inward FDI is limited, particularly in LDCs (LDCR, 2007; WIR, 2005).<sup>34</sup> This is especially the case where FDI is focused on assembly activities, or – in cases where more high-tech activities are deployed – where the absorptive capacity of local companies is insufficient. Failure to address such weaknesses has given rise to concerns about a “middle-income trap”, since several countries have moved into the labour-intensive slices of the global value chain but have found it difficult to further develop the technological infrastructure needed to support the growth of larger domestic firms, or to sustain upgrading and productivity growth.<sup>35</sup>

<sup>34</sup> For a review of the recent evidence on FDI spillovers, see Harrison and Rodríguez-Clare (2010).

<sup>35</sup> For further information on the middle-income trap, see TDR (2002), Ohno (2009), Felipe (2010) and Wade (2010). Similar concerns are even being expressed in China. In this regard, see: The Economist (2011). Beware the middle-income trap: China’s roaring growth cannot last indefinitely. 23 June.

Table 4

**Research and development expenditure (as a percentage of GDP)**

	1996	2000	2004	2007
OECD members	2.2	2.4	2.3	2.3
Middle-income countries	0.6	0.7	0.8	1
East Asia and the Pacific	0.5	0.7	1.1	1.4
South Asia	0.6	0.7	0.7	0.8
Latin America and the Caribbean	0.5	0.6	0.6	0.7

Source: World Bank. *World Development Indicators*.

87. FDG has not only failed to support catch-up growth and structural transformation. In many developing countries, it has also been detrimental to the creation of decent jobs (UNDESA, 2008; TDR, 2010). Given the structural constraints facing many developing countries, an emphasis on making labour markets “more flexible”, when combined with restrictive macroeconomic policies, rapid trade and financial liberalization, and boom-and-bust cycles, has often failed to support the formalization of employment or to promote the rapid creation of secure jobs. The exception is, once again, East Asia, where development strategies have differed most significantly from the mainstream policy prescriptions (Bacchetta, Ernst and Bustamante, 2009; Khan, 2007; and table 5). Since the expansion of employment can reinforce the impact of productivity growth in establishing virtuous growth circles, the low employment intensity of growth in most developing countries poses another obstacle to more inclusive development paths.

Table 5

**Vulnerable employment shares, world and regions (percentages)**

	1998	1999	2000	2005	2006	2007	2008	2009
World	53.7	53.5	53.3	51.9	51.4	51	50.2	50.1
Developed economies and European Union	11.3	11.1	10.8	10.3	10	9.9	9.7	9.7
Central and South-Eastern Europe (non-EU) and CIS	24.1	26.7	25.6	22.8	21.9	20.7	20.4	20
East Asia	61.4	60.2	59.1	55.8	55.2	54.5	52.2	50.8
South-East Asia and the Pacific	63.8	66.2	65.5	62.6	62.3	62	62.5	61.8
South Asia	81.9	81.1	82.1	80.5	80.2	79.9	78.9	78.5
Latin America and the Caribbean	35.7	36.1	35.8	33.8	32.7	32.3	31.8	32.2
Middle East	36.8	36	35.7	33.9	33.7	33.3	32.9	32.7
North Africa	43.7	42.1	42.4	42.6	41.1	41.2	40.2	40.4
Sub-Saharan Africa	80.5	79.9	79.5	77.1	76.6	76	75.3	75.8

Source: ILO. *Global Employment Trends: 69*.

88. Paradoxically, the winners under FDG have been those developing countries that have resisted rapid financial and capital account liberalization (box 2; and fig. 19) and have continued to deploy creative and heterodox policy innovations along the lines of those which, in the 1960s and 1970s, helped Japan, the Republic of Korea, Taiwan Province of China and other economies to break their constraints on growth. In all these cases, very high rates of capital formation, economic diversification and technological upgrading have been mutually reinforcing, while global market forces were used strategically to fill resource gaps and strengthen local capacities. These economies have, as a result, been able to manage a successful structural transformation towards higher-productivity sectors. These successful economies have also built industrial capacity in the context of a strong regional growth dynamic, including through managed trade and FDI. In all these cases, industrial

policy, rather than purely market processes, has been essential in order to be able to take full advantage of the scale economies and externalities that external integration can bring.

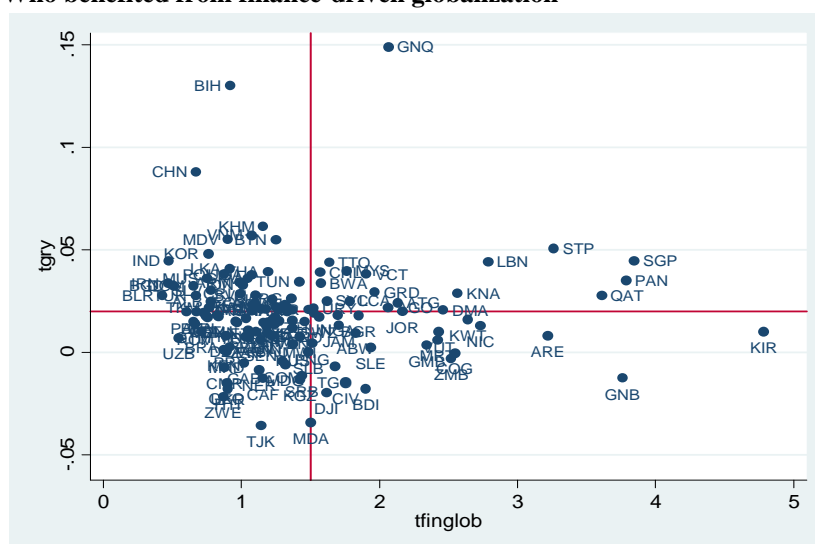
### Box 2. Who benefited from finance-driven globalization?

For developing countries as a whole, there is no positive correlation between financial globalization and economic growth or investment. The lack of such a correlation may be due to the fact that econometric exercises do not have the power to separate countries that benefit from financial globalization from countries that are harmed by unruly global capital flows. Figure A (below) uses a sample of 136 developing countries to plot financial globalization against average real per capita GDP growth over the period 1990–2007. The figure is then divided into four sub-quadrants. The bottom left corner shows that there are 52 countries with relatively low levels of financial globalization (less than 150 per cent, which is close to the cross-country average for this period) and low growth (below 2 per cent per year, again closer to the cross-country average in the sample). The bottom right corner shows that there are 24 countries with high financial globalization and low growth. The upper left corner includes the 41 countries with low financial globalization and high growth. Finally, the upper right corner shows that there are 19 countries with high financial globalization and high growth. While figure A cannot provide a counterfactual and thus does not allow causal statements to be made, it is interesting that the upper right quadrant is the least populated part of the figure.

A closer look at the upper right quadrant may shed some light on which countries can benefit from financial globalization. Out of the 19 countries included in the high financial globalization high-growth group, 8 are small island economies, 6 are commodity exporters, and 4 are regional financial centres. Only one (Malaysia) is a country with a large and successful manufacturing industry. Figure A does not seem to support the view that financial globalization is associated with a process of industrialization and structural transformation.

Figure A

#### Who benefited from finance-driven globalization

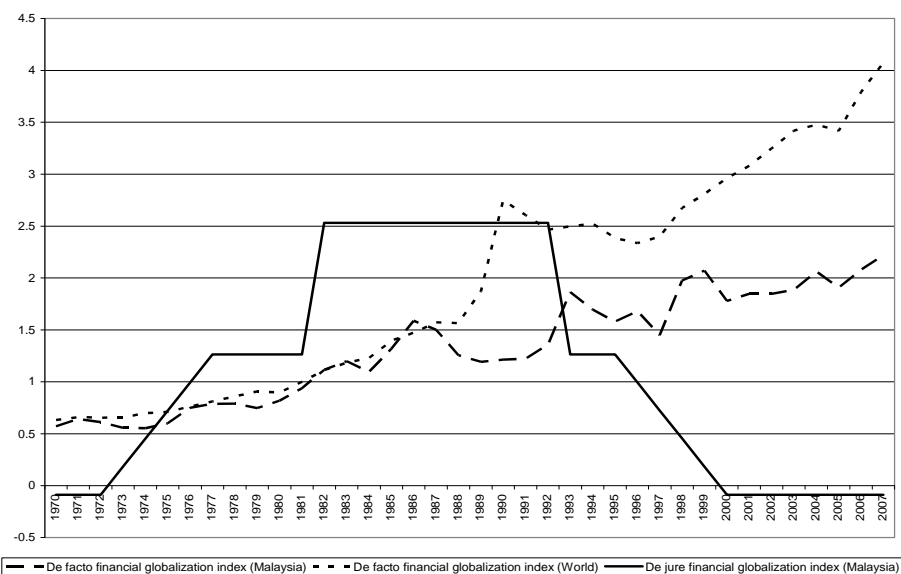


Source: UNCTAD secretariat elaboration, based on Lane and Milesi-Ferretti (2006) and the UNCTADStat database.

*Note:* The vertical axis plots average real GDP per capita growth over the period 1990–2007, and the horizontal axis plots average financial globalization (defined as gross foreign assets plus gross foreign liabilities divided by GDP) over the same period. The eight small island economies are: Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Seychelles, and Sao Tome and Principe. The six commodity producers are: Angola, Botswana, Chile, Equatorial Guinea, Qatar, and Trinidad and Tobago. The four regional financial centres are: Lebanon, Panama, Singapore and Uruguay.

It is ironic that the only country in this sample undergoing a successful structural transformation and benefiting from financial globalization is a country that, in the recent past, fought hard against the latter. Malaysia started relaxing restrictions on capital flows in the mid-1970s, and by 1982, it had a fully open capital account (this is the solid line in figure B). In the early 1990s, the Malaysian authorities started worrying about large inflows of capital and imposed some restrictions on capital flows. These restrictions were further tightened in the aftermath of the Asian crisis of 1997–98. By the year 2000, the Malaysian *de jure* index of capital account liberalization was back at its 1970 level. Rather than resulting in a collapse of *de facto* financial globalization (the dashed line in figure B), these changes in capital account regulations were successful in slowing down the process of financial integration and in decoupling Malaysia from the rapid increase in global financial integration (the dotted line in figure B). While IMF and several observers criticized Malaysia for retreating from the rapid process of financial integration (Johnson et al., 2007), there is evidence that Malaysia's more careful attitude towards foreign finance paid off, and helped the country to recover from the effects of the Asian financial crisis of 1997–98 (see also box 4 on capital controls).

Figure B  
**Financial globalization: Malaysia versus the world average**



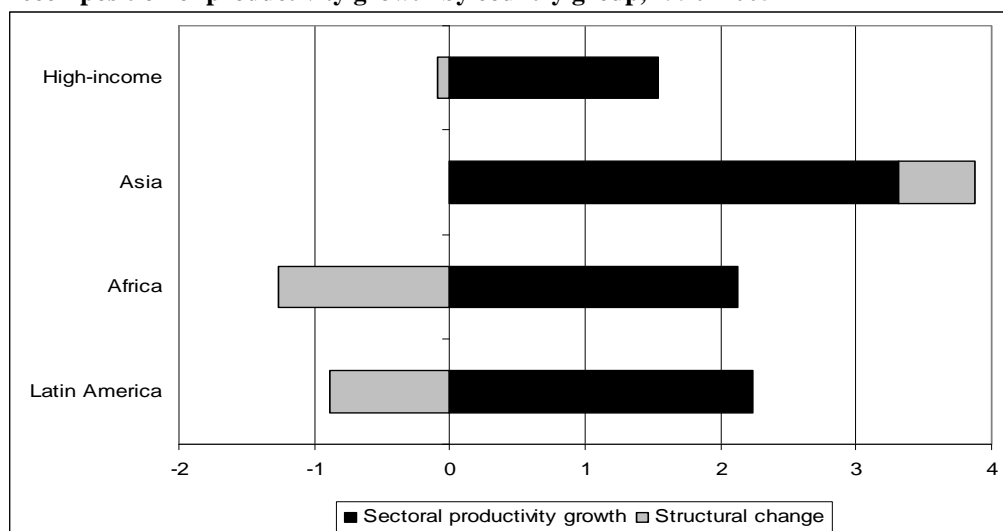
*Source:* UNCTAD secretariat elaboration, based on Lane and Milesi-Ferretti (2006) and the UNCTADStat database.



89. These experiences suggest that, in order to establish a successful development path, it is essential to ensure the space to introduce a range of policies for building domestic productive capacities and local technologies, and to establish the institutions and support measures to spread the resulting gains. However, for many developing countries, policy space has been reduced under FDG and through a variety of channels. Firstly, capital account liberalization can make independent monetary policy impossible, regardless of the exchange-rate regime (developing countries often cannot bear the balance-of-payments pressures under a fixed exchange-rate regime, or the costs of exchange-rate volatility under floating exchange rates; see TDR, 2002 and 2011). Secondly, while a commitment to arbitrarily low inflation targets and tight public sector spending is more a signalling device to demonstrate commitment to FDG than an effective anti-inflation policy (TDR, 2010), these measures do restrict the potential of macroeconomic policy to achieve wider developmental goals (Bradford, 2005). Thirdly, since FDG increases the elasticity of the supply of capital, it reduces the ability of countries to set their preferred tax schedule, induces a shift towards taxes on labour, and encourages a race to the bottom in which several countries try to attract capital by lowering taxation, and, eventually, end up with lower tax revenues and no change in their capital stock. Fourthly, since most developing countries are unable to borrow abroad in domestic currency (the “original sin”; see Eichengreen et al., 2003), during recessions the real value of their currency tends to decline, raising the cost of servicing foreign debt exactly when the capacity to pay is diminished. This increases the risk attached to lending to poorer countries, reduces the space for countercyclical policies, and induces monetary policy to target exchange-rate rather than output stability (Hausmann and Panizza, 2011). Finally, FDG has eroded policy space through the changes it has triggered in the political process, particularly in the advanced economies. The lobbying power of the United States financial industry has increased enormously (Johnson, 2009), and its political clout has been used to push for further liberalization in the United States and abroad. Three manifestations of this strategy were the sharp financial liberalization demanded of the East Asian countries after the crisis of the mid-1990s, the requirement that countries signing free trade agreements and bilateral investment treaties with the United States should renounce some forms of capital account management, and the concerted push for the deregulation of financial services at the multilateral level (Igan et al., 2011)..

Figure 19

**Decomposition of productivity growth by country group, 1990–2005**



Source: McMillan and Rodrik (2011).

*Note:* Sectoral productivity growth refers to contributions to labour productivity growth from within sectors; structural change refers to productivity growth resulting from the movement of labour across sectors.

## **F. The ongoing downturn**

90. The full extent of excessive indebtedness, unregulated capital flows and financial speculation became apparent in the wake of the collapse of Lehman Brothers in September 2008. The cost of the subsequent crisis, in terms of declining asset values and government bailouts of collapsed financial institutions, has already run into the trillions of dollars. The crisis has wrought widespread damage via growth collapses, job losses, corporate bankruptcies, and the prospect of prolonged stagnation in several advanced economies. Developing countries, which bore no responsibility for the crisis, were hit by declining export prices and volumes, contracting markets, frozen credit lines, reduced FDI, capital flight, and lost migrant remittances. No country has avoided the impact of the crisis completely, and the percentage point drop in GDP growth was even larger in many LDCs than in some advanced countries (LDCR, 2010).

91. The myth of the self-regulating market has proved itself to be damaging, precisely when it had been given maximum latitude to deliver its promised benefits. Those economists who saw the warning signs were not listened to, as their voices were drowned out by the chorus of praise for a system offering increasing rewards to the few and transferring the risks to those least able to understand them. At least since Adam Smith, serious thinkers have understood that the destructive features of markets need to be moderated through an array of rules and institutions. Moreover, the idea that dismantling the checks and balances on financial markets would help unleash a new wave of productive entrepreneurship and technological progress goes against history, which shows that these markets are prone to generating wrong information, excessive risk-taking and herding behaviour, and regularly culminate in large-scale panics, crashes and protracted crises.<sup>36</sup> As Keynes famously noted, the casino is no place for promoting productive entrepreneurship. But the irrationality (exuberant or otherwise) of markets is only part of the problem. The United States economist Hyman Minsky has demonstrated that moral hazard and fragility is hard-wired into the structure of deregulated financial systems. When it is combined with the tendency of markets to concentrate economic power, financial deregulation becomes a potential source of not-so-innocent economic fraud (Galbraith, 2004) and a danger to social stability (Soros, 2008).

92. Rolling back the “rule of rentiers” (Krugman, 2011) is certainly an essential step to rebalancing the global economy, and to the prospect of sustained and inclusive growth for developed and developing countries alike. To date, attention has, instead, largely focused on saving large financial institutions through direct government support and the provision of cheap money. This was no doubt necessary to prevent a repetition of the Great Depression. However, the response of the financial sector has been to speculate globally, even as it denies loans to the productive sector. At the moment, finance is a macroeconomic dead weight, bearing heavily on global recovery efforts. If “business as usual” persists, growth will remain patchy, investment will remain subdued, unemployment will remain high, and inequality will increase further, as states seek to balance budgets through additional cuts in investment, salaries and social security transfers. Indeed, if history is any guide, the likelihood of mounting social tensions spilling over into political instability is a very real one (Voth and Ponticelli, 2011). Moreover, the longer the crisis drags on, the

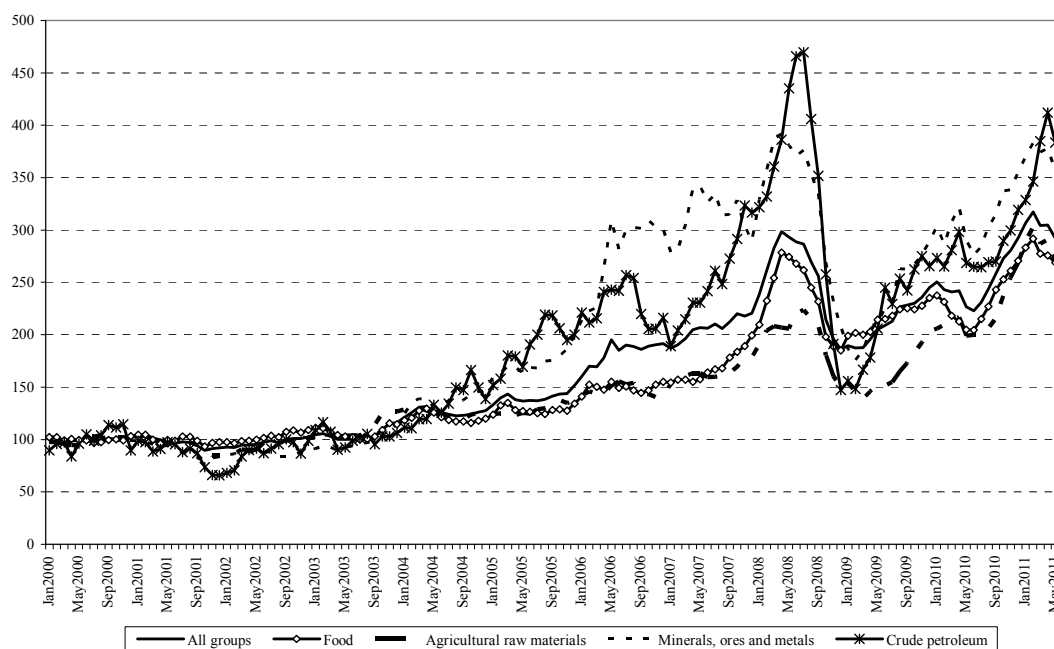
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<sup>36</sup> The periodic tendency of unregulated financial markets to “go crazy”, in the words of the *Financial Times* journalist Martin Wolf, is described by Kindleberger (1984).

greater the temptation is for economies to resort to a more inward-looking agenda. Meanwhile, speculation in the food and energy markets is again contributing to increased food and energy insecurity, with the price of oil again climbing sharply and some food staples hitting new highs (fig. 20).

93. In this context, it would be optimistic to expect large emerging economies to lead the global recovery, especially if this is accompanied by calls for them to open up the next frontier for financial accumulation. The proposition sounds encouraging but is in fact deeply misleading. Even in the best possible circumstances, the emerging economies are constrained by their relatively low absorptive capacity and inability to issue international currencies. Moreover, there is a growing recognition of the need for countries that have built growth around a strong investment–export nexus to start relying more on domestic sources of growth. This will involve difficult adjustments and trade-offs, along with strategic policy action. Without far-sighted and effective measures at national, regional and international levels, new imbalances will build up in these economies, with the threat of repeated shocks and crises increasing while the advanced economies have already exhausted much of their capacity to prop up the financial sector.

Figure 20  
Commodity prices, January 2000–May 2011 (2000=100)



Source: UNCTAD GlobStat.

## G. Future shocks

94. FDG promised to eliminate chronic resource misallocation and balance of payments instability and, “for all practical purposes”, the business cycle itself (Lucas, 2003). In reality, rising debt levels and increased leverage and speculative behaviour have created a world of systemic financial fragility and new types of business cycles. These have brought episodes of prosperity, but they have often collapsed through currency, banking or balance-of-payments crises, and been followed by long periods of sluggish growth and weak job creation. Hopes of a more inclusive growth model were dashed by growing inequality and a shift in the risks and stresses generated by unregulated markets onto individuals and households.

95. The ongoing global crisis has already caused untold damage to livelihoods and to prospects of employment and prosperity in many countries. However, this crisis is accompanied by the slowly unfolding environmental crisis – in particular, by rising global temperatures, which pose even more fundamental challenges to sustainable development. There is a growing recognition that so long as environmental risks and imbalances are linked to long-run economic (and demographic) pressures, it will be difficult to correct these separately from the financial and social imbalances that have emerged over the past two or three decades. This makes attempts to return to “business as usual” even more misguided. The recomposition of FDG is not only undesirable for economic and social reasons; it would also impose intolerable stresses on the planet’s ecological balance.

96. It is widely recognized that the development path adopted by today’s advanced countries has not properly accounted for its (ab)use of “natural capital” or damage to ecosystems, and that, given current technologies (or those on the horizon), the Earth’s ecological limits do not permit the replication around the world of the patterns of production and consumption of the advanced countries. Industrialization based on fossil fuels has, over the past two centuries, helped those countries achieve unprecedented increases in living standards, but at the cost of a build-up of carbon emissions that has overrun the absorptive capacity of the atmosphere and brought about dangerous and potentially irreversible changes in the earth’s climate.

97. Despite a growing awareness of those limits, the world remains far from finding ways of correcting the mounting environmental imbalances or the catastrophic outcomes that the scientific community predicts for the planet. Recent evidence that carbon emissions have continued to rise even during the recession adds to concerns that the planet is heading towards dangerous tipping points beyond which it may become impossible to recover a recognizable form of ecological balance.

98. For many developing countries, these environmental threats are already adding to the vicious circle that traps them at a low level of income, degrades their resource base, and constrains their ability to build resilience to withstand future shocks. Recent estimates suggest that 300,000 people die each year because of global warming, while 300 million lives are seriously threatened by the ongoing environmental transition (Global Humanitarian Forum, 2009). Unfortunately, an environmentally sustainable growth path for the global economy has proved an elusive goal, in part because of the reluctance of the most advanced countries to recognize the closely interrelated nature of development and environmental challenges (box 3).

### **Box 3. The climate–development nexus**

A temperature increase of 2°C above pre-industrial levels is the maximum target established by the scientific community for stabilizing carbon concentrations at a level that would prevent dangerous imbalances in the climate system, and for adapting to the changes that such a rise would still bring. This corresponds to a target greenhouse gas concentration (in terms of carbon dioxide equivalents (CO<sub>2</sub>e)) of between 350 and 450 parts per million (ppm), and to a global emission reduction of around 50–80 per cent over 1990 levels by 2050.

These targets will require aggressive action by the advanced countries and the active participation of the developing countries, which can occur only if economic growth and development are allowed to proceed in a sustainable manner. In accordance with the principle of common but differentiated responsibilities, distinct climate policies will be required in developed and developing countries.

Energy is the pivotal issue at the interface of climate and development. In

most of the developing world, access to energy services is far below what is needed to achieve human development goals; indeed, around 2 billion people are without access to modern energy services. Globally, approximately 31 million tons of oil equivalent are consumed in the form of primary energy every day, which is equivalent to 55 kilowatt-hours (kWh) per person per day, with rich countries on average consuming more than twice that figure. Most African countries and all countries in South Asia consume well under 20kWh per capita per day. China is still well below the global average, and even most emerging markets consume less than a third of the advanced economies' per capita average. It goes without saying that rising income levels in poorer countries will tend to close these energy gaps.

100kWh per capita per day can be used as a reasonable target for energy security. Up to this level, there is a very strong correlation between increased energy consumption and development outcomes. However, these levels of energy consumption will be out of the reach of most poor countries unless the price of energy services declines significantly. For example, if energy costs 10 cents per kWh, then \$10 per day would be needed to consume the requisite levels of energy services. This is not just a problem for the bottom billion; spending \$10 per day on energy services would also exhaust the per capita income of countries such as Angola or Ecuador.

The bulk of energy infrastructure in developing countries is yet to be built, leaving energy services undersupplied and expensive; meanwhile, many people still rely primarily on traditional biomass fuels for their energy needs, especially wood, crop wastes and animal dung. Under these circumstances, it may be cheaper and easier to switch to a renewable pathway than to retool existing infrastructure. Cost and technical improvements across a wide range of small-scale, decentralized technologies based on renewable energy already offer, in many situations, a cost-effective and sustainable approach to rural electrification.

Most market-based solutions under discussion in climate circles, such as cap and trade and carbon taxes, could work against development because they aim to raise the price of renewables in order to make them attractive to private investors. What is needed, instead, is a strategy leading to a significant and rapid reduction in the cost of renewable energy. The most promising option is a massive public investment push, coupled in the short term with appropriate subsidies to offset high initial technological and scale hurdles. If targeted at the most promising technology options, especially solar and wind, such a strategy would give the private sector clear and credible signals and encourage productivity gains and energy efficiency.

For further information, see TDR (2009) and UNCTAD (2011c).

99. It would be economically unrealistic and morally unacceptable to demand that, as part of their contribution to addressing the climate challenge, the developing countries should compromise their economic growth ambitions in order to protect much higher living standards elsewhere. Rather, new partnerships will have to be formed around the development and diffusion of green technologies, large-scale retrofitting programmes, the coordinated replacement of energy-intensive patterns of production by alternatives fuelled by renewable sources, and changes in trade patterns supporting the transition of the global productive matrix towards environmental sustainability (TDR, 2009; UNDESA, 2009). The only way to close income gaps, within and across countries, while building a low-carbon high-growth global economy is through a shift to a new modality of global development

encompassing economic, social and environmental dimensions, which this report refers to as development-led globalization (DLG).

100. This first part of the report has argued that “business as usual” is the wrong response, both for short-term macroeconomic and for long-term structural, social and environmental reasons. The interconnected challenges of rebalancing financial systems and real economies, repairing domestic social contracts, and tackling environmental, demographic and food challenges cannot be dealt with through the incremental and discrete actions which are typical of the interplay of market forces. It will be difficult to face these challenges and kick-start global recovery while Northern consumers, businesses and governments seek to repair their balance sheets, and with the financial system entangled in a wholly speculative web of debts entirely of its own making. Greater austerity is certainly not the way to lift all boats. Moreover, under these conditions, attempts by most countries to push down hard on the export pedal would be ineffective, while also generating dangerous frictions in the global trading system. It is nothing short of disastrous that an effective investment-led and environmentally sound response to the current global predicament continues to elude the international community. Identifying some of the elements of a new DLG is the aim of the next part of this report.

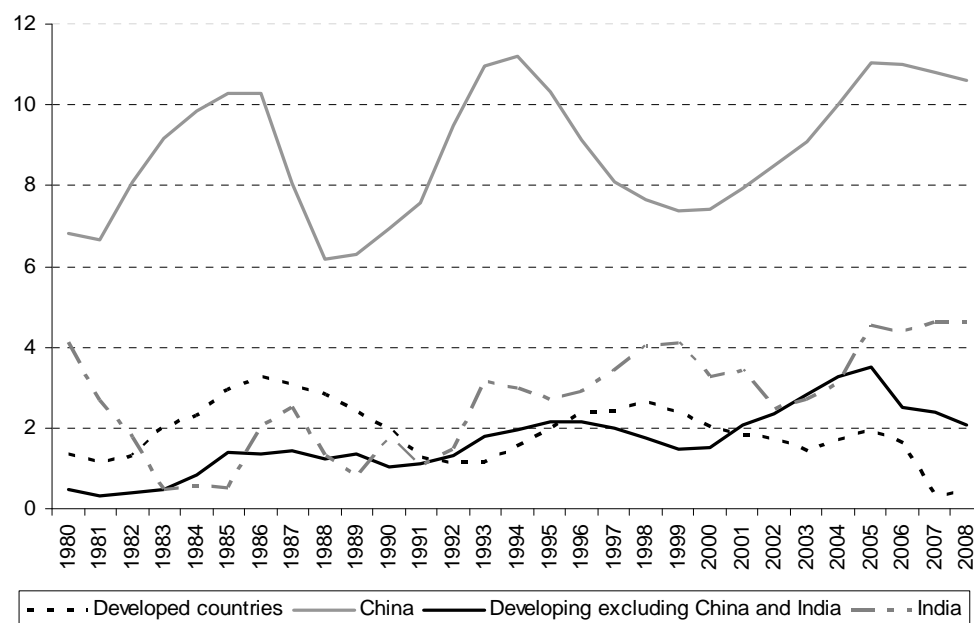
## II. Rebalancing the global economy through sustainable and inclusive development

### A. Introduction

101. Part I of this report argued that FDG has failed to harness the creative forces of markets in support of broad-based growth, while giving greater sway to their more destabilizing and destructive tendencies. Despite this, several success stories in the developing world have delivered sustained growth for several decades, and have proved resilient in the face of the crisis. These achievements have spurred speculation about new “global growth generators” and a “great convergence” in incomes. These are certainly encouraging trends. However, it would be misleading to ignore the fact that, for long periods of FDG, most developing countries posted lower per capita growth than advanced countries (fig. 21). Moreover, these trends give little support to calls to stick to business as usual, since one of the paradoxes of FDG is that emerging success stories have adopted proactive development strategies which are, in many respects, at odds with the dominant strand of economic thinking. Hanging the future of catch-up growth on the recent debt-fuelled boom would seem particularly risky, given what has happened since 2008, given that the imbalances that have accompanied FDG continue to impair sustainable and inclusive development in most countries, and given the real concerns that, in the absence of lasting reforms to the international architecture, another financial crisis could have damaging consequences even for successful developing countries. All the while, demographic and environmental pressures have been mounting, but lasting solutions have been elusive.

Figure 21

#### Real per capita GDP growth rates, five-year average



Source: UNCTAD secretariat, based on the World Bank's *World Development Indicators* (2010).

102. The challenge for policymakers is to put inclusive development firmly at the forefront of the policy agenda. The interrelated nature of the components of inclusive development will add significantly to the burdens of this task. Still, it remains possible to set out policy measures at the national, regional and global level to rebalance the world economy, transcend FDG, turn recent growth spurts into sustainable development paths, and ensure that the gains are enjoyed by all sections of society, particularly the poorest and most vulnerable. This, in essence, is the challenge of DLG.

## **B. Inclusive development and the investment challenge**

103. There is a strong correlation between per capita income and social welfare. This is hardly surprising, but it does not imply that development is synonymous with economic growth. Even growth spurts that continue for some years need not lead to widely shared gains, and where spurts are followed by collapses there is a likelihood that social welfare will suffer. This appears to have been the case with the boom-and-bust cycles generated under FDG. Moreover, at any income level, there is considerable variation across countries in terms of their social indicators: policy choices matter to the kind of development path that countries follow.

104. The key to inclusive development lies in the institutional and policy links which ensure that growth promotes social development, while social development supports economic growth. The Millennium Development Goals (MDGs) have added poverty, employment and social objectives to the international policy agenda, and have indicated the need for a significant scaling-up of resources to finance new investments in social infrastructure and safety nets, along with the formation of new partnerships to accelerate progress on human development. These have been welcome developments. However, and even before the crisis hit, the MDGs had been hampered by the uneven growth and global imbalances accompanying FDG and by inconsistent economic policy advice.

105. A clear picture that emerges from developments over the last decade is the very strong correlation between high levels of inequality and limited progress on the MDGs. Figure 22 plots the average Gini index over the period 2000–2008 against the average headcount poverty rate for the same time interval; it suggests a weak but positive association between inequality and the share of population earning less than \$2 per day. The picture is enriched once we assess directly the impact of inequality on the mapping between growth and human development. Figure 23 shows the differential impact of growth on poverty, by splitting the sample between equal and unequal countries. Those countries with a relatively low inequality (e.g. a Gini index below the sample average) display a much stronger correlation between growth and poverty reduction vis-à-vis the unequal economies for which the impact of growth is close to zero. The importance of addressing inequality becomes even clearer when we consider other measures of human development such as the under-five mortality rate (MDG-4) and the primary school enrolment rate (MDG-2). While the association with growth is positive for the more equal countries, it turns negative when we look at unequal societies. Economic growth, in other words, can worsen the living conditions of vulnerable people where the distribution of income is unequal (UNCTAD, 2010a).

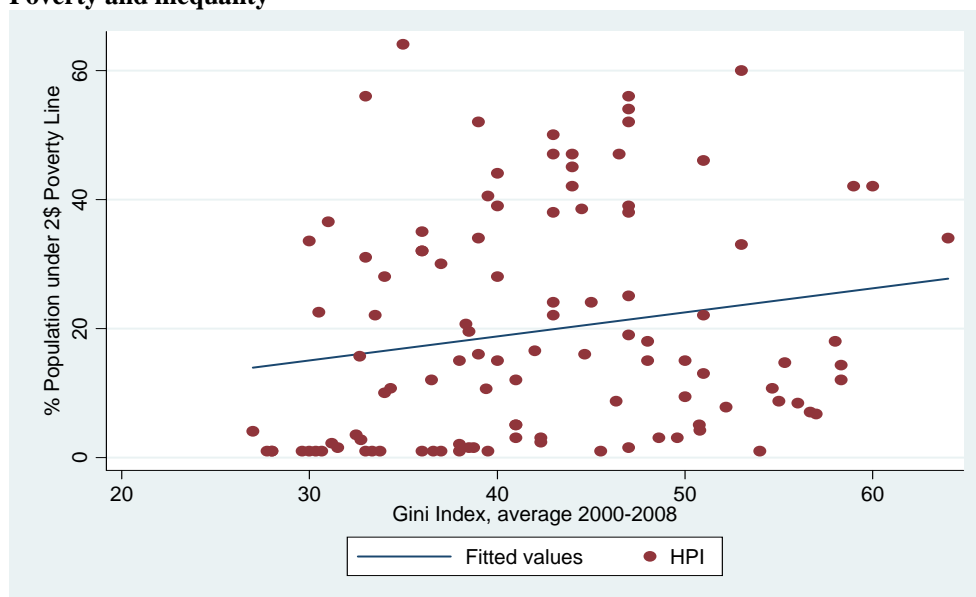
106. Economic and social imbalances are not the only threat to inclusive and sustainable development. Growing environmental fragility poses a profound threat to sustainable development, and this, in turn, is closely linked to demographic pressures and particularly those associated with a rapidly urbanizing planet. This demographic shift, in turn, is placing increasing pressure on labour markets and social services in many developing countries, while also adding to the demands on agricultural systems, which have, in many developing



countries, suffered in recent years from underinvestment even as climatic changes impact on their yields.

Figure 22

**Poverty and inequality**

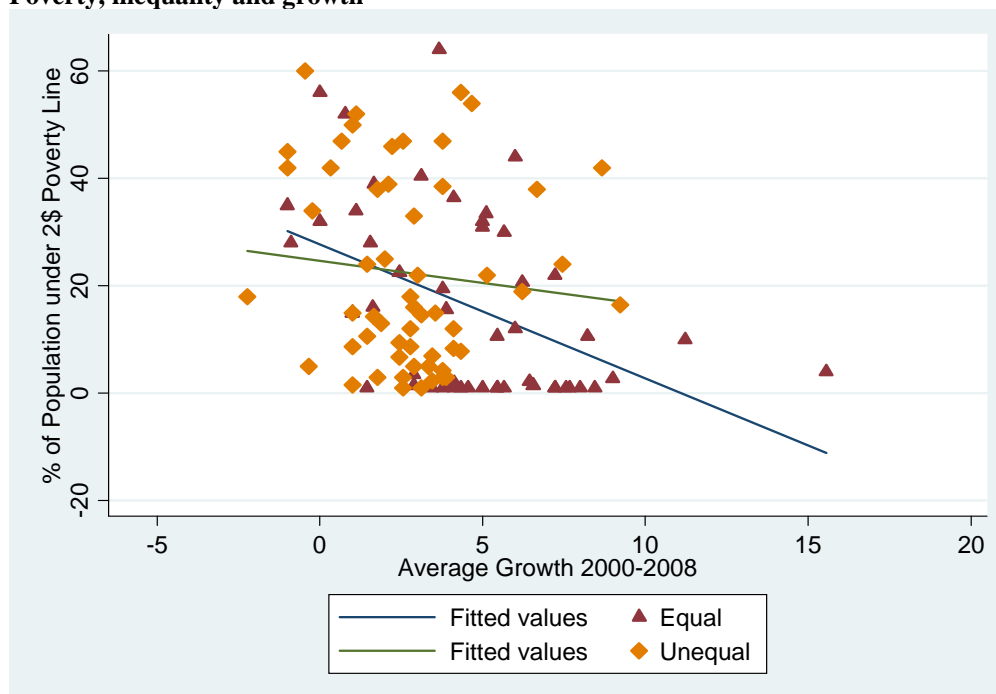


Source: UNCTAD secretariat, based on the World Bank’s *World Development Indicators* (2010).

Note: HPI is the Human Poverty Index.

Figure 23

**Poverty, inequality and growth**



Source: UNCTAD secretariat, based on the World Bank’s *World Development Indicators* (2010).

107. Rebalancing the global economy along these interconnected fronts will be unlikely in the context of slow or unstable growth. Most developing countries need to sustain annual growth rates in excess of 6 per cent per annum to address their economic and social deficits and close the income gap on those higher up the development ladder. The central economic policy challenge remains that of absorbing underutilized domestic resources and adding new ones by building stronger links between productive sectors and expanding markets, at home and abroad. The nature of that challenge varies over time, and across countries at different levels of development. However, in all cases, it is essential that resources are not wasted or siphoned off by a small minority, that support is given to sectors with strong employment multipliers, and that infrastructure investment, including in social sectors, receives strong government support. This will often require investment rates in excess of 25 per cent of GDP.<sup>37</sup> There are complex relationships between investment, growth and development, with multiple lines of causation running across changes in technology and productivity, scale economies, complementarities between demand and supply, and shifting patterns of employment and trade.

108. Very few countries have achieved the required investment and growth rates under FDG, and in those that have, market forces have not been left alone to generate the required financial resources or to direct them in the most productive manner. A significant body of evidence suggests that, after the initial stages of industrialization, when agricultural and commercial incomes provide the main sources of finance, a large part of capital accumulation is financed from retained profits, often in a symbiotic relationship with long-term bank lending which, in turn, is frequently state-led.<sup>38</sup> For many developing countries, a persistent obstacle to building this profit–investment nexus is the absence of local enterprises with the ability to generate sufficient profits to manage a big investment push and the large projects that are needed for industrial and technological upgrading. Given the well-documented rise in the minimum scale of investment needed to maintain a process of structural transformation, more attention needs to be given to the challenge of building and regulating large enterprises in developing countries.<sup>39</sup> Where local capacity to undertake large projects is weak, FDI can make a contribution to industrial upgrading and the progressive establishment of such local capacity, provided appropriate strategies and regulations are in place.

109. Beginning the discussion of DLG with productive investment is important, because it provides an initial link between inclusiveness and a more traditional development agenda. As was discussed earlier, FDG has encouraged the rich to get much richer, on the grounds that they save and invest more than other sectors of society. This trickle-down logic has not worked. For example, economists have long understood that savings may be low because investments are low, rather than vice versa. Moreover, the extent to which the rich save and

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<sup>37</sup> Among the many variables fed into growth equations, investment still emerges as one of the few with a consistently robust and independent impact on economic growth. See TDR (2003): 61–64.

<sup>38</sup> On this profit–investment nexus, see TDR (1994, 1997, 2003), Singh (1999), Ros (2000) and van Treeck (2008). An examination of this nexus from an historical perspective will inevitably have to address the role of entrepreneurship in the development process. Such an examination will need to avoid seeing it as an exogenous variable. In analysing the steady loss of England’s economic lead to the United States starting from the late nineteenth century, Habbakuk (1962: 213) concluded that “the abundance of entrepreneurial talent in the United States of America was the consequence rather than the cause of a high rate of growth, and it was the slow expansion of English industry which accounted for the performance of English entrepreneurs...not the reverse.”

<sup>39</sup> It is a paradox of FDG that while the growing economic influence of large corporations, both financial and non-financial, has been a visible trend in advanced countries, the accompanying development agenda has devoted most of its attention to small enterprises and microfinance. Again, the issue is one of finding the right balance; on the links between firm size and economic growth, see Tybout (2000).

invest their incomes in productive assets can vary considerably among countries, depending on how profits are generated and the extent to which they are consumed. Moreover, if profits are siphoned off into luxury consumption or financial assets, as has happened under FDG, the investment linkages required for inclusive development will be weak or missing.<sup>40</sup> Depending on circumstances, different combinations of fiscal, monetary and exchange-rate policies, including capital controls (box 4), can support the achievement of high rates of productive investment and growth.

#### **Box 4. The case for capital controls**

Foreign capital can make a positive contribution to economic development. However, experience shows that some types of international short-term capital flows can inflict devastating effects on an economy when policies falter in managing those flows (Bernanke, 2011: 24). Even IMF is breaking away from its traditional reluctance to endorse capital controls, despite the fact that these have always been permitted by its Articles of Agreement (see, for example, Articles VI and VII). There is a growing global consensus around the proposition that capital controls may be legitimate policy tools to address macroeconomic and prudential imperatives. However, while IMF economists recognize that “controls seem to be quite effective in countries that maintain extensive systems of restrictions on most categories of flows”,<sup>41</sup> the Fund still seems to see these as a last resort and to be applied only on a prudential and temporary basis.

A regulatory framework appropriately extended to transactions involving foreign assets and liabilities can help to contain destabilizing capital flows by addressing maturity and currency mismatches and exchange rate-related credit risks. Such controls have recently been introduced by a number of emerging economies, including market-friendly taxes on selected inward capital (Brazil), on foreigners’ government bond purchases and banks’ foreign exchange borrowing (Republic of Korea), and on interest income and capital gains earned by foreigners (Thailand and Republic of Korea). Their outcomes have been contested, with suggestions that some of these measures were too marginal to be effective.

It is also not clear that this approach would provide sufficient protection against the risks posed by the kind of unstable capital flows witnessed in recent years. Thus, a broad array of measures to control the entry of non-residents might be needed.

UNCTAD research suggests that controls over short-term capital inflows and outflows should be part of the arsenal of public policy, to be used as and when necessary to regulate currency movements, secure sufficient reserves of hard currency, and maintain the exchange rate within reasonable levels, rather than being introduced as ad hoc temporary measures. The instruments available are well known. Many of them were widely and successfully used during the 1960s and 1970s in the advanced economies, and more recently by many developing countries (TDR, 1998). Over time, and across different countries, they have included:

<sup>40</sup> In this sense, productive investment acts like a social tax restricting the use of profits for the personal consumption of the owners of capital, thereby making for less personal inequality and also bestowing a degree of legitimacy on the broader pattern of income distribution. For further discussion of these links, see TDR (1997).

<sup>41</sup> <http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf>

- (a) Licensing, ceilings on foreign participation, and differential rules on the establishment and operation of foreign financial institutions;
- (b) Taxes, administrative limitations and compulsory deposits – on foreign currency bank accounts, on currency transfers, on foreigners' purchases of government bonds, on bank borrowing in foreign currency, and on interest income and capital gains earned by foreigners;
- (c) Controls on domestic borrowing linked to foreign currency transactions, through the imposition of variable bank reserve requirements and ceilings on foreign holdings of debt issued by the domestic private and public sectors;
- (d) Limitation of offshore trading in the domestic currency, to prevent speculation and foster the repatriation of domestic assets.

These measures carry costs as well as benefits, and the choice to use them should reside with domestic policymakers after careful consideration of circumstances and depending on local needs.

At a global level, a financial transactions tax has been proposed as a way both to limit unruly flows and to provide funding for global public goods. This was originally suggested by Keynes, and it was made famous by James Tobin who proposed a small ad valorem tax on all spot transactions in foreign exchange, including on forward and swap transactions. The impact of the tax on volatility and revenue would depend on its size and incidence. However, most proposals currently on offer would have only a modest impact on both fronts. Despite this limitation, the political obstacles to such a proposal remain deep.

See the following materials for additional details: TDR (1998); Epstein G, Grabel I and Jomo KS (2004). *Capital Management Techniques in Developing Countries: An Assessment of Experiences from the 1990s and Lessons for the Future*. G-24 discussion paper no. 27. UNCTAD. Geneva; IMF (2011). *Recent Experiences in Managing Capital Inflows: Cross-Cutting Themes and Possible Policy Framework*.

110. Access to credit can complement the use of retained profits in financing productive investment. However, left to themselves, private financial institutions often fail to provide credit on a sufficient scale or on appropriate terms. In particular, sectors that have large sunk costs or long gestation lags or high risks (such as infrastructure) are often starved of finance even where it is understood that they are required to support growth elsewhere in the economy. As a result, financial deepening needs to be properly managed by policymakers, for example through selective equity stakes and directed credits, and in a manner that supports building productive capacities (Chandrasekhar, 2008). The need for appropriate regulation of the financial sector is relevant regardless of the ownership structure of the financial institutions, e.g. whether they are state-owned or privately owned, and in the latter case, whether the dominant interests are domestic or foreign. Development banks have a potentially prominent role in supporting the profit–investment nexus in developing countries by filling financing gaps, whether at near-commercial rates on a general basis and on more favourable terms to selective sectors, and/or by providing other investment support services (box 5).

### **Box 5. Back to the future: The role of development banks**

A key problem for developing-country governments is how to achieve policy coherence and mobilize domestic resources in support of virtuous circles of investment, productivity growth, and rising incomes. Commercial financial institutions are part of the required institutional environment, but their procyclical lending patterns, their focus on short-term profitability and the widespread market failures in developing countries set limits on their potential contribution. One possible alternative is national development banks (NDBs), partially or wholly owned by the state. These are understood as “financial institutions set up to foster economic development... taking into account objectives of social development and regional integration, mainly by providing long-term financing to, or facilitating the financing of, projects generating positive externalities” (UNDESA, 2005: 9).

NDBs are far from unusual. Since the Industrial Revolution, but more often since the Second World War, governments have intervened extensively in financial markets to support capital accumulation through the mobilization and (re)direction of financial flows towards priority sectors, regions or firms. These experiences have been widely diverse in terms both of their forms and their outcomes. However, in the wake of the balance-of-payments and other crises taking place across the developing countries since the early 1980s, and the ensuing structural adjustment programmes, there has been strong and continuous pressure to privatize and liberalize the financial system and transfer government control of resource allocation to private (often foreign-owned) financial institutions. This has included winding down or privatizing many NDBs.

A basic rationale for NDBs is that they can take externalities (i.e. discrepancies between social and private returns) into account in their lending decisions, and can lend in order to promote social inclusion and to maximize long-term social welfare rather than short-term private profits. This can give NDBs a pivotal role in catalysing catch-up growth through long-term and large-scale strategic projects. These include infrastructure (energy, transport, sanitation, housing and so on), agriculture, heavy industry, R&D (where externalities are especially pervasive), the internalization of significant production chains, national integration, regional development, import substitution and export diversification. In sum, NDBs “can play a role in both the creation of markets for long-term financing and in guaranteeing access to financial services by the poor” (UNDESA, 2005). In contrast to private commercial banks, development banks can also help to stabilize domestic financial markets because they do not engage in speculative operations, which can support the government during financial or balance-of-payments crises.

NDBs are likely to be capitalized through tax revenues, however diversifying the sources of funding (subsidized foreign loans or aid) will increase the financial autonomy of the NDBs, avoid competition with other potential uses of tax revenues and with the sources of regular bank funding (e.g. public deposits and short-term papers), and reduce the maturity mismatches which limit the capacity of commercial banks to finance development projects.

Once in operation, NDBs tend to engage in several types of operations, including (a) project appraisal, taking into account social rather than private rates of return; (b) provision of long-term loans, which is essential for infrastructure projects, either to domestic investors or to a combination of

domestic and foreign enterprises; (c) purchase of equity positions (shares or options) to signal state support and commitment; (d) provision of expertise and technical assistance to key sectors and strategic projects; (e) signalling government support for specific projects, and catalysing private sector credit into supporting ventures; (f) provision of countercyclical credit in order to moderate economic fluctuations; (g) pooling of small private- or public-sector (e.g. municipality) loans into negotiable packages; and (h) creation of new mechanisms and markets for long-term lending.

The ownership structure and operations of NDBs can take very different forms, which invariably change over time. For example, state-owned banks have been pervasive in some advanced countries; in Germany and Japan they account for credits equivalent – respectively – to 45 and 20 per cent of the domestic market (in 2005). In Brazil, state-owned banks provide credit directly to strategic firms, while in India they more usually take the form of universal banks. In China, household retail deposits support the lending programmes of the four main (state-owned) commercial banks. In most countries, NDBs offer support to strategic sectors, such as the Banque Nationale de Développement Agricole in Mali (agriculture) or the Banco Nacional de Desenvolvimento Econômico e Social in Brazil (infrastructure, heavy industry and the emergence of “national champions”). Other priority sectors can include education, fisheries, health, manufacturing, mining, tourism, and export-import activities. Experience shows no contradiction between a developed and internationally integrated financial system and extensive public sector intervention in the provision and direction of credit flows.

111. Private firms are most likely to take the lead role in animating the profit–investment nexus. However, this does not exclude a potentially significant role for public investment. Rather, an important policy challenge for countries at all levels of development is to strike an appropriate balance between the two. Reversing the declining share of public investment that has occurred under FDG is likely to be a priority in many developing countries, including the least developed (UNCTAD, 2010b; TDR, 2011). As will be discussed further below, retooling macroeconomic policy to strengthen its capacity to mobilize financing for long-term public investment and social development will require enlarging the fiscal policy space by steadily broadening the tax base, where possible, making the tax structure more progressive.

112. Finally, FDI can help catalyse and bolster the profit–investment nexus. To do so, and as with large domestic firms, policymakers will need to monitor whether and to what extent TNCs bolster the capabilities of domestic firms through, for instance, access to finance and technological and other spillovers. At the same time, it is also important to monitor potential negative consequences, such as net balance-of-payments impacts, or the attrition of local companies in the face of competition with TNCs.<sup>42</sup> A range of policies is available to more assertive governments to make sure that the interests of TNCs, as much as possible, coincide with national development objectives. Countries that have adopted clear policies to guide FDI as part of their national development strategy do not appear to have had much difficulty in attracting it: coherent national policies and good prospects for

<sup>42</sup> On the balance-of-payment effects of FDI flows, see WIR (2006) and TDR (1999).

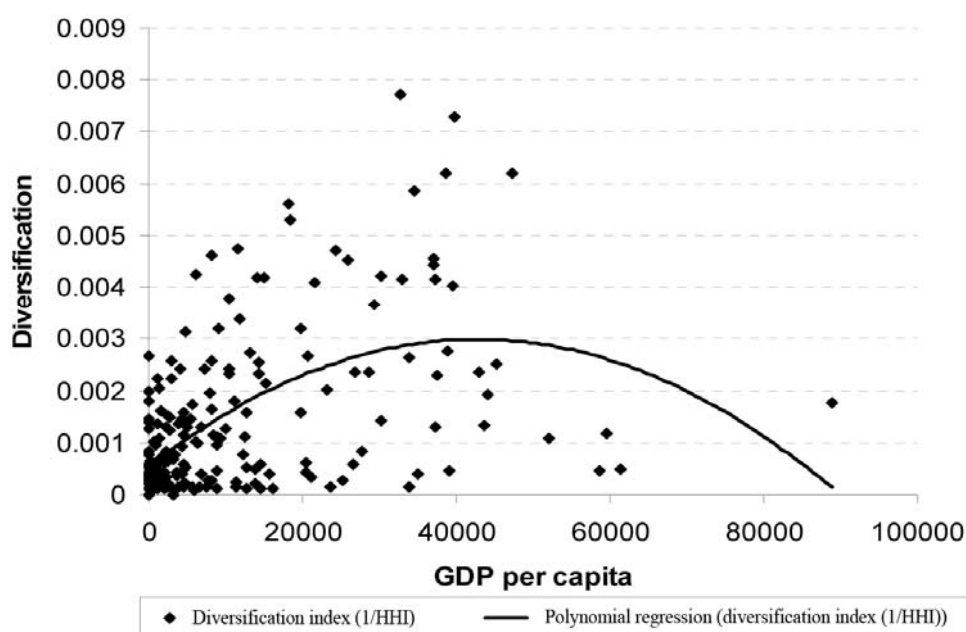
growth remain the key attraction for TNCs, and at the same time increase the chances that host countries will take advantage of TNCs' presence.<sup>43</sup>

### C. Trade, technology and industrial policy

113. As discussed earlier, strong links between investment and exports provide another key link in building virtuous growth and development circles. The kind of investment–export nexus compatible with sustainable growth and development is unlikely to emerge automatically, even in the case of commodity exporters and labour-intensive manufacturers where many developing countries have their greatest resource and cost advantages. However, when it comes to building more inclusive and sustainable development paths, it is not just the volume of trade that matters. Most countries appear to have diversified their economies as they successfully move up the income ladder, before becoming less diversified as they shift to a more service-driven economy at high levels of development (see Imbs and Wacziarg (2003), and fig. 24). Such diversification appears to be closely linked to improving employment conditions and bolstering economic resilience to external shocks. The policy challenges will increase considerably as the production process becomes more scale- and knowledge-intensive, since the technological and organizational capabilities required to compete internationally are becoming more costly to acquire and more difficult to master, and the investment climate is becoming more challenging.

Figure 24

#### Diversification and economic development



Source: UNCTAD secretariat, based on the World Bank's *World Development Indicators* (2010).

Note: Diversification is 1/Herfindahl-Hirschman Index.

<sup>43</sup> For further discussion of the kinds of policies needed to ensure that FDI brings about wider development gains, see various editions of WIR, as well as TDR (1996) and the *Economic Development in Africa Report* (EDAR) (2005).

114. The middle-income trap, as discussed earlier, has become a reality for a number of countries under FDG, particularly where trade in manufactures (and services) is tightly organized around international production networks. The danger is that countries are stuck with a narrow structure of production which is difficult to broaden and deepen. A vibrant industrial base, robust local markets and a dynamic enterprise sector are essential if FDI is to contribute to a continuous process of economic and technological upgrading. Countries where an inflow of FDI has been accompanied by significant investments in building domestic capabilities (e.g. China, Ireland and Singapore) have been the most successful in leveraging the potential benefits of FDI (Harrison and Rodríguez-Clare, 2010).

115. Accordingly, there is a need for policymakers to continuously promote investment in activities with potential for raising productivity growth and with strong backward and forward linkages both within and across borders. Macroeconomic policies, including exchange rate and interest rate policies, can certainly have a strong bearing on the pace and direction of structural change (Rodrik, 2010), although their impact tends to be “horizontal” (or cross-sector). By contrast, industrial policy is “vertical”, aiming to produce differentiated outcomes in order to promote expansion of the sectors and activities with the greatest potential for generating economies of scale, upgrading skills and raising productivity. However, a continuous process of structural transformation and upgrading will almost certainly require the constant interaction of these policies; aggregate investment can be boosted through the expansion of sectors with strong backward and forward linkages to the rest of the economy, while industrial policies can help to strengthen the profit–investment nexus, boost the fiscal base, and ease the balance-of-payments constraint.

116. As discussed earlier, FDG has often failed to generate the required productive linkages in developing countries. This is not so much because FDG has shunned industrial policies, but (as with macroeconomic policy) because its preferred measures – privatizing state assets, attracting FDI, promoting SMEs etc. – were subordinate to the task of getting prices right. This approach lacks the strategic focus needed for establishing a more dynamic development path, does not actively extend support for the absorption, diffusion and upgrading of technologies, and does not alleviate the balance-of-payments constraint.

117. In most developing countries, a much more expansive and active industrial policy is required to support, direct and coordinate the processes of capital accumulation and structural transformation. This is not synonymous with public ownership or picking winners, although these are not precluded; rather, it is part of a process of coordinated search and discovery, whereby firms and governments uncover market failures, learn about the underlying costs and profit opportunities associated with new activities and technologies, evaluate the possible externalities associated with particular projects, and use the acquired information and skills to push towards a more diversified and higher-value-added economy.

118. Successful industrial policies have often targeted the expansion of capital- and knowledge-intensive sectors with high technological sophistication, supported strategic forward and backward linkages and aggregate demand growth, and relaxed the balance-of-payments constraint through the creation of new competitive advantages. These strategic sectors tend to be concentrated in manufacturing.<sup>44</sup> However, as these features are present in other sectors of the economy in many developing countries, and particularly LDCs, these policies will more likely depart from priority areas in agriculture, because of their economic significance, potential linkages to other sectors, importance for the balance of payments, and the fact that large numbers of poor people still live in rural areas (LDCR, 2009).

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<sup>44</sup> The capital goods sector remains, in this respect, key to diversification in many middle-income countries. See Lo and Zhang (2010) for a discussion of the importance of this sector to the recent Chinese growth story.



119. Specific constraints that must be addressed in order to raise growth prospects in the rural economy include poor soil fertility, limited access to seeds at affordable prices, limited availability of water, lack of appropriate crop technologies, and gender-biased property rights. There are no quick or general solutions, but macroeconomic and exchange rate policies can be used to reduce income instability and raise the relative profitability of different activities. Beyond these horizontal measures, effective policy intervention might, depending on circumstances, require reforms to the land tenure systems, the provision of extension services, tailored financial institutions to provide credit, and significant investments in physical and social infrastructure, including irrigation, rural roads, and storage and transportation facilities. Still, it remains the case that even in predominantly rural economies, there tends to be a strong positive correlation between the growth of manufacturing output and the growth of productivity in manufacturing as well as non-manufacturing activities. In countries that have experienced “premature deindustrialization”, as has been the case in sub-Saharan Africa, simply recovering lost ground in manufacturing is likely to bring rapid productivity gains.<sup>45</sup>

120. A comprehensive industrial policy framework should consider the following elements (TDR, 1996 and 2006):

- (a) A managed financial sector, including both private and state-owned institutions, to help mobilize and protect savings, and to bolster profits for productive investments particularly in priority areas (e.g. using preferential credit conditions and measures to help socialize risks on long-term projects).
- (b) Subsidizing the early stages of new products or technologies, including through favourable fiscal measures, public R&D funds, training schemes and other measures to bolster human capital development.
- (c) Sectoral dialogues between businesses and the government, to identify investment opportunities that might be vulnerable to coordination failures or to other kinds of market failure.
- (d) General and strategic trade measures, including export incentives, targeted import restrictions, support in meeting international product standards, a competitive exchange rate etc. to help firms take advantage of foreign market opportunities.
- (e) The use of public spending to support strategic sectors, including through government procurement (such as tendering and reverse auctions), and the use of public investment to remove general growth bottlenecks, especially in infrastructure.
- (f) Competition rules and targeted policies to regulate market power, manage entry into key growth sectors, address coordination failures, and promote knowledge development, including in intellectual property, with the aim of maximizing learning spillovers.
- (g) Targeted regional measures to address geographical inequalities – including tax incentives and regional funds, as well as support for local skills development to attract investment.

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<sup>45</sup> Moreover, it is essential to begin absorbing the rapidly expanding urban population into the formal economy. For a more detailed discussion of the specific industrial policy challenges in LDCs and Africa, see TDR (1998), LDCR (2009) and EDAR (2011).

121. There has, in recent years, been a tendency to restrict industrial policy measures through multilateral, regional or bilateral agreements (TDR, 2006; Rodrik, 2007). However, some countries have carefully crafted their international commitments (see, for example, WIR (2011), chapter 3), and there still remains scope for many of these policies, especially if countries do not give up policy space any further. Just as importantly, because these policies work by creating, directing and withdrawing rents to the private sector, there are a number of institutional factors which appear to be important for their success and whose absence can help to explain the failure of past efforts in developing countries. First, the rents created by these measures should be provided only to productive activities that support the broader national economic strategy and on a temporary basis. Second, these rents should be made available only as a condition of enhanced performance, especially with respect to exports and technological upgrading. Third, an appropriate structure of public institutions and, not least, a dedicated and competent public bureaucracy is required to manage these rents (see below). Fourth, strong counterparts in the private sector are needed to coordinate with the government, facilitate information exchanges, and resist short-term pressures which could undermine these development policies. Large, diversified business enterprises that have close, interlocking ownership relationships with banks provide one such model.

122. Development strategies should also, albeit with appropriate limits, look to constantly push the technology frontier by incorporating selected high-productivity projects with a more advanced technological and skill profile and with higher levels of R&D. Doing so can be linked to investments in tertiary education, science parks, or efforts to attract a skilled diaspora abroad with the hope that there will be transfers of expertise elsewhere through changing jobs or opening small businesses. UNCTAD has argued that a national innovation strategy can help coordinate the various activities and policies, in both the private and public sectors, in support of the stronger knowledge and learning capacities that are needed to close technological gaps (LDCR, 2007).

123. At all levels of development, strengthening non-tradable sectors will also have a role to play in ensuring inclusive growth. These include infrastructure (roads, ports and airports, electricity generation and transmission lines, housing, water and sewerage provision), which might benefit from large-scale public works programmes, as well as lower-productivity sectors including construction, repair workshops and non-durable consumer goods industries, which have a significant employment-generating potential and train entrants to the labour markets. It should be clear that in these sectors there are potential trade-offs between boosting productivity and expanding employment. How best to manage those trade-offs cannot be determined outside particular circumstances.

124. What seems abundantly clear from an examination of success stories is that the investment and industrial policy challenges have been approached in an integrated fashion as part of a broader development vision of progressive structural changes and rising living standards. This requires the presence of institutions that can fashion a vision of the national interest that is not limited to those with privileges and vested positions in the status quo. Political leadership and effective governance structures to build and sustain support for inclusive development paths is, as a consequence, a crucial ingredient for the prospects of their success.

125. The challenge of industrial policy is likely to take on even more importance as efforts step up to create a low-carbon future and for which policies focused on specific sectors – particularly energy, transport, and extractive industries – will be critical. Currently, many countries still have policies favouring high-emissions sectors. A logical, though not easy, first step would be to reorient support from these sectors towards renewable and/or cleaner energy sources. The lead will need to come from advanced countries, whose emissions have contributed most to the problem of warming temperatures.

But in all cases, taking that step will involve the kind of integrated approach to macroeconomic and industrial policy outlined in this section.<sup>46</sup>

## D. Developmental states

126. Active macroeconomic and industrial policies are often seen with scepticism because of concerns that the state, especially in poor countries, is “too inefficient” or that civil servants are “too corrupt” to implement discretionary policies successfully. There are undoubtedly failed policy experiments to point to, but concentrating on these is often driven by an ideology which either ignores or deliberately aims to obscure the policy successes in countries, at all income levels, in nudging and bending as well as supplanting market forces in order to achieve their economic goals.

127. Despite any number of shortcomings, the state remains the only institution that can manage large-scale economic and social change, that can influence the aggregate level of employment, the production and allocation of goods and services and the distribution of income and assets, that can limit the power of sectional interests, and that is (or at least is potentially) accountable for its decisions. Institutional weaknesses and governance deficits must be confronted at every level of development; the history of today’s advanced countries is one of constantly reforming corrupt bureaucracies, inefficient markets and weak state institutions while building up effective public services.<sup>47</sup> Regardless of its preferred policy goals and instruments, any successful state must be able to strengthen its own capacities to promote learning and cooperation and to deepen the institutional networks that are needed by non-government actors to support long-term growth and innovation, especially where market failures are rife.<sup>48</sup>

128. Developmental states have not been unduly concerned with ownership or direct control of large parts of the economy, but with the design of policies and incentives in support of rapid and broadly shared growth.<sup>49</sup> The key features that discriminate between the institutions that have promoted sustained catch-up growth and those that have not, including in the era of FDG, are related to the state’s capacity to coordinate different interest groups, generate confidence in its actions and behaviour, and establish national development as an urgent overarching project. Successful states have enhanced their competencies through the development of structures of accountability; through continuous improvements to staff recruitment, promotion, compensation and training; and through the introduction of (semi-)public institutions and other types of partnerships, particularly with industry associations, but also with trade unions, universities and research bodies. They have also created regulatory and supervisory bodies, often with significant degrees of independence from the political process, to provide the rules and surveillance that help markets to operate, while seeking to minimize possible microeconomic and macroeconomic distortions.

<sup>46</sup> For further discussion of the role of industrial policy in promoting low-carbon economies, including the advanced role of a number of developing countries, see UNDESA (2009), TDR (2009), WIR (2010) and UNCTAD (2011c).

<sup>47</sup> On Britain and France in the nineteenth century, see Wraith and Simpkins (1963); on the United States in the early twentieth century, see Glaeser and Goldin (2006); on Japan, see Johnson (1982); and on the small European economies, see Vartianen (1995).

<sup>48</sup> For a useful comparative assessment of different developmental state arrangements, see Akyüz, ed. (1999), Kohli (2004) and Omano (2010). Douglas North (2004) has used the term “adaptive efficiency” to refer to political arrangements that encourage change through a process of participation and cooperation. Accordingly, North places a strong emphasis on institutional arrangements that are predisposed to learning and experimentation as a condition for long-term growth and development.

<sup>49</sup> Government spending is not, therefore, a good measure of state intervention.

129. Building upon this idea of continuous adaptation to shifting economic circumstances, the notion of the developmental state grew in relevance through its perceived role in the industrialization of several East Asian economies, with Japan as the classic precursor, followed by the four “tigers” (Republic of Korea, Taiwan Province of China, Singapore and Hong Kong) in the 1960s and 1970s (TDR, 1994). These were followed, in turn, by Malaysia, Thailand, Indonesia, China, Viet Nam, and others. In all these cases, the state created a predictable economic environment with reasonably secure property rights, a prominent role for market competition based on technological advantages, and a broadly pro-investment stance. These states also invested heavily in human capital. This has been referred to as “market-enhancing governance” (Khan, 2009).<sup>50</sup> However, albeit with varying degrees of success across these countries, the basic bargain between the state and business went well beyond providing these conditions; it also increased the supply of investible resources, socialized long-term investment risks, and provided support services in such areas as technology, training and exporting. State-sponsored accumulation and technological progress involved, variously, the transfer of assets from less to more productive sectors, control of the financial system, obtaining foreign technologies and adapting them to local conditions, a pro-investment macroeconomic policy, and direct public investments in some activities along with selected priority investments to encourage diversification and upgrading. These have been pursued within an integrated strategy based on a shared vision of the country’s development, and have generally enjoyed broad, though not unanimous, social consent, supported by institutional arrangements for continuous dialogue and coordination with key stakeholders.

130. Successful developmental states exhibit a number of other important qualities other than being open to dialogue. Particularly importantly, they have also been willing and able to discipline the beneficiaries of state support. This has meant attaching clear performance criteria – whether in the form of export targets, the replacement of imports, increasing local content, or closing the gap between domestic and world prices – to that support, and withdrawing it when firms eventually become competitive in international markets or if they consistently fail to perform according to expectations. The weakness or absence of such criteria, or their inconsistent application, appears to be one of the reasons why industrial upgrading in Asia’s second-tier NIEs has advanced more slowly than in its first-tier NIEs.<sup>51</sup>

131. Developmental states have also been willing and able to experiment with policy choices. This reflects the realities of operating in an uncertain world where knowledge of the best ways to promote economic growth and development is both limited and heavily contextual. Experimentation, together with rules and norms to ensure that failed experiments are dropped rather than continued, is thus crucial for raising the probability of success for an adopted development strategy.

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<sup>50</sup> This is what many commentators refer to as “good” governance. As Khan (2009) shows in his examination of cross-country correlations, there is a positive (albeit weak) relationship between good governance and subsequent growth performance. However, this is explained by the performance of advanced countries. Market-enhancing governance does not correlate positively with growth among developing countries. This does not mean that it is not important – any country in which the market plays a prominent role should be concerned with improving its efficiency through market-enhancing governance – but rather that it is not sufficient for achieving catch-up growth.

<sup>51</sup> For further discussion on the disciplining role of the state, and why some states appear to be better than others in this respect, see Amsden (2001) and Wade (2010). The ability of the state to carry out this function is likely to be made more difficult where TNCs have a particularly dominant role in the economy. On the differences between the role of the developmental state in the first- and second-tier NIEs, see the papers in Akyüz (ed.) (1999).

132. Given the pressing need to build more inclusive development paths, as well as the successes achieved in several countries over time, the notion that the poorest countries in the world should wait until their state institutions are judged by others to be “good enough” before they can exercise their national developmental prerogatives is both unrealistic and destructive of the prospects for development (LDCR, 2011). There is no reason to suppose that the stock of successful development strategies has already been exhausted, and countries are likely to thrive in the future by discovering unique development paths responding to their specific challenges (box 6).

**Box 6. Inclusive growth in sub-Saharan Africa: An alternative agenda**

At the beginning of the millennium, there was little doubt that the promises of structural adjustment programmes had failed to materialize in sub-Saharan Africa (SSA). The combination of macroeconomic austerity, rapid liberalization, privatization and deregulation not only failed to produce a supply-side revolution but, instead, set the region back economically; productivity growth stalled in most sectors, and the informal economy had grown rapidly since the onset of the international debt crisis in the early 1980s.

Since then, there has been much discussion of an African “economic renaissance”. GDP growth between 2001 and 2008 averaged 6 per cent per annum across the region, which translated into real per capita growth of about 3 per cent. Growth was also relatively widespread, and only a few economies contracted during this period. There was a sharp downward swing in 2009 as a result of the financial and economic crisis, but generally growth rates remained positive, and there has been a rebound in many countries.

In light of these changes, IMF has talked of a “great SSA growth take-off” attributed to the earlier structural and institutional reforms “that reduced state controls and liberalized trade and domestic financial markets”. It has also speculated that SSA could be the new financial frontier, with calls to intensify financial liberalization and integration. Ignoring its own research on the lack of empirical evidence linking financial liberalization to growth, the Fund has also claimed that “there is general agreement that the kinds of reform needed to curtail the power of entrenched economic interests and liberate the productive potential of developing economies are also helpful in attracting private capital flows and making these flows more productive” (IMF, 2010).

While the growth spurt in SSA is a welcome development, the term “take-off” is too strong to describe what has been happening across the region. First, there has been wide variation in economic performance across the region, with very rapid growth rates in some oil and mineral exporters, which distorts the picture for the majority of non-booming-export countries. Second, even during IMF’s chosen period (1995–2007), the number of fast-growing countries (17) is matched by the number of slow growers (14). Third, even under these exceptional circumstances, the average performance for the region still lags behind that in East and South Asia for this period, and the income gap with other developing countries has continued to widen – for some countries sharply. SSA is still a long way from repeating the East Asian take-off, and business as usual will not bring it about.

An alternative and pragmatic development agenda for SSA is needed to bring about more inclusive and sustained growth across the region. Such an agenda will need to be both more comprehensive and more integrated than was the

case previously. It will, on the one hand, have to better connect macroeconomic policies with the sectoral measures needed to effect structural transformation, and on the other hand, construct a social agenda beyond simply meeting the MDGs. This will require building a policy framework around a strong growth–investment–employment nexus. It will mean more active fiscal measures, including countercyclical measures and a commitment to public investment. Monetary policy will also have an important role to play, ensuring that interest rates remain low and exchange rates remain stable and competitive. These policy instruments can help to strengthen investment prospects, including in the agricultural sector, but they will require support from development banks to ensure that credit is effectively channelled, and capital controls to support an effective and stable exchange rate regime.

Structural transformation will also require effective industrial policy. Traditional aspects of this agenda, including dealing with market failures and picking winners, need to be addressed, together with the creation and management of rents. However, the absence of firms of an adequate size remains an obstacle, not only to building a strong profit–investment nexus in many African countries, but also to taking advantage of increased FDI flows in some key sectors.

A key institutional challenge will be creating (or in some cases recreating) developmental states in SSA. In doing so, it will be important to take lessons from other experiences, even while recognizing that local conditions and constraints are paramount in defining the context for rethinking the role of the state. Success cases from the region, including Botswana and Mauritius, provide useful lessons in this respect. However, as is the case in SSA, external constraints remain tighter than in other regions. Emerging African developmental states must also be ready to position themselves in the wider regional context and beyond, including the establishment of South–South links outside the region. Given the adjustments currently under way in many advanced countries, this South–South agenda has arguably become much more important than in earlier periods. It will necessarily involve both augmenting strategic economic ties through trade, FDI, finance and technology, and greater cooperation through the sharing of information and policy lessons.

For further discussions, see TDR (1998) and the annual *Economic Development in Africa Report*.

133. Still, securing the means to “govern the market” in support of inclusive development will require the (re)construction of state policymaking and managerial capacity in many developing countries, including reforms to administrative processes and policymaking. Restoring an effective role for the state will, in many cases, require a break with the adjustment programmes that accompanied FDG. Although the intention was often otherwise, these programmes have in many cases led to a softening of state authority and its capture by privileged insiders (Mkandawire, 2001). Honest, impartial and competent administrative, fiscal and judicial systems are crucial, not only for upholding the rule of law and limiting corruption, but also for building an atmosphere of trust in public institutions without which any state is likely to prove highly fragile.

134. All this should not be taken to imply that states – developmental or otherwise – are infallible, or even necessarily benevolent, but it recognizes that market economies can operate efficiently within a wide spectrum of political and social arrangements, and that

successful development strategies are moulded to local conditions and constraints. Moreover, when market economies are compared over time, we see considerable shifts in their political and social arrangements, suggesting that what works in one period may fail in another, and that successful economies are those that have developed the capacity to adapt their institutions and conventions to changing circumstances. This implies that, beyond a few core elements, there is no homogeneous model of state–market relations. Each country must experiment and find the configuration of institutions and conventions that will work best in its national conditions, and meet the shifting expectations of its population at each point in time.

## **E. From social protection to inclusive development**

135. Successful developmental states have been able to rise to the investment and industrialization challenges. However, doing so is not necessarily sufficient to establish an inclusive development path. Experience shows that abject poverty has persisted despite rapid growth in several economies; in contrast, some poorer and slower-growing economies have been remarkably successful in alleviating extreme poverty and social deprivation (Dagdeviren et al., 2002). The relatively equal distribution of income and wealth in several Asian “tiger” economies and, before them, in the Scandinavian countries, demonstrates that equality is compatible with strong economic performance.<sup>52</sup> By contrast, high levels of inequality in many Latin American economies have coincided with weak and uneven economic performance. These lessons suggest that growth and social inclusion can be pursued together with the aim of building a resilient social contract that can support structural changes but also mitigate the social costs that often accompany the development process (UNDESA, 2008; United Nations Research Institute for Social Development (UNRISD), 2010).

136. The channels linking inequality and growth are many and complex. However, three crucial variables for building greater inclusiveness into any policy strategy, and at all levels of development, are the distribution of income, the employment content of growth, and its gender dimensions. In light of the earlier discussion, measures to reregulate finance are likely to have a direct and positive impact on stimulating a more inclusive pattern of growth, including by impacting on all these variables, but also by freeing up policy space to address them more effectively. This is particularly important in strengthening the employment content of growth. In many developing countries, where the labour force is expanding quickly, particularly in urban areas, job creation remains the only assured way of tackling poverty on a sustained basis. However, for inclusive development, jobs must also bring steadily rising household incomes and expanding local markets. In this respect, as discussed earlier, the tendency under FDG for wages to lag behind productivity growth can pose a major obstacle to inclusive development. In part, this reflects the recent additions to the global labour force along with heightened mobility of capital, leading, under some circumstances, to a race to the bottom. However, policy choices also matter; under FDG, low levels of inflation and labour market flexibility have been given priority over job creation and decent work conditions. More appropriate macroeconomic policies, along with active labour market policies, can help to manage the cyclical threats to employment, and also boost skills and capacities to ensure that workers can adapt to longer-term structural changes. There is, in addition, an array of measures, from transfer payments and microfinance schemes to public work programmes, that can be used to improve the effectiveness of labour markets even in the poorest countries (UNDESA, 2008; ILO, 2011).

<sup>52</sup> For a comparison of the East Asian and Scandinavian experiences, see Chang and Kozul-Wright (1994), Yu (1999) and Moene and Wallerstein (2006).

137. There is a close relationship between socio-economic development and women's empowerment. Economic policies, particularly those aimed at fostering market integration, tend to impact on men and women differently, and development strategies should aim to promote gender and other forms of equality, in order not only to increase social welfare and facilitate the realization of human potential but also to improve the underlying performance of the economy. It is often claimed that international trade offers opportunities for women's empowerment through employment in the export sectors, the production of cash crops, and the creation of new businesses by women entrepreneurs. This is certainly true. However, trade can also have a negative impact on women, if it disrupts economic sectors and markets where they were active, or if it creates mainly temporary or seasonal low-paid jobs with few opportunities for training and promotion and limited or no social security provision. Indeed, on some assessments, gender inequality has been an important factor in the unfavourable movement in the terms of trade between developed and developing countries (Osterreich, 2007). The opening to international markets requires adaptation at several levels, but women are often less able to adapt than men, due to gender biases in education and training, gender inequalities in the distribution of income and command over resources, and entrenched inequalities in the distribution of household tasks, which translate into gender differences in occupational distribution and earning potential (box 7).

138. These variables are as important for building new and inclusive growth paths in developed and developing countries alike. However, three particular issues for policymakers in developing countries are likely to come to the fore. First, over half of the labour force in many developing countries works in agriculture, often mixing paid employment with work on their own small plots, with insecure conditions and poor rewards. Experiences in Asia and Latin America (though less so in Africa) show that the expansion of non-farm rural employment and improvements in job conditions for these workers can have a large and immediate impact on household security.<sup>53</sup> In the case of China, for example, it has been found that growth in agriculture is 3.5 times more successful in reducing poverty than growth in the non-agricultural sector, and the figure is even higher in South Asia (United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP), 2008: 127). Public spending in support of this sector is therefore key to the inclusive development agenda in many countries. However, particularly where agriculture comprises mainly smallholders, the state will need to partner with producer associations and other non-state actors to deliver support services.<sup>54</sup>

#### **Box 7. Trade and gender**

Millions of women in developing countries work in sectors such as agriculture, textiles and clothing, which are not only important for export performance but are also highly vulnerable to the impact of premature trade liberalization. For example, between 50 and 90 per cent of workers employed in the export sector of middle-income countries are female (OECD, 2005). Women also play a significant role in informal cross-border trade. While many of them pay taxes and duties, they are disproportionately exposed to bribery, harassment and physical attacks at border points (UNIFEM, 2010; World Bank, 2011). Additionally, women are more vulnerable than men to shocks emanating from the trade sector, and empirical evidence shows that trade liberalization can generate a greater adjustment burden for women.

Recognition of women's contribution to trade and their exceptional vulnerability have led to a growing interest in the relationship between trade

<sup>53</sup> See Demeke, Guta and Ferede (2003), Gordon and Craig (2001), and Mugrai and Ravallion (2005).

<sup>54</sup> UNCTAD has extensively researched the potential of organic farming, both for its economic and its ecological potential. See, for example, UNCTAD (2006).



and gender. A key issue is how to better integrate gender analysis (which tends to focus on the household level, including women's unpaid labour and the gender wage gap) with a detailed analysis of the adjustment burden associated with trade liberalization, and the implications for women's empowerment.

Initial concerns about gender being a "new" issue or another potential source of conditionality are easing, as more governments realize the importance of adopting a proactive stance to engendering trade. The reasons are twofold. Firstly, there is recognition that gender equality is a commitment emanating from international negotiations, including the Committee on the Elimination of Discrimination against Women, the Beijing Platform for Action, and various regional initiatives. Most governments are also committed to social equity and social development objectives, including the MDGs. Secondly, there is growing empirical evidence about the relationship between gender and trade competitiveness, leading several governments to take action to mitigate the adverse impact of technological disparities, market distortions, information bias and asymmetries in resource mobility on women's productivity, livelihoods and empowerment. Government initiatives promoting gender equality and women's empowerment in the field of trade include:

- (a) The gender-sensitization of Uganda's export strategy in 2007;
- (b) The implementation of the East African Subregional Support Initiative for the Advancement of Women (EASSI) at five border points including Kenya, Rwanda, South Sudan and the United Republic of Tanzania, as part of its joint gender and trade project; and
- (c) The Government of India has conducted a study on gender and trade and is currently examining the scope for a gender-based foreign trade policy.

Gender-related commitments need to be tailored to the economic and political context of the countries involved. Gender and trade impact-assessment tools could provide useful information on sensitive sectors where trade liberalization should be expedited, delayed or avoided, with a view to protecting or promoting women's employment and women-owned enterprises. In these sectors, training and educational policies and other measures should be put in place to upgrade women's skills, tailor their market integration, and provide financing and technology to enable them to move to higher value-added sectors.

Explicit references to gender equality in the trade agreements could also help to increase the political commitment of key stakeholders, and may increase the funding available for gender-related programmes of technical cooperation, including the Aid for Trade framework. Such financing is critical for the establishment of research capacity in the developing countries to conduct gender impact assessments of trade agreements, to foster the construction of gender-disaggregated databases, and to further encourage developing-country governments to take ownership of gender-related policy options, while enhancing the coverage of gender-related trade assessments.

139. Second, in many developing countries, rapid liberalization and tight macroeconomic policies have added to the informal labour market and contributed to downward pressure on wages in the formal economy. Improvement of employment conditions depends on increasing investment and accelerating economic growth. However, well-designed labour market and workplace regulations can prevent a race to the bottom by restricting the ability of firms to gain competitive advantages through the erosion of wages and benefits or standards of safety and security in the workplace. Inclusive growth can be promoted through steadily rising minimum wages (appropriately tied to productivity and inflation rates), coupled with incentives for improving the incomes of small-scale producers (such as credit subsidies), improved health and safety regulations (and the means to enforce them), and the reduction of wage dispersion. The introduction and design of such measures will be country-specific, but will in all cases require the developmental state to engage in an open and continuous extended dialogue with relevant interest groups, including organized labour, much as it has done with business interests. Under some circumstances, and where the institutional conditions are in place, an incomes policy can serve as a useful framework for combining fast growth, employment creation and rising living standards (TDR, 2010).

140. Third, the state can create markets, including through government procurement and public sector investment in education, training and health programmes, and can boost aggregate demand and crowd in private investment. How these are managed will impact on developmental and poverty reduction goals, especially in economies operating below potential (UNCTAD, 2010b). In particular, universal development-oriented social programmes, unlike targeted programmes and safety nets, can have a significant impact against different modalities of poverty and exclusion. Programmes including environmental preservation, and the provision of public education and training, health, water and sanitation, housing, transportation, parks and public amenities, food security and affordable clothing can have relatively low managerial costs and improve the standard of living of the poor (EDAR, 2002). Cash transfers can also support vulnerable groups, including single parents, children, senior citizens, and those suffering from chronic illnesses or disabilities, who may have few alternative sources of income. These transfers have also been shown to support regional development through the generation of employment in deprived areas and the expansion of markets for local produce (UNDESA, 2008).

141. In countries that have already built state capacities in support of development, the administrative infrastructure required to manage universal social programmes is also likely to be in place, or can be created relatively quickly. In other cases, this will be part of a wider effort to establish a developmental state. Public goods and social wage programmes can be rolled out gradually, for example one product or service at a time, or in selected regions, making them relatively simple and cost-effective. Despite their universal coverage, they can incorporate several advantages of narrowly targeted programmes, which may be called “smart targeting”: they are universal because they are available to all, and they are targeted because distinct social groups are affected differently by each project or initiative. These welfare programmes are not optional extras; they are essential components of an inclusive development strategy, because they support productivity growth, skills development, and the growth and stabilization of demand as the economy is transformed through rapid economic development.

142. Universal social programmes have been criticized for creating incentives leading to overconsumption (e.g. free health services could lead to unnecessary consultations) or to manipulation by unscrupulous politicians. This is possible, but it can be minimized by “smart targeting” and the introduction of democratic mechanisms of accountability for

public policy.<sup>55</sup> Private (including foreign) providers can in some cases supplement state efforts in this area. However, the commercialization of health or education services through certain types of public–private partnerships or outright privatization can, particularly in the absence of appropriate bureaucratic capacity, be costly for the state, unreliable in terms of impact, and unaccountable to the citizens (Akitoby et al., 2011).

143. The influence of market forces on the provision of public goods can become especially destabilizing if the goods are financialized, that is, if provision is mediated by financial transactions or financial markets.<sup>56</sup> For example, privatization can dilute the social priorities of utility companies through the imposition of fees (e.g. for sanitation) or other restrictions on use (e.g. healthcare services or water), or it can subject the providers to the vagaries of the stock market and the threat of takeover, with the attendant pressures for subcontracting, downsizing, break-up, investment cutbacks, or deterioration of standards of service in order to beef up short-term profitability.

144. The financing of public investment and social programmes is bound to be challenging in most developing countries. Unlike the measures to support productive investment and structural transformation, such programmes involve the state in the mobilization of a much larger share of national resources. While there are some broadly regular features linking state expenditure and development, trust and credibility are key to the effective delivery and management of public services.<sup>57</sup> Building that trust, in many countries, is likely to require the modernization of the tax system, the expansion of the tax base, and the development of financial markets to finance the public sector debt on a sustainable basis. It is impossible to sustain ambitious public sector initiatives with tax rates much lower than 20 per cent of GDP, as is often the case in poor countries. Tax revenues play a fundamental role in the mobilization of resources for the allocative, distributive, growth and stabilization functions of the state, especially in the light of the weakness of the financial systems in poor countries and the persistent volatility of commodity prices and international aid flows. Research shows that there is scope for raising tax revenues in poor countries and, simultaneously, expanding fiscal space and shifting the tax systems in a more progressive direction (TDR, 2011). This will require the enforcement of tax laws and a reduction or elimination of the scope for capital flight and the deductions, exemptions and loopholes favouring the well-off, financial-sector interests, and TNCs. For many poorer developing countries, it is also important to recognize that trade taxes remain an important component of revenue generation, and that the efficiency gains from liberalization can be offset by revenue losses.

145. In sum, inclusive development will depend on the integration of growth-promoting macroeconomic policies with developmental industrial policies and redistributive measures. These elements must be combined with a social protection framework aiming at the elimination of the causes of poverty and exclusion: dispossession from the land; lack of decent employment, and poor housing, education and health provision. These are ambitious targets, but they have been achieved in several countries. In contrast, in developing

<sup>55</sup> In the case of East Asian developmental states, selective welfare developmentalism involved a combination of state, market and family institutions to advance social policy, often to secure political stability and support. See Kwon (1999).

<sup>56</sup> The term public–private partnerships (PPPs) has become increasingly popular among the donor community. However, this covers a very broad range of approaches, and if the record of advanced countries is any indication, an equally wide array of outcomes. An independent assessment of PPPs in the development context would be a useful exercise in mapping out what might work and under what conditions.

<sup>57</sup> There is, for example, a strong positive correlation between per capita income and government spending (Wagner’s Law), as well as between trade openness and the size of government. There is also an inverse relation between government revenue and the size of the agricultural sector.

countries lacking a vision of a more inclusive future, the resources needed to extend social protection have often been wasted, or they have lagged far behind policy pronouncements, leaving gaps in coverage and quality, as well as dashing expectations and fuelling discontent.

## **F. A global New Deal**

146. Since the international debt crisis of the early 1980s, most developing countries have increased their integration with the global economy. Their commitments have included trade and capital account liberalization, adherence to WTO and WTO-plus trade agreements, incentives to attract FDI, tighter intellectual property laws and so on. They have done this against a backdrop of slowing global growth, an increased incidence of economic crisis, and widening gaps within and across countries – all of which can be traced, in varying degrees, to FDG.

147. Suggestions for a more measured pace of integration have often been resisted, particularly at the international level, and portrayed as a sign of reluctance to implement the reforms required to compete globally. However, and as argued previously, the countries that have made the strongest gains under FDG have pursued a discretionary and strategic integration with the global economy rather than adopting wholesale policies of liberalization and financialization, have placed considerable emphasis on industrial development, and have, in many cases, looked to strengthen their economic ties with neighbouring countries. In doing so, they have often gone against conventional wisdom.

148. For many other developing countries, the international trade and finance system that evolved after the debt crisis has not only broken with the flexibilities of the post-war system, it has failed to provide sufficient financial and technological resources to enable them to achieve rapid and inclusive growth. Indeed, under present arrangements, most countries almost invariably find themselves obliged to adjust to the shocks associated with FDG through domestic retrenchment. IMF has abandoned the objective of stable exchange rates in an orderly international financial system, or rather, has entrusted that stability to market forces, and while its surveillance activities have been increasingly tied to financial crisis management and lending, it has a patchy record in detecting mounting fragility and issuing timely warnings. The World Bank has also retreated from its principal aim of long-term infrastructure lending in favour of adjustment lending and poverty reduction. Much like IMF, its surveillance activities have shifted as a result, away from project implementation and the creditworthiness of borrowers, and more to adherence to detailed policy programmes in line with market-friendly development strategies (Ahluwalia, 1999: 3–5).

149. Developing countries have, in response, consistently called for more predictable multilateral resources to support their integration efforts, for more flexibility to tailor policies to local needs and conditions, and for greater coherence across the overlapping international trade, financial and production systems. Building these aims into the multilateral architecture will be essential to achieving DLG. This does not, however, mean simply returning to the earlier Bretton Woods system, even if this were possible. The post-war global deal was never completed in areas of particular interest to developing countries, and the flexibilities allowed to countries were often established on an ad hoc basis rather than as a formal part of the rules themselves. Indeed, given the much more variable geometry of today's global economy, combining effective multilateral rules and disciplines with appropriate policy space is a major challenge facing the international community.

150. The need for reform is not only in the interest of developing countries. The crisis has made it clear that the advanced countries also need policy space to manage changing circumstances, and that they can no longer guarantee a stable global economy or deal with

new and interrelated threats to future prosperity by themselves. Moreover, if they are to avoid damaging deflationary adjustments, return quickly to robust growth, and ensure that the international trading system remains open, they also have a direct interest in strengthening international coordination and support, and in an inclusive manner.

151. Just as much as at the domestic level, these overlapping interests cannot be effectively united by muddling through or a return to business as usual. The rebalancing challenges at the heart of DLG will need a global new deal involving a large and diverse group of economies, and must reflect the ongoing shifts in the distribution of economic power and political influence among countries. Unfortunately, the degree of trust among countries that is needed in order to manage appropriate collective responses and actions and deliver reliable development cooperation for the most disadvantaged members of the international community has been gradually eroded during FDG and has been hit even harder as a result of the financial crisis, and is in urgent need of repair.

152. The idea of a global New Deal alludes to the rebalancing efforts that a number of countries undertook during the 1930s in response to a deeply destructive financial crisis.<sup>58</sup> In the case of the United States, a series of interconnected public investments in energy, agriculture, and social infrastructure, along with strong regulation of financial and labour markets and expansionary macroeconomic policy, laid the foundation not only for a return to full employment but for a strong industrial take-off in some of the most underdeveloped parts of the country, crowding in substantial private investment and building local markets through a virtuous growth circle.

153. Today's global New Deal should also look to lift all boats, through support for productive investment, economic diversification and expanding markets. However, it goes without saying that coordination at the international level is very different from national-level programmes, given that representative governments are being asked to surrender some measure of their sovereignty in support of collective actions and goals. It is imperative, therefore, for international measures to be designed in such a way that they complement or strengthen state capacities to deliver on national objectives and meet the needs of their constituencies. If reforms to the existing multilateral architecture are to be credible and effective, they must provide for much greater collective influence from developing countries and embody a much stronger sense of cooperation among all countries. This will require rethinking the global agenda, and, in particular, a willingness to examine rebalancing challenges from a much more integrated perspective. It will also require careful examination of the structure of representation in the existing multilateral trade and financial institutions and their decision-making practices.

## **1. Taming finance**

154. Taming finance is the place to begin rebalancing the global economy. It is now generally recognized that financial liberalization was pushed too hard in the 1990s, that global surveillance failed to pick up the emerging imbalances that built up under FDG, and that multilateral arrangements lacked the resources, authority and ideological orientation to prevent the build-up of financial fragility (IMF Independent Evaluation Office, 2011). We have been here before. After the Asian financial crisis in the late 1990s, a series of proposals were put forward to reform the international financial system (TDR, 1998; Rogoff, 1999). These were resisted (particularly by developed countries and international financial institutions) and subsequently stalled, and were then largely forgotten as the next

<sup>58</sup> The New Deal was, strictly speaking, a term coined to refer to a series of initiatives of the Roosevelt administration in the United States. However, similar initiatives which shaped an alternative development model can be found across a number of countries starting from the early 1930s, even though they only took off after the end of the Second World War.

boom in capital flows took hold. Instead, a series of ad hoc arrangements was adopted. This included self-insurance through reserve accumulation, along with various codes and standards to help strengthen domestic financial systems in debtor countries, enhance these countries' macroeconomic and financial policy formulation, and improve the collection and disclosure of information. While such measures can be beneficial, they have not been sufficient to address macroeconomic imbalances or recover financial stability, and in many cases have involved substantial costs (TDR, 2001: 79–107; and TDR, 2011).

155. A much more ambitious reform agenda for the international financial system is clearly necessary if it is to bring about lasting stability and support the shift to a truly development-led globalization. This should include the following elements:

- (a) Measures to align and stabilize exchange rates, particularly among the G-3 currencies, are urgently needed. This will likely involve moving away from a dollar-based payments system, stronger surveillance of the macroeconomic policies of reserve currency countries, the promotion of capital controls, and the possible use of exchange rate target zones (TDR, 2001 and 2011). However, to the extent that some of these reforms will take time to implement, regional monetary arrangements might provide a useful option for developing countries (see below).
- (b) A more balanced approach to sovereign debt restructuring is needed, including arrangements spreading the burden of adjustment more equitably between borrowers and private sector creditors (box 8). The use of “bailouts” to deal with financial crises has proved very costly and has created moral hazard. Furthermore, the funds required have been getting larger and more difficult to raise.
- (c) The expansion of multilateral financial resources in line with the growth of cross-border transactions, bringing them to a level sufficient to undertake effective countercyclical financing and to deal with payment difficulties that emerge on the capital account. The recent tripling of IMF funding marks progress in this direction, but it is also necessary to move towards more reliable and less politicized ways of creating international liquidity (box 9).
- (d) A pruning back of the policy conditionalities that have mushroomed around adjustment and crisis lending. These have imposed a deflationary bias on borrowing countries and reduced the policy space to manage crises and launch sustainable recoveries. The international financial institutions should, instead, help developing-country policymakers to identify trade-offs, examine the policy options, and draw upon the experiences of other countries.

#### **Box 8. Dealing with debt**

The ongoing global turbulence has highlighted the need for new approaches to external debt management and debt crisis prevention. Although attention should continue to be paid to debt sustainability indicators, including fiscal balance, these do not seem to be sufficient. There was unprecedented risk-taking by lenders and borrowers during the boom years before the crisis, with responsibility and accountability missing on both sides. Global financial interconnectedness has made contagion swifter, more severe, and larger in scale. The interlinkages between the financial sector and state budgets have made the assessment of contingent liabilities especially challenging. The change in debt composition, from predominantly syndicated bank lending to

bond financing, has increased financial instability during crises, as marketable securities can change hands much faster, making herd behaviour both more prevalent and more damaging.

Worse still, there is currently no early warning system for public or private debt-servicing difficulties, even in cases where default could have systemic implications. The rating agencies are supposed to be whistle-blowers, but all of them failed in the run-up to the current crisis. Indeed, as these agencies have no liability in case the market proves them wrong, they have an incentive to bias credit ratings upwards in order to satisfy their customers. This is most clearly seen in the case of private instruments, but a similar effect could, arguably, be observed in the overrating of the sovereign debt instruments issued by financially fragile states before the crisis. UNCTAD (2008) has proposed subjecting these agencies to regulatory oversight, and regularly publishing their rating performance.

In 2009, UNCTAD started an initiative to establish principles of responsible sovereign lending and borrowing, in order to reduce the frequency and severity of debt crises. This process has been inclusive and transparent, with the participation of a range of stakeholders – including experts in economics and law, senior representatives of the private sector, non-governmental organizations, and observers from the multilateral financial institutions. In May 2011, a set of draft principles was released by UNCTAD specifying the key responsibilities of lenders and borrowers, including due diligence, fiduciary duty, proper approval, transparency and disclosure, and alternatives for debt restructuring. In view of the heterogeneity of national conditions, these principles do not include specific thresholds or quantitative targets. However, they offer economic, legal and moral guidelines for lending and borrowing, and their adoption has been encouraged by the United Nations General Assembly (resolution 65/144). As with any set of voluntary standards, free riding and enforcement will pose significant challenges, but in the absence of effective global action, the burden of coping with international financial instability will continue to fall mainly on developing-country governments.

UNCTAD has also been a long-standing advocate of orderly debt workout procedures drawing on national bankruptcy laws, notably chapters 9 and 11 of the United States bankruptcy code. These procedures should meet two objectives. On the one hand, they should help prevent financial meltdown in countries facing difficulties servicing their external obligations, which often results in a loss of market confidence, currency collapse and drastic interest rates hikes, inflicting serious damage on public and private balance sheets and leading to large losses in output and employment and a sharp increase in poverty. On the other hand, they should provide mechanisms to facilitate an equitable restructuring of debt that can no longer be serviced according to the original contract. These goals need not require fully fledged international bankruptcy procedures, but simply the application of a few principles:

- (a) A temporary standstill, whether debt is public or private, and regardless of whether the servicing difficulties are due to solvency or liquidity problems (a distinction which is not always clear-cut). In order to avoid conflicts of interest, the standstill should be decided unilaterally by the debtor country and sanctioned by an independent panel, rather than by IMF, since the countries affected are among the shareholders of the

Fund, which is itself also a creditor. Sanction should provide an automatic stay on creditor litigation.

- (b) Standstills should be accompanied by exchange controls, including the suspension of convertibility for foreign currency deposits and other assets held by residents as well as non-residents.
- (c) Provision of debtor-in-possession financing, automatically granting seniority status to debt contracted after the imposition of the standstill. IMF should lend into arrears for financing imports and other vital current account transactions.
- (d) Debt restructuring including rollovers and write-offs, based on negotiations between the debtor and creditors, and facilitated by the introduction of automatic rollover and collective action clauses in debt contracts. IMF should not be involved in the negotiations between sovereign debtors and private creditors.

Although these principles leave open several details, they could serve as the basis for a coherent and comprehensive approach to crisis intervention and resolution in the early twenty-first century.

#### **Box 9. Special drawing rights**

International monetary cooperation, orderly exchange rate arrangements and confidence in the availability of liquidity are necessary for the continuing growth of international trade, and to ensure that balance-of-payments adjustments are achieved “without resorting to measures destructive of national or international prosperity” (IMF Article I (v)).

One of the principal goals of the architects of the Bretton Woods system was to ensure the provision of international liquidity. It is common knowledge that an international reserve system based on a national currency (or on a basket of national currencies) cannot provide for an orderly global monetary environment, because national central banks are primarily committed to national targets. However, the decisions taken by those central banks issuing international reserve currencies strongly affect all other countries; for example, international liquidity can fluctuate because of domestic imperatives, regardless of global needs. FDG has failed to address this problem. Instead, it has introduced a deflationary bias in the world economy and forced many countries to take out expensive “self-insurance” through reserve accumulation, whereby resources that might support socially desirable goals are transferred by the developing countries, at low interest rates, to the developed countries which issue reserve currencies simply to lie dormant in case of future need.

There has been considerable discussion about establishing a global reserve currency in parallel with national currencies. This could be arranged in different ways, but the most practical way is to build on existing mechanisms to support an expanded role for special drawing rights (SDRs), or expanded SDRs. Under present arrangements, SDRs are allocated to member countries in proportion to their IMF quotas. Members obtain or use SDRs through voluntary exchanges, or by the Fund designating members with strong external positions to purchase SDRs from those wishing to use their allocated SDRs. When members’ holdings rise above or fall below their allocation,



they either earn or pay interest, with the interest rate being determined as the weighted average of the money market interest rates in the currencies constituting the SDRs. Any increase in the supply of SDRs should obey some basic principles: it should accommodate global growth, so as to meet global demand for reserves; it should be flexible enough to operate in a countercyclical manner; it should include both liquidity finance and incentives for surplus countries to share the burden of adjustment; and it should include what UNCTAD has called a “development link”, or incentives for the use of reserves to finance expenditures related to development and climate change.

The low cost and other advantages of SDRs have given rise to calls for their regular distribution to poor countries to ease the burden of holding reserves. Regular allocations of SDRs are certainly the most straightforward way to raise developing countries’ share in reserve assets and help address the inequities in the current system. Allocations should be on a predetermined basis, and should be linked to growth in world income and/or trade. They could also be adjusted countercyclically – for example, accelerated at times of global slowdown. Using current quotas as the basis for allocation among countries would not raise the share of SDRs in reserve assets, since a large proportion would go to countries that do not need or use them. Given their external vulnerability, developing countries have much greater need and demand for reserves, and this should be taken into consideration in reaching a formula for the allocation of SDRs (under some proposals, all allocations could be given to developing countries). Another possible way forward is to make IMF an SDRs-based organization; that is, to have SDRs replace quotas and the General Arrangements to Borrow and New Arrangements to Borrow as the single source of funding for IMF.

The Fund could be permitted to issue SDRs to itself on a regular basis, to be used in lending operations. Again, this could be linked to growth in world income and/or trade. Such an arrangement could bring a considerable improvement to the governance of IMF, allowing it to stay at equal distance to all its members and helping the Fund to perform policy surveillance even-handedly. It is also possible to supplement this proposal with a mechanism to remove the dollar overhang by allowing countries to replace their existing stocks of dollar reserves with SDRs without disrupting the currency markets.

SDRs would allow the expansion of international liquidity without requiring the United States to run ever-growing deficits – a major source of global imbalances. However, a simple shift from dollars towards SDRs cannot address the deflationary bias in the global economy because of the lack of effective arrangements for adjustment in the surplus countries. This bias may even be aggravated because the United States can no longer run growing deficits in times of worldwide need. Consequently, any initiative to move away from the dollar as the dominant reserve currency should be accompanied by arrangements to ensure adjustment in surplus countries as well as changes in the governance of the Fund itself.

For further discussion, see UNCTAD (2001) and UNCTAD (2009).

156. These measures are hardly new or particularly radical, and the obstacles are, in all cases, political rather than technical. It is, in this context, worth recalling the remarks of Kenneth Rogoff following the Asian financial crisis, but which seem just as germane to the discussion of DLG in light of what has happened since:

It is easy to fall into the trap of thinking that big institutional changes are unrealistic or infeasible, especially in the United States where macroeconomic policy institutions have generally evolved only slowly for the past few decades. Not so long ago, the prospects for a single European currency seemed no more likely than those for the break-up of the Soviet empire or the reunification of Germany. Perhaps large institutional changes only seem impossible until they happen – at which point they seem foreordained. Even if none of the large-scale plans is feasible in the present world political environment, after another crisis or two, the impossible may start seeming realistic (Rogoff, 1999: 28).

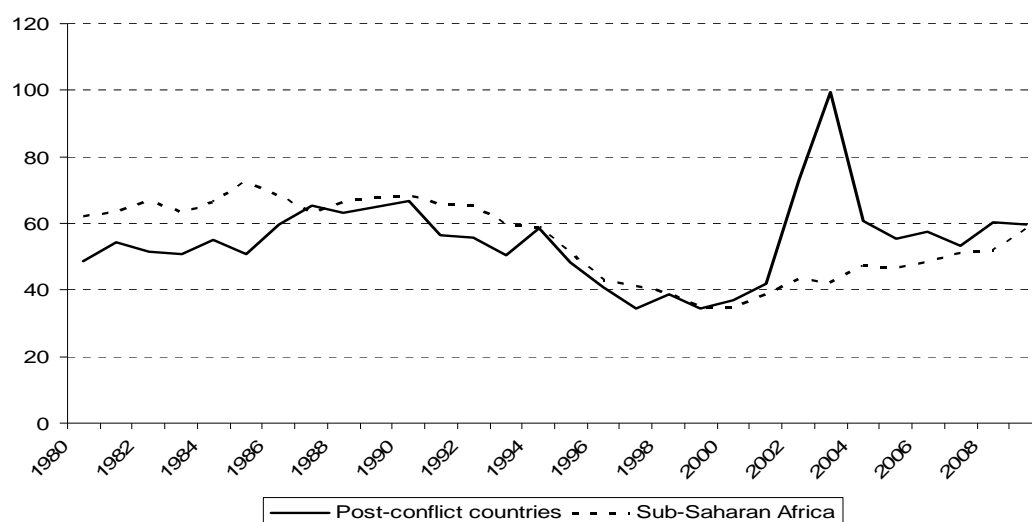
157. Stable, affordable and long-term finance remains a constraint on sustainable and inclusive growth in many developing countries, particularly LDCs. At the time of the International Conference on Financing for Development, held in Monterrey in 2002, UNCTAD estimated that a doubling of official financial flows would be needed to close the resource gap facing recipient countries. Following declines in the 1990s, aid flows have recovered sharply, albeit still short of the levels promised by the international community, and at times strongly oriented to countries emerging from conflict (fig. 25).<sup>59</sup> There has also been a good deal of constructive discussion about aid effectiveness, with a growing consensus around the need to reduce the unpredictability of aid flows, to deal with the fragmentation of flows among sources and destinations, and to transfer ownership of aid programmes to recipient countries. These have been long-standing UNCTAD demands. However, this is only the start of a reform process to get development cooperation back on track (box 10). In recent years, aid programmes have focused increasingly on social outcomes, often at the expense of support for developing domestic resource mobilization and the creation of new productive capacities. This has taken attention away from what should be the principal preoccupation of development cooperation, which is to move its recipients as quickly as possible to a position where they can mobilize their own resources for development (EDAR, 2006). As such, the delivery of aid should be carefully and constructively tied to the ambitions of recipient developmental states. This would make budget support, including through a large grant component, a desirable form of cooperation.<sup>60</sup> Moving development cooperation in that direction is central to UNCTAD's efforts to promote a New International Development Architecture for the LDCs (LDCR, 2010).

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<sup>59</sup> UNCTAD was closely involved in establishing the 0.7 per cent aid goal, which was formally recognized by the United Nations General Assembly as a best endeavour of donor governments but was never officially endorsed as a binding target. On UNCTAD's contribution, see Clemens and Moss (2005).

<sup>60</sup> Donors have a precedent for this approach in their own experience with the Marshall Plan. See EDAR (2006).

Figure 25  
**Net official development assistance and official aid flows to sub-Saharan Africa  
 (constant 2008 dollars, per capita)**



Source: World Development Indicators 2011.

Note: The post-conflict countries are the Democratic Republic of the Congo, Eritrea, Liberia, Mozambique, Rwanda, Senegal and Sierra Leone. Sub-Saharan Africa excludes Nigeria.

#### Box 10. Making aid work for inclusive development

Over the years, aid has been provided to address a variety of problems. There are grounds for both satisfaction and disappointment, though generally aid skeptics have failed to prove their case. Still, there is a need for a new international architecture for aid that ensures that official development assistance (ODA) better complements national resource mobilization efforts, helping to fill the gap between domestic saving and the volume of investment required to meet national development goals, including the MDGs. There is a growing recognition that aid should be channelled through the state budget, and that it should be part of a comprehensive fiscal and financing package supporting the implementation of national programmes and priorities. This shift would reinforce the ownership of national policies and programmes and improve the accountability of governments to their national constituencies. At the same time, several relatively new aid organizations, such as the Investment Climate Facility for Africa, the Global Fund, and the Millennium Challenge Account need to be accommodated in any discussion of a future aid architecture. These tend to focus on global public goods and do not necessarily deliver aid in accordance with the development priorities of the recipient countries.

The experience of the European Union (EU) with regional funds offers one model for reforming the aid architecture. These funds have a clear focus on strengthening investment, are packaged in the form of multi-year programmes, have strong local ownership, and seek to deal with fungibility problems through matching funds and additionality principles. They also contain clearly stated aims to strengthen state capacity at the local and central level. UNCTAD has also argued that greater multilateralization of aid, along similar lines to the EU model, can help to correct the unpredictability of aid

flows, reducing unnecessary and costly competition among donors as well as the administrative burden of aid. It can also provide a buttress against the politicization of aid, which has been so damaging in the past. Well-designed, grant-based regional development funds under more inclusive multilateral arrangements could provide one possible way forward. Such funds would be explicitly focused on economic development, with a major responsibility for strengthening the investment–growth nexus. In part, these would build on MDG-8, but there would be a wider mandate to include investment in physical infrastructure, support for sectoral strategies, technological upgrading, and urban development.

While the use of aid to strengthen productive capacities has diminished in recent years, UNCTAD has for more than 40 years tried to bring out the potential complementarities between aid and trade, insisting on a more integrated approach to managing these flows in support of lasting development gains. The notion of “Aid for Trade” (AfT) has gained prominence in the international aid discourse since it was introduced at the Sixth WTO Ministerial Conference held in Hong Kong (China) in 2005. This recognizes that developing countries, and especially LDCs, need targeted financial support to help them adjust to the stresses that accompany increased openness, and to build a strong investment–export nexus around a more diversified economy that can ensure significant future gains from trade. These objectives will be more easily reached if AfT gains an appropriate scale, includes genuinely new funding in excess of current aid commitments, is accompanied by appropriate trade and industrial policies, and is managed within the United Nations system in order to ensure that the gains from trade support inclusive development strategies.

Finally, there is currently no permanent multilateral forum addressing aid effectiveness from the perspective of the recipients. The OECD Development Assistance Committee is an important venue for these debates, but it focuses largely on donor issues. This is one of the reasons why proponents of South–South cooperation have been reluctant to join the traditional aid architecture. Given these concerns, it may be worth exploring alternative ways to combine the experience of different international agencies and the wider development community, working on the consensus-building principle, and offering an open forum for frank, well-informed and constructive debate on aid and development issues.

158. The multilateral development banks also have an essential role to play supporting DLG. These institutions have traditionally offered a range of services and a mixture of hard and soft lending channels (UNDESA, 2005). There are a number of important unresolved issues, in particular the extent to which their financing takes the form of grants or lending (and whether at commercial or compensatory rates), and whether poverty reduction or broader development goals should define their mandates. Moreover, given that the flow of finance, particularly to middle-income countries, has been inadequate in recent years, their ability to leverage more innovative sources of financing deserves closer attention and consideration.

159. To revitalize their role and refocus their activities in support of inclusive development, they will need to retreat from policy-based lending and concentrate more on funding those public goods, including infrastructure, that are likely to strengthen the productive capacities of borrowing countries. These institutions should also be in a position to provide trade finance, particularly during crises, to play a constructive role in the

development of local bond markets, and to devise more innovative mechanisms to combine public and private resources in support of developmental and socially inclusive goals (Griffith-Jones, 2008). Existing institutions with a strong regional focus might be complemented by more functional financing agencies in areas such as agriculture development or climate financing (box 14). But in all cases, there is a pressing need to reform the governance structures of these institutions to make them more representative and socially accountable.

## 2. Turning trade and investment towards development

160. Since the early 1980s, the governance of international trade has moved towards a single-tier system of rights and obligations, with exceptions granted only for the LDCs. At its best, this has brought a degree of predictability to trade relations and controlled the arbitrary action of powerful countries.<sup>61</sup> On the other hand, it has lent itself to prolonged negotiations which, in part, have contributed to the proliferation of bilateral and regional agreements covering a range of trade and trade-related issues. Moreover, at all levels of rule-making, priority has been given to liberalization (and deregulation), which has crowded out a range of issues including movements in the terms of trade, technology transfer, non-tariff barriers, and restrictive business practices – all of which has had a strong bearing on trade performance in developing countries, and in instances where effective norms and regulations could be usefully discussed at the international level. The absence of rules in some areas contrasts with the proliferation of demands in others, through the different layers of the trading system. Given the diminishing capacities of the state in many developing countries, it has become difficult for many states to take full advantage of their rights, defend their interests and even meet their obligations.

161. In order to maximize the potential gains from trade and to direct them towards inclusive development, developing countries require not just a rules-based global trading system, but also the support and the space to use policy instruments to promote capital formation and economic diversification and to manage the adjustment costs that such changes imply. There must be an effort to ensure that existing agreements maximize policy space, and where appropriate, expand it in sectoral areas of interest to developing countries through the formalizing and strengthening of special and differential treatment.<sup>62</sup> At the same time, developing countries are aware that the absence of rules and effective surveillance in areas of particular interest to them continue to hamper efforts to build a more balanced international division of labour.

162. The balance between global trade rules and sufficient policy space is proving increasingly challenging as new issues emerge (e.g. the environment and food security) and become interlinked with the workings of the trading system. These issues are also likely to have differential impacts on countries due to their diverse economic and institutional capacities. Some of these issues (such as climate change and resource depletion) involve managing truly global externalities, but others have a stronger regional dimension (such as many health and conflict issues), and others are more in the nature of “semi-public” goods.<sup>63</sup> Given that these issues have already produced tensions in the trading system, and

<sup>61</sup> It is still the case, however, that a range of commercial policies – including tariff escalation, non-tariff barriers, subsidies, anti-dumping procedures and product standards – continue to favour products and markets in which more advanced countries have either a very weak or a dominant market position.

<sup>62</sup> For a discussion of where things currently stand on special and differential treatment, see Faizel (2007).

<sup>63</sup> The idea of global public goods is often used to describe international policy challenges, although the two defining features of a public good, non-excludability and non-rivalry, often do not strictly apply at the international level, hence the use of the term “semi-private”. There is a case for further clarification of this terminology.

that these are likely to intensify in the future, WTO, as custodian of the rule-making process linked to trade, might usefully examine, through an independent blue-ribbon commission, the question of whether or not the right balance is being struck. Such a commission could explore the technical and legal implications of such issues as moving to a plurilateral approach to negotiating trade rules, the appropriate scheduling and implementing procedures, the use of a supermajority or other means to ensure arrival at a timely consensus, the formalization of rules on policy space etc. In those areas where the goal of an open trading system overlaps with the delivery of other public goods (such as a healthy and stable environment), or carries strong development implications (such as those relating to international production or food security), the appropriate United Nations bodies should be invited on an equal footing to any deliberations on the design of appropriate rules and standards. In addition, and in much the same way as IMF has an independent evaluation office to “enhance the learning culture within the Fund, help build the Fund’s external credibility, and promote a greater understanding of the work of the Fund”, something similar could be considered for the trading system.

163. In the case of international production, where trade and investment issues have become increasingly intertwined, the issues range from restrictive business practices to transfer pricing and non-tariff barriers. The case for a common set of global rules on FDI has been rejected by developing countries, in large part because the tenor of such discussions has been unduly focused on liberalization measures and the rights of corporations. However, there may be room to develop a developmental approach to these challenges through a different kind of forum. For example, the implementation and surveillance of responsible investment procedures could help reduce abusive or distortionary practices in areas that are sensitive to developing countries (box 11).

**Box 11. Principles for Responsible Agricultural Investment (PRAI)**

Responsible international investors are companies, funds or individuals which, in the course of their operations, act within the law, behave as good citizens, and do not generate extraordinary social, economic or environmental costs on host countries and communities. And yet, there are ample examples of TNCs and other investors creating or profiting from market and other distortions in developing countries through the payment of bribes, using their political influence to shut out potential competitors, causing inordinate environmental damage, or ignoring the rights of local communities. Such concerns underlie the development of the *Principles for Responsible Agricultural Investment that Respects Rights, Livelihoods and Resources*.

In the 2000s, international organizations began to take note that foreign commercial interest in agriculture was rising in the developing world because of increasing prices and profits in food and other agricultural products. Alarming press reports were partially validated by major incidents taking place in Madagascar and elsewhere. These led four international agencies (UNCTAD, the Food and Agriculture Organization of the United Nations, the World Bank, and the International Fund for Agricultural Development) to initiate a joint project addressing these challenges. The issue of responsible investment in agriculture, including large-scale land acquisitions, was debated at the United Nations General Assembly during its sixty-fourth session, at which UNCTAD gave submissions based on the *World Investment Report 2009*. The General Assembly took note of “the initiative on promoting responsible international investment in agriculture, which aims to develop relevant principles and an international framework”, and stressed “the importance of promoting responsible international investment in agriculture, and in this regard invites the United Nations Conference on Trade and

Development, in cooperation with other relevant international organizations, to continue its research and analysis on this issue” (General Assembly resolution 64/192).

The PRAI are based on detailed research on the nature, extent and impact of foreign investment and on best practices in law and policy, and they provide a framework for national regulations, international investment agreements, global corporate social responsibility initiatives, and individual investment contracts. The principles are:

**Principle 1:** Existing rights to land and associated natural resources are recognized and respected.

**Principle 2:** Investments do not jeopardize food security but rather strengthen it.

**Principle 3:** Processes relating to investment in agriculture are transparent, monitored, and ensure accountability by all stakeholders, within a proper business, legal, and regulatory environment.

**Principle 4:** All those materially affected are consulted, and agreements from consultations are recorded and enforced.

**Principle 5:** Investors ensure that projects respect the rule of law, reflect industry best practice, are viable economically, and result in durable shared value.

**Principle 6:** Investments generate desirable social and distributional impacts and do not increase vulnerability.

**Principle 7:** Environmental impacts of a project are quantified and measures taken to encourage sustainable resource use, while minimizing the risk/magnitude of negative impacts and mitigating them.

The PRAI should reduce the scope for negative externalities and raise the likelihood of positive outcomes from foreign investment in agriculture. To further the application and implementation of the PRAI, UNCTAD and its partner agencies have several projects under way, including capacity-building, calibrating private-sector compliance with the PRAI, and engaging investor commitment to the PRAI.

*Source: World Investment Report (2009).*

164. The absence of clear international norms and rules on technology transfer has also been damaging to the interests of developing countries. Technology is a critical lever for raising economic growth but at the same time it is a potential source of rising inequality. Under FDG, the latter has trumped the former. In part, that is because technology is a major source of rents, and their protection has become a priority for countries and corporations at the top of the technological ladder, especially through tighter intellectual property rules. A more balanced set of arrangements is urgently needed to ensure that access to technology becomes part of a more inclusive DLG. UNCTAD has already proposed several international measures (in LDCR, 2009) in support of technological development in the LDCs, many of which have wider relevance across the developing world (box 12). Such arrangements are becoming all the more important in the context of moving towards a low-carbon future, for which technological learning and capacity-building will require international collaboration if the appropriate technologies are to be developed and

disseminated in a timely manner. A much bolder and more flexible approach to green technologies will be needed than is currently the case, including with respect to intellectual property rights (IPRs), subsidies for new technologies, multilateral R&D funding etc. (see UNDESA, 2009; and UNCTAD, 2011c).

**Box 12. Rebalancing the international environment for technology transfer**

The global IPR regime has tended to skew research and development towards technologies offering high market returns, rather than towards those offering the greatest social benefits or addressing the needs of developing countries. The idea that gains from innovation would trickle down the development ladder has found little empirical support. It has also been difficult to find evidence of significant indirect benefits from tighter intellectual property protection in the form of technology spillovers from FDI inflows, or evidence of greater innovative activity as a result of access to patent disclosures and technologies. Instead, IPR debates have tended to emphasize the safeguards and flexibilities contained in the global intellectual property regime, notably through parallel import arrangements and compulsory licensing. However, many countries have forgone these flexibilities through bilateral “TRIPS-plus” agreements with the major technology exporters.

These difficulties are beginning to be recognized, along with the realization that the global IPR regime should be reoriented towards the technology and knowledge needs of developing countries. In order to be effective, such mechanisms should address issues of technology policy space and promote local technological learning. Some avenues that might be considered for these purposes are examined below.

**Technology-sharing consortia:** These are based on the voluntary exchange of technology among firms involved in similar activities. Such collaboration can lead to faster rates of adoption of superior technologies than licensing arrangements, and can encourage greater R&D spending by internalizing the externalities of innovation. In order to cooperate effectively, a firm must have sufficient internal capacities and technological information of its own to offer in exchange, and there must be a strong culture of transparency among consortium members to reduce the threat of free riding. Various financial incentives and support could be provided to consortia through development cooperation, including triangular cooperation.

**Global and regional research funds:** Several areas of interest to developing countries, including health, agriculture, energy, and climate change, have lacked funding for technology development. Public expenditures in these areas have been stagnant or falling, even in the advanced economies. Dedicated research funds could become focal points for the coordination of research at national and international levels, and among private, public and non-profit organizations, while ensuring open access to all available research in line with the urgency of these challenges. Scaled-up technical cooperation and training programmes could complement these funds, including incentives for the short-term mobility of skilled workers from advanced and emerging economies. Some initiatives are already under way, including through South–South and triangular cooperation, in the areas of medical and agricultural research. Regional R&D facilities could be further supported by the international community, through South–South collaboration, or even across developing countries and LDCs (offering and receiving technical know-how and training) and developed countries (offering financial support).



**A technology licensing initiative:** Developing-country firms often find it difficult to search for appropriate technologies, and they tend to lack the negotiating skills to acquire licences at cost-effective rates. A technology licensing initiative funded by developing-country governments or through donor agencies could help to address these issues by acting as a licensing pool offering technologies at subsidized rates for developing-country firms, particularly those from LDCs. A licensing initiative would also provide a database of similar technologies and their relative merits and licensing costs. By acting as a clearing house for the licensed technologies, it could also reduce bargaining asymmetries between firms based in developed and developing countries. As incentives for firms in the advanced countries to participate in these initiatives, licensing fees could be waived, while internationally agreed standards of IPR protection would be maintained. Advanced-country firms could also receive a label that they are “pro-development” (similar to eco-labelling). Developing-country firms wishing to participate in this initiative might be subsidized according to their country of origin and/or ability to pay.

165. There is, finally, an urgent need for greater coherence between the international trading, production and financial systems. Rather than being governed by comparative advantages, trade flows are frequently distorted by unstable and misaligned exchange rates with little relation to underlying economic fundamentals, the effects often being analogous to those of changes in tariffs. This problem is ignored in current global arrangements, which are based on a false dichotomy between trade and finance. The dangers of that dichotomy have been further exposed by policy incoherence across the various parts of the multilateral system in response to the financial crisis, on such issues as the use of instruments to manage capital flows (TDR, 2011). The financialization of markets has also distorted trade in areas of pressing concern to many developing countries. In particular, the mechanisms for dealing with commodity price volatility are piecemeal and in many cases are an obstacle to the smooth functioning of the trading system. These problems can be addressed in a more systematic way by the international community to mitigate the potentially adverse impacts of speculative trading upon the security and livelihoods of the most vulnerable communities and the poorest countries (box 13).

### **Box 13. Stabilizing commodity prices**

The impact of price volatility depends on the commodity and on the economy's structure, but typically, it affects the balance of payments and the external debt, hampers fiscal planning, exacerbates social inequalities and impedes inclusive development. These effects tend to be stronger in developing than in developed countries, and to pose particular problems for the least developed countries.

Global price volatility is partly due to the increased participation of financial players in commodity markets, which has changed the nature and use of information driving price formation (see box 1). Market participants no longer base their trading decisions purely on the fundamentals of supply and demand; they also consider other markets as part of their strategies of portfolio diversification which, in turn, introduces spurious signals into commodity price formation. Therefore, in addition to emergency measures designed to assist the most vulnerable, and longer-term measures designed to increase and stabilize commodity supplies, it is necessary to consider how commodity markets can be reformed so as to provide more reliable price signals to producers and consumers, avoid herding, and prevent market players from systematically sending misleading signals to countries and

firms.

Significantly, the developed countries and the international financial institutions currently reject international commodity agreements or compensatory facilities to offset shortfalls of commodity export earnings, such as IMF's Compensatory and Contingency Financing Facility and the European Commission's STABEX, aimed at the stabilization of African, Caribbean and Pacific countries' export earnings. Instead, they have pushed for market mechanisms for managing commodity price risks and the accompanying income shocks, and have encouraged primary commodity producers to contribute to the financialization of commodity markets through their engagement with market-based hedging instruments in futures and derivatives markets. So far, these initiatives have not been very successful. Given the limitations of the mainstream policies, and in order to restore the proper functioning of commodity markets, swift political action is required on a global scale. It should focus on the following measures:

First, a global countercyclical financial facility to support demand management in commodity-dependent countries, particularly in LDCs where the opportunity cost of holding savings abroad is high in the light of immediate needs to accelerate economic development and reduce poverty. This should allow for fast disbursement of funds with low policy conditionality and high concessionary elements at times of commodity price shocks.

Second, greater transparency in physical markets, where this is appropriate, in order to assist producers and traders' estimates of stocks and spare productive capacity, areas under plantation, harvests, and likely demand shifts.

Third, better access to information in commodity derivatives markets, especially regarding position-taking by different categories of participants. Ensuring that the reporting requirements for trading on European exchanges more closely follow those enforced in the United States would considerably improve transparency of trading and discourage regulatory migration.

Fourth, tighter regulation of financial market participants, in order to contain financial investors' impacts on commodity markets. Measures could include position limits, or the prohibition of proprietary trading by financial institutions involved in hedging transactions on behalf of clients because of potential conflicts of interest. Moreover, introducing a transaction tax system, which could generally slow down financial market activities.

Fifth, 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 deflating price bubbles. It is commonly believed that mechanisms that try to stabilize commodity prices with internationally held buffer stocks and/or supply controls are not successful in reducing price volatility and tend to be more effective in moderating downward price movements than price surges. However, such intervention could be reconsidered if reforms aimed at achieving greater market transparency and tighter market regulation either were not in place or proved ineffective. While most of the trigger mechanisms could be rules-based, and therefore predictable, such intervention would necessarily have some judgmental components. Unlike the other market participants, such an intervening authority would have no incentive to engage in any form of herd behaviour.

Rather, it could break the informational cascades that underlie herd behaviour, by announcing when, in its view, prices are far out of line with fundamentals.

For further discussion, see LDCR (2010) and UNCTAD (2011a).

### 3. Managing new threats

166. The search for sustainable and inclusive alternatives must address the growing threats and insecurity linked to the interrelated crises in food, energy and water, and their links to climate change. In all these cases, any balanced solution will require massive investments (from the public and private sectors) in new infrastructure, new technologies and new institutions.

167. A global New Deal should seek to establish a comprehensive public policy agenda that aims to protect the planet's natural resources by promoting conservation and more efficient resource use, but that also supports alternative investment strategies that can ensure that future resource use is consistent with catch-up growth and job creation in developing countries. New rules and regulations to help establish effective carbon markets will certainly have a role to play in this process. However, in order to combine the responsible use of resources with these development goals, nothing less than a fundamental transformation as regards financial and technological support to developing countries is needed. Such a transformation would involve moving beyond the long-standing promises of such support from developed countries, to a full-blown strategy of how the investments that developing countries would have to undertake in order to meet their side of the bargain will be generated. Establishing such an agenda will require a much greater degree of collaboration between rich and poor countries.

168. This is particularly true in the case of climate change, where estimates can – depending on the assessed scale of the threats and the chosen time frame – reach 2 per cent of world output per year to meet this challenge. The amounts currently available to deal with mitigation and adaptation challenges remain woefully inadequate. Private investment should fill this gap in the long run, but given the uncertainties and externalities surrounding areas such as transportation and energy supply, the required incentives will only come from large upfront investments by the public sector. Consequently, national and international resources will need to be mobilized much more vigorously than in the past, in order to launch low-emission, high-growth paths. The institutional framework to support this push should include a development compact addressing the issues of equitable adjustments, and an inclusive governance structure where all voices can be heard, as well as transparent financing mechanisms that avoid past biases in multilateral arrangements (box 14).

#### **Box 14. Financing sustainable development**

In the coming decades, as in the recent past, few issues are likely to be as challenging to established patterns of international collaboration as the need to mobilize adequate financial investment to constrain global temperature increases within internationally agreed limits. Estimates of the scale of sustained public and private investment required per year between 2020 and 2050 range from about 1 per cent of world GDP to more than 2 per cent of world GDP. Much of this investment will be required to take place in developing countries.

There are, accordingly, two essential aspects of the problem to be solved. First, on any reasonable level of ambition or optimism, the pace and scope of the transformation required in both production and consumption patterns is

unprecedented. Unlike in the past, the technological revolutions and the necessary changes in basic patterns of consumption and production cannot follow the slow and highly uneven patterns of global diffusion of previous global technological transitions. Eighty per cent of the transformation required will be in the energy sector – with decarbonization of the energy supply by 2050 and massive reductions in global per capita emissions and energy consumption being the twin requirements for success (see box 3). Achieving these objectives will require sustained, consistent and intensive efforts by both developed and developing countries across a wide range of technologies and activities, and will also require far more efficient and equitable means of coordination than have yet been devised.

The second aspect of the problem, which has received significant and necessary attention since the Copenhagen meeting of the Conference of the Parties to the United Nations Framework Convention on Climate Change (UNFCCC), is the challenge of mobilizing and prioritizing financial resources for the required developing-country investments in ways that equitably balance the still large development needs of developing and emerging countries with the requirements of planetary sustainability. Ensuring that achievement of fundamental development goals is not hindered by higher costs of energy production and consumption, or by an unreasonable shifting of the burdens of adjustment onto developing countries, is not simply a question of the availability of international financing, however. Development in its fullest sense is not primarily about assuring access to international finance or technology on reasonable terms; instead, it is about substantially strengthening national capabilities for self-sustaining innovation, and about competitiveness and convergence.

Historical experience suggests that although there are many potential pathways to development, financial self-reliance and sustained attention to developing home-grown industrial capabilities have been decisive factors in most successful cases of “late” industrial development or “catch-up”. It is vital, accordingly, for developing countries to place the question of international finance in the context of how different approaches to global finance strengthen or weaken their national capacities for industrial development, and especially their prospects for co-ownership and co-development of the core industrial and consumer technologies of the twenty-first century.

Today, any discussion of prospects for mobilizing large-scale financial resources for investment to contain global climate change must begin with the Report of the United Nations Secretary-General’s High-Level Advisory Group on Climate Change Financing (AGF). The terms of reference for the AGF posed the challenge narrowly, asking the panel to develop “practical proposals on how to significantly scale up long-term financing for mitigation and adaptation strategies in developing countries from various public as well as private sources, and how best to deliver it.” While AGF members were also enjoined to “provide views and suggestions, based on the best possible analysis, that are in support of development”, the analysis conducted did not attempt to link financial instruments and mechanisms to developing-country uses or needs.

The AGF report finds that mobilizing \$100 billion in annual flows is “challenging but feasible” – but does so on strong assumptions concerning the optimum path to global climate financing and, less plausibly, the

willingness of the international community as whole to adopt that path. The report argues that carbon pricing is the most efficient pathway to simultaneously raise revenues on this scale, a small share of which can be diverted to international transfers from developed to developing countries, and provide adequate stimulus for non-incremental private investment response. Establishing a clear link between new revenue measures and “moderate” carbon pricing of \$20–25 CO<sub>2</sub>t<sub>e</sub>, the AGF analysis also suggests, is the key to both revenue efficiency and political acceptability. Moreover, imposing a global carbon pricing regime may unlock a new “business logic” for new and dynamic forms of private international business collaboration – as much between developing as between developed countries.

Developing countries have expressed at least three concerns with the AGF conclusions. First, they rely upon a mechanism – carbon pricing – that is far from enjoying the broad political support required for effective implementation, even among developed countries whose capacity to scale up falls a long way short of what many countries believe is required to ensure that the burden of adjustment to a low-carbon future will not be carried by those who contributed least to the problem. The second concern is whether such a global regime could “solve” the climate and sustainability problem merely by reproducing, and perhaps intensifying, the problem of (uneven) development. Since one of the most important consequences of carbon pricing is to create significant new markets for products that are low-carbon-emitting or highly energy-efficient, developing countries will need to be assured that their own industries and labour will stand to benefit proportionally from the political and financial investments they make in global market development by participating in a global carbon pricing regime. Third, given that private financing is unlikely to provide the needed upfront investment because the returns from such investment are nearly impossible to capture, public investment by developing countries that only builds industries in developed countries will enjoy little if any public support.

Within a strong global regime for carbon pricing, it is likely, as the AGF report concludes, that large-scale international public and private resource flows will become both feasible and attractive. Yet there are not only serious doubts about whether the scale will be sufficient to meet the challenge; there are also important reasons for developing countries to wish to limit their reliance on large-scale international financial flows. First, long and hard experience has taught that large-scale financial flows can be, and eventually almost always are, destabilizing. Second, to the extent that financial flows are used to purchase goods and services that can be more beneficially or efficiently produced at home, they are inefficient – especially where non-financial flows of licensing rights and claims on future revenue streams can be accomplished with far less transfer of real resources.

This means that new vehicles might ultimately have to be designed to avoid these problems. In this respect, leveraging scale and financial commitment through regional financial collaboration presents an important alternative to traditional multilateral financing mechanisms.

#### 4. Governance matters

169. The effectiveness of the international economic system to deliver sustainable and inclusive outcomes is very closely tied to whether the various members recognize its

legitimacy and act accordingly. There is nothing more corrosive to an effective rules-based system than the belief that there is one set of rules for some and another set of rules for others, or that rules can be circumvented because of asymmetric power relations.

170. The current system continues to be dominated by a small number of economic powers, which are home to the world's largest corporations and financial institutions, and which exercise a controlling influence in IMF and the World Bank. The weighted voting systems of these institutions more closely resemble the Prussian electoral rules of 1848 than the constitutional principles of today's advanced countries. In contrast, at WTO, countries have equal voting rights, but decisions are taken by a consensus which emerges through consultations held by the Chairs of the three principal WTO bodies. This process has allowed countries with superior resources for negotiation to drive the agenda. The deadlock in the Doha Round suggests, however, that this dominance is no longer assured. Similar impasses have emerged around other issues taken up by the international community, such as climate change, as was dramatically illustrated in Copenhagen in 2009.

171. In recent years, measures have been introduced to improve representation and accountability in the Bretton Woods institutions, but these have been tentative (Helleiner, 2009). The G-20 process has also helped to broaden participation in global decision-making. However, the voice of most developing countries remains either weak or entirely absent. A global New Deal will need to accelerate the reform process if more effective approaches to global problems are to materialize. There have been intermittent calls for modernizing the structures established at the end of the Second World War, including pruning back overlapping mandates and finding better ways to coordinate their actions and policy advice. But despite the recognition that the growth in global interdependence poses greater problems today, the mechanisms and institutions put in place over the past three decades have not been up to the challenge regarding the coherence, complementarity and coordination of global economic policymaking. Proposals in the current context of globalization should start with an attempt to address these problems, *inter alia* through the appropriate parts of the United Nations system.

172. While United Nations Member States have repeatedly reaffirmed the role of the Economic and Social Council (ECOSOC) in promoting overall coherence, coordination and cooperation in economic, social and related fields, the Council continues to face difficulties in effectively fulfilling this role. A revived and strengthened ECOSOC could address global economic issues in a manner that parallels what its counterpart does in the security sphere. Such a reform of international governance should be supported by all countries sharing the conviction that democratic accountability is a prerequisite for sustainable and inclusive development.

## **G. New partnerships in the South**

173. An effective global regulatory regime supporting inclusive development needs to address the imbalances and vulnerabilities which currently structure the world economy. Multilateral governance will need to strengthen collective rules and actions in some areas, particularly finance, even as it looks to expand national policy space in others. Progress towards a new regulatory regime can be facilitated by well-designed regional anchors. After several disappointments and false starts, there are signs that regional integration is gaining renewed support across the developing world. The initiatives include attempts to forge greater consistency around trade and investment policies in Africa and Latin America, the creation of regional production networks in Asia, and the renewed efforts to strengthen South–South cooperation.

174. Much of the alarmism about regional arrangements and regional blocs is misplaced, and most actions enhancing regional cooperation need not discriminate against outsiders or

undermine global trade rules. As discussed earlier, the expansion of regional intra-industry trade is driven by dynamic economies of scale and specialization, and it tends to be more intense among countries at similar levels of development. It is also likely to lead to demands for further integration in order to lower intraregional trade barriers including conflicting rules and administrative procedures, and to demands for better transport and communications infrastructure, and for institutions to manage regional cooperation, as was the case in Western Europe. At first, such cooperation tends to focus on technical issues (standards, trade barriers and the like), but as regional production systems become more integrated, the regional policy framework is likely to include financial and structural challenges. Such shared challenges can often be better handled through a dialogue between neighbouring countries whose priorities are similar and where trust and a sense of common purpose can be more readily forged.

175. Despite the potential gains, including the incentives and support which larger countries can offer to their smaller partners, it has not been easy to reach agreement around proposals for a regional division of labour combining countries at different levels of development. Such arrangements can favour the concentration of economic activity in particular firms and locations, producing uneven and divergent tendencies which will disrupt efforts at greater cooperation. In part, the problem has stemmed from a one-sided emphasis on liberalization measures and efficiency gains at the expense of a discussion of institutional arrangements that support a broader cooperation agenda and structural transformation. An emphasis on the latter should help to ensure a stronger focus on the challenges of building productive capacities. This can be best achieved with the support of strategic industrial policies as well as active financial, labour-market, trade and macroeconomic policies, in order to expand and diversify trade among developing countries. This latter goal can also be pursued by combining measures to accelerate industrialization while cutting trade barriers. Consequently, policy coordination at the regional level is likely to take on much greater importance than it has today (box 15).

176. One possible model, involving a mixture of market and non-market forces, is the “flying geese” paradigm associated with East Asian development. As discussed earlier, while strong trade and investment ties have forged an economic hierarchy around recycling comparative advantage, government policies have played a critical role in fostering this pattern of regional integration. The emergence of similar models elsewhere cannot, however, be taken for granted, nor can it be assumed that their developmental impact will replicate East Asia’s. Still, this experience does suggest that, with proper policies, South–South cooperation can play a decisive role in fostering inclusive development through closer trade and investment links.

177. In light both of the expansion of these networks and their ongoing dependence on markets in advanced countries, there is a need to explore whether and how they can be harnessed to supply markets in the South. Arthur Lewis (1979) recognized this potential some time ago, but it has arguably become all the more important given the deflationary adjustments currently under way in the advanced economies and their weak medium-term growth prospects. The long-standing effort among developing countries through the trade negotiations around the Generalized System of Trade Preferences (GSTP) could be scaled up in support of such an orientation, but the agenda must move beyond tariff-cutting among members to include arrangements for trade financing as well as adjustment support (particularly in LDC members) and measures to bolster industrial cooperation.

**Box 15. Rethinking the regional trade agenda**

The proliferation of regional trade agreements (RTAs) has generated calls to clean up the existing “spaghetti bowl” of agreements. This is certainly needed, but the traditional “building block versus stumbling block” paradigm no longer offers an appropriate basis to assess RTAs. Rather, the key

challenge is how to ensure that RTAs bolster trade through productive integration, and support economic diversification among countries at different levels of development.

One reason why such agreements have proliferated is the international fragmentation of production. Fragmentation is not a new phenomenon, but in recent years it has been extended greatly, generating new challenges for global policy cooperation. Correspondingly, FDI has strengthened the investment–export nexus at the regional level, but it has also thrown up new challenges calling for improved regional coordination and monitoring, particularly in those dynamic sectors where there is a significant danger of overinvestment. In contrast, uncoordinated policies aimed at attracting FDI can result in a race to the bottom, as governments cut regulations and offer tax incentives in a wasteful bidding war to attract TNCs, rather than striking a more sensible balance between the costs and benefits of foreign investment. Regional arrangements can help to establish common bargaining positions on such areas as the harmonization of corporate codes, contract enforcement, tax incentives, and avoidance of transfer pricing.

An integrated approach addressing the challenges of building productive capacities, including strategic trade and industrial policies as well as financial, labour market and macroeconomic policies was adopted in the early discussion of the GSTP, which aimed at expanding and diversifying trade among developing countries by combining measures to cut trade barriers with efforts to accelerate industrialization. A similar approach underpinned the European experience, although it was conceived and implemented under very different historical, economic and political circumstances. These types of regional arrangements can help to:

- (a) Lower technical and bureaucratic barriers to trade, harmonizing customs regulations and ensuring the dissemination of information about trading opportunities and institutional sources of support for exports, helping to match potential suppliers with foreign buyers. These barriers and market distortions currently impede the involvement of many small and medium-sized enterprises in foreign trade;
- (b) Build cooperation on such trade-related services as insurance, export credits and trade facilitation;
- (c) Harmonize rules and regulations on a regional basis, and pool resources to ensure the more effective allocation of resources in light of local needs and circumstances;
- (d) Provide physical infrastructure, particularly transport and communications networks, energy supply, and management capacity;
- (e) Address constraints to growth, including those associated with technological development.

Achieving these outcomes will require reforms to the multilateral trading system. Consideration could be given to experimenting with innovative forms of commitment, including those without a linkage to WTO-type dispute settlements, and allowing some space for (temporary) rollbacks. It will also be necessary to strengthen the monitoring of the RTAs. A basic rationale for international cooperation is that the cost of complying with different



standards and rules of origin across RTAs may be high. Economies of scale (across countries) and scope (across issues) are likely to exist in rule-making. Whether or not this can help to bring some of the areas currently being negotiated in RTAs into the multilateral system, it could help to shift the RTAs in a more developmental direction.

The multilateralization of RTAs could be facilitated by the establishment of large-scale RTAs such as the GSTP, which is the largest South–South trade cooperation initiative in existence, and where the big country/small country division might be better addressed. Integration between member countries beyond trade liberalization, including around administrative procedures, should also be promoted in order to improve coherence across the multilateral trading system and the RTAs.

178. The expansion of regional trade has added impetus to discussions on regional monetary and financial cooperation. Though policy shifts at IMF and the expanded role of the G-20 have opened up the possibility for reforms at the multilateral level, the pace of reform may prove too slow or indecisive to address developing-country concerns over the impact of financial shocks and global crises. Gaps in the multilateral framework have created incentives for several developing countries, starting in post-1997 East Asia, to accumulate foreign reserves as an insurance policy against future shocks and contagion. However, as noted earlier, they are costly, their accumulation has contributed to the overvaluation of domestic currencies, and they have often not supported growth-oriented policies.

179. Regional monetary and financial cooperation covers a wide spectrum, ranging from relatively simple trade-related payment initiatives to more complex measures related to liquidity and development finance, and from macroeconomic dialogue between policymakers to mechanisms of surveillance and policy coordination, ultimately leading to a monetary union (TDR, 2001, 2007 and 2011). Such cooperation is often considered a second-best option, but this is misleading. The combination of knowledge and voice which can accompany regional arrangements may allow for better focus, greater timeliness, and softer conditionalities than those currently emerging from multilateral discussions (Griffith-Jones, 2008; Ocampo, 2006). Nevertheless, there is no recipe, mandatory sequence or ideal timing when it comes to regional financial arrangements, and distinct initiatives may be combined according to the degree of integration and the political economy of each region (TDR, 2007; LDCR, 2011).

180. Given the recent events in Western Europe, there may be growing resistance against regional monetary and financial cooperation. However, the European experience has achieved significant successes over several decades, including the European Payments Union and the European Investment Bank, as well as the wider process of economic and social integration. Moreover, regional cooperation does not necessitate the liberalization of capital flows or uniform macroeconomic regulations along the lines of the Stability and Growth Pact, neither does it necessarily lead to monetary union or prevent countries from controlling their exchange rates. In other words, monetary and financial cooperation need not restrict policy space. Rather, it can offer a constructive response to the loss of sovereignty under FDG, supporting the emergence of stronger countercyclical, inclusive and developmental macroeconomic policies and providing the financial support for a common industrial strategy (box 16).

181. Beyond these regional arrangements, the emergence of new growth poles in the South can be leveraged in support of more widespread developmental gains through South–South integration and cooperation that targets in particular the LDCs. Indeed, following a two-decade hiatus, new institutional arrangements have emerged among developing

countries to discuss mutual needs and challenges and to extend cooperation and support (EDAR, 2010). In contrast with traditional North–South cooperation, South–South initiatives involve countries with shared development challenges and suggest more equal relationships between donor and recipient countries. However, growing divergencies between emerging countries and LDCs suggest that capacity-building in support of developmental states should become an important component of South–South cooperation, as it has distinct advantages over traditional forms of development cooperation (LDCR, 2011).

#### **Box 16. Regional monetary arrangements**

The idea that developing countries can benefit from closer trade integration with each other and, especially, with neighbouring countries, is one of the cornerstones of UNCTAD's tradition. Trade among neighbouring developing countries is much more concentrated on industrial and more sophisticated goods than their exports to developed countries (TDR, 2007). This can be particularly important in promoting the structural changes associated with development. In recent years, successful regionalization experiences have been built on closer trade and investment ties.

Maintaining stable and properly aligned currencies is essential for this process to be driven by underlying economic fundamentals, and for preventing financial instability and trade tensions within the region. It is unlikely that these objectives could be achieved with each country acting alone, reinforcing the idea that closer monetary and financial cooperation could help underpin the efforts towards regional economic integration (UNCTAD, 2011b).

The main benefit of regional monetary integration comes from greater currency, payments, and financial stability, but this depends on the design of the integration process, including its supporting institutions and mechanisms – for example, the provision of trade finance, liquidity to cushion against external shocks, and long-term development finance to support private and public investment. These can be at least partially supplied by regional payments systems, monetary funds, and development banks.

Regional payments systems save foreign reserves and reduce the transaction costs associated with their use. They can also provide short-term credit to deficit countries, include regulations ensuring that surplus and deficit countries have to contribute to a more balanced position, and create incentives for exchange rate coordination. In case of a shortage of international currency, regional payments systems can reduce the adverse impact of that shortage on regional trade, as the Agreement on Reciprocal Payments and Credits did in Latin America. While Argentina and Brazil have recently created the System of Payments in Local Currency, targeting only the reduction of transactions costs, the Unified Regional Payment Clearing System (SUCRE) – an initiative of the Bolivarian Alliance for the Peoples of Our America (ALBA) – means to build upon the much more complete experience of the European Payments Union in the 1950s.

Regional monetary funds can pool reserves and organize swap arrangements among central banks, leveraging the available resources and helping to avoid uncontrolled devaluations that may compromise the integration process. As external shocks often strike first and most intensely at one or two countries in a region, a timely response from a regional fund can help to prevent contagion. The Latin American Reserve Fund (FLAR) and the Chiang Mai

Initiative provide examples to be emulated and improved upon. Again in Latin America, the creation of a wider Common Reserve Fund has been proposed, since FLAR includes only some countries in the region.

Regional development banks can be particularly suitable for financing regional public goods, especially when these require large investments and regional coordination, such as cross-border infrastructure. Together with regional monetary funds, development banks can contribute to the reduction of the financial fragility derived from currency mismatches, issuing bonds and making loans in local currencies or helping to introduce new financial assets. The Andean Development Corporation, often singled out for its efficiency and for being (until recently) entirely funded by countries in the region, has been the main source of multilateral finance for the Andean countries. In 2007, seven countries in South America decided to create a new regional development bank, the Banco del Sur.

There is also scope for initiatives involving larger groups of countries. First, the assets of developing countries' sovereign wealth funds have reached \$3.5 trillion. Even 1 per cent of these funds, if used to finance development projects in LDCs through regional development banks, might generate a far higher volume of loans than those provided by the World Bank and its existing network of regional development banks. Second, ODA can be channelled into regional programmes in order to meet development goals, which could also be funded through more innovative forms of financing mechanisms at the regional level. Third, the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System has proposed the establishment of a new global credit facility with a modular governance structure operated through regional financial institutions, which could be partly funded by countries' reserves. Finally, the United Nations has recommended that regional financial institutions should be given a central role in the provision of interim finance, when the system for sovereign debtors is reformed.

For additional details, see UNCTAD (2011b) and LDCR (2011).

182. A related area where South–South policy initiatives could make an important contribution is in curtailing “races to the bottom” as part of wasteful bidding by countries hoping to attract TNCs. Developing countries could increase their bargaining strength vis-à-vis TNCs, and improve their chances of following a growth path consistent with their own strategic priorities through a greater harmonization of their codes and policies towards contract enforcement, tax, and other incentives to FDI.

183. Beyond development cooperation, many of the new threats to inclusive growth and development can be approached through stronger South–South links. They include food security, where scaling up agricultural extension and support services, improved water management and strengthened R&D can benefit from shared circumstances among developing countries (UNCTAD, 2009 and 2010c). Other areas where South–South cooperation opens up new possibilities include climate adaptation and improved response to natural disasters (UNDESA, 2008). In such cases, new partnerships, such as those involving triangular cooperation, can be used to support more effective action. This has already been noted in the cases of agriculture and renewable energy. However, because these new challenges require large-scale investment and new technologies, effective actions will still have to be managed and financed at the multilateral level.

### III. The political economy of development

184. The architects of FDG have insisted that, left to themselves, market forces would unleash a wellspring of entrepreneurial energy, ensure a fair distribution of the resulting increase in prosperity, and guarantee a more secure and stable future for all. This reflected a willingness to stick to textbook assumptions of how markets work, even in the face of overwhelming evidence that the promised results were not materializing. In the wake of the crisis, Alan Greenspan, former Chair of the United States Federal Reserve, acknowledged that “a misplaced faith in market forces” had brought the economy to the edge of an economic abyss. This is a particularly telling phrase. Fundamentalists, whether religious or secular, are usually distinguished by a limpet-like attachment to a basic set of beliefs and to linear models of causation. This, in turn, encourages a retreat from complexity and a search for simple and apparently irrefutable solutions. A good deal of economic thinking in recent years has reflected this pattern, and has encouraged a disdain for alternative viewpoints and policy options.

185. Such thinking has dangerous historical precedents. During the interwar years, the upholders of conventional economic thinking were preoccupied with a “return to normalcy” through the natural workings of the gold standard; the restraining of any interference with market forces required budgets to be balanced, central bankers to be given independence, the rights of creditors to be upheld at all costs, labour markets to be flexible, and the rapid liberalization of trade and finance. In the absence of effective governance structures to manage the resulting imbalances and contradictions that followed, normalcy eventually turned to nightmare.<sup>64</sup>

186. Contemporary economists are perhaps more aware than their predecessors that markets can fail, that economic reality is characterized by persistent disequilibria, irregular fluctuations, cumulative development and unforeseen shocks, and that in such a world, both power and history are likely to have a bearing on economic performance. Still, these are not things they feel comfortable talking about, and the tendency remains to suggest that the job of the economist is to present “technocratic” solutions to particular problems while the job of the politician is make value judgments as to their feasibility and popularity. The current crisis has done much to expose this false dichotomy. In fact, the language of conventional economics shapes how it sees the world, and in ways which are often strongly supportive of the most fortunate, articulate, and politically influential in the larger community (Galbraith, 2004).

187. As a result, the crisis has not only served as a reminder that markets can fail, and in quite spectacular and damaging ways; it has also exposed the flawed values and assumptions behind the idea of a self-regulating market economy. Indeed, in many respects, the greatest damage from the crisis is to the underlying trust, confidence, cohesion and sense of justice and responsibility that are essential to a balanced economic and social system, at the national as well as the international level. These are proving difficult to repair.

188. The latest crisis, which began in the financial markets of the most advanced economies, has provoked some soul-searching by policymakers and politicians who had previously embraced this faith. The former Prime Minister of the United Kingdom, Gordon Brown, for example, has concluded that markets need morals as much as money men and to be fair as much as laissez-faire, and that bankers need to see themselves more as public servants than as masters of the universe. French President Nicolas Sarkozy has talked about the “intellectual, moral and political battle” that must be fought to correct the “injustices,

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<sup>64</sup> See Boyce (2009) for a detailed account of how the economic and political forces behind this return to normalcy played out to disastrous consequences during the interwar period.

improprieties and acts of folly that in the future will no longer be tolerable and will not be tolerated". And at the 2009 G-20 summit in London, both were joined by other world leaders in calling for a "new global consensus on the key values and principles that will promote sustainable economic activity". This remains work in progress.

## A. Towards a new development consensus

189. In this report, we have argued that any new consensus must also be inclusive if the measures adopted at the national as well as the international level are to bring about a more balanced and prosperous future for all. The following points are intended as a starting point for a discussion on the alternative principles around which a new consensus might be forged:

(a) **Development is about ends, not means:** Most people in most countries want similar things: a decent job, a secure home, a safe environment, a better future for their children, and the right to voice their opinion on how the larger community goes about achieving these goals. There is no universal blueprint for achieving these ends, and the institutions and policies that are required can only be fashioned around the matrix of local capacities, conditions and needs.

(b) **Growth is an important means to achieving these ends:** Developing countries must create the conditions for mobilizing domestic resources and build productive capacity, including local enterprises with a high propensity to invest and strong incentives to learn and innovate. Markets and property rights can all help to achieve robust growth and development, but they require complementary legal and financial institutions, shared values and agreed modes of behaviour. Moreover, a wide range of policy instruments, including discretionary macroeconomic and industrial policies, are essential tools for addressing the structural threats and weaknesses that constrain the development of more diversified and dynamic economies.

(c) **Technological progress is key to sustained growth:** Technological change is key to building virtuous circles of productivity growth, structural transformation, rising living standards, and increased investment in knowledge production. It has also been a source of global economic divisions as technological innovators have forged ahead; for developing countries, closing the technological divide requires importing technologies from abroad and adapting them to their economic circumstances, and this is only possible with much greater volumes of investment, including FDI, and integrated policies and institutions that promote learning, innovation and experimentation. This is just as big a challenge at the global as at the national level, and perhaps more so, as new threats require global technological responses.

(d) **Sustainable growth has a social dimension:** Faster growth, without the gains being broadly shared across all households and communities, is neither desirable nor viable. Inequality is an obstacle to economic and political stability and to sustained growth. Consequently, building a more inclusive future requires paying as much attention to employment, distribution and social protection as to inflation, efficiency and the protection of property rights. An integrated policy framework is needed to ensure that social and economic goals are mutually supportive.

(e) **Developmental states are central to balanced growth and development:** Inclusive development is a continuing process of transformation in which economic, political and social factors are closely interrelated. Institutions for consultation, discussion and participation are essential to generate the popular assent that is needed to ensure development is inclusive and stable. This will require a developmental state to build a robust social contract and provide a coherent vision of the future. Such a state is required

not only to help mobilize and channel resources productively but also to manage the conflicts and trade-offs that change brings. Outside pressure and advice for economic and institutional reform can play a role in strengthening developmental states, but in doing so, this should recognize that there are no easy solutions or quick fixes to development problems, that questions about the nature and direction of development policy are properly the responsibility of local institutions and their representatives, and that room for policy experimentation will be key to establishing an effective combination of economic and social forces in support of inclusive outcomes.

(f) **A balanced global economy requires strong national economies:** International competition can help to strengthen the creative impulse of market forces. However, in the presence of scale economies, technological asymmetries and dominant market positions, it cannot be presumed that trade and financial liberalization will automatically benefit all countries in the global economy. Rather, whether global firms and markets help establish a virtuous development circle where domestic growth and external integration reinforce one another will depend on initial productive capacities and institutional capabilities at the time of exposure and the effective design of policies to manage the integration process. A balanced global economy will not emerge if countries lack the policy space to leverage the potential benefits and mitigate the costs of closer integration.

(g) **Strong national economies require robust international cooperation:** Building the institutional structures and flexibilities in support of inclusive development has become more challenging as the world has become more interdependent. For many countries, external shocks and the balance-of-payments constraint remain an obstacle to growth, and for the poorest countries these are often the binding constraints. The multilateral system that has evolved under FDG is underresourced, overpoliticized and too fragmented to underpin effective development cooperation both to support more inclusive and stable growth paths and to deal with new threats to global stability and prosperity. A thorough examination of the governance of international economic relations and the premises on which current policies have been built is long overdue.

(h) **Global markets need global rules:** In an interdependent world, diversity and inclusiveness can be mutually supportive, providing there is room to establish a judicious mixture of market forces, policy intervention and international cooperation tailored to local needs and preferences. Still, to the extent that markets and firms operate globally, there are grounds for having global rules and regulations. Just like domestic markets, these are needed to establish the rules of the game and to curb actions that infringe on the rules. They are also needed to help provide and manage global public goods that markets are unable or unwilling to provide. The failure to establish such rules in some areas has long been a source of incoherence and instability in the international economy. Dealing effectively with emerging threats, such as climate change, would also appear to need global rules and regulations. However, given the existing asymmetries and inequalities in the global economy, designing appropriate rules and flexibilities is an even greater challenge than at the national level. Moreover, if governments, at all levels of development, are to cede some degree of influence to international bodies, then these must exhibit much more transparency and democracy than is currently the case.

(i) **The future matters:** Taking excessive risks with other people's resources has been a defining feature of FDG; it has proved very costly in financial terms, but in many respects the longer-term damage as a result of underinvestment in social and ecological stability could prove even costlier. Where economic or environmental debts are incurred, they should be accompanied by a clear and realistic plan of how they should be paid off without jeopardizing the well-being of future generations. Financial markets are an

imperfect instrument for making these decisions, in large part because they privilege short-term private returns over longer-term social and development goals.

## B. Norms and values

190. There is no disputing that money and finance have a critical role to play in any market economy. The danger comes from allowing financial markets to set the policy agenda and to dictate social values. This report has insisted that this makes for bad economics; but it also makes for bad politics and bad ethics. Scholars from Smith to Schumpeter to Stiglitz have all, in their different ways, understood that a self-regulating market society would eventually give rise to deeply disruptive strains and crises and even collapse. This is particularly true where finance takes charge, given its dangerous proclivity to undermine two of the key values on which its own contribution ultimately depends, namely trust and confidence. As Harold James (2009: 231–236) has observed, in a world of finance-driven globalization, monetary crisis and uncertainty can lead to a “universal questioning of every type of value”, including globalization itself.

191. An alternative approach should recognize that a society’s moral well-being depends on its economic well-being and vice versa (Friedman, 2005: ch.13). Markets do not appear to be able to make the connection on their own. Getting prices right is not enough; the real challenge is to get the markets right. For Adam Smith, the solution was to nestle the invisible hand in a visible set of public values (“moral sentiments”) nurtured by an educated elite drawn to academic pursuits and sensibilities. Keynes, who believed that a dynamic economy would require taming financial markets and the “euthanasia of the rentier” (despite his own indulgence in speculative activities) entrusted this task to a technocratic elite with artistic sensibilities. His intellectual rival, Joseph Schumpeter, offered a different understanding of the workings of capitalism which nevertheless recognized its self-destructive tendencies; but he believed that such an elite would harbour anti-market sentiments and turned instead to the old aristocracy to save the market from itself. More recently, Joseph Stiglitz and his colleagues have suggested that what is needed in the contemporary era of highly interconnected markets is a whole new “metrics” that can turn market-based societies away from their traditional (price- and income-based) measures of economic performance and social progress to a more complex and sustainable notion of community well-being.<sup>65</sup>

192. All these approaches share an emphasis on the importance of education and learning in forging an alternative set of values that can help get the market right. A stress on learning certainly goes hand in hand with a rejection of the more fundamentalist strains of economic thinking that have accompanied the rise of FDG and with an acceptance of a more pragmatic approach to the policy challenge of building new and more inclusive development paths. This should also help to encourage respect for diversity of opinion and approaches, which seems appropriate for a world of distinct but interdependent nations.<sup>66</sup>

193. Another feature of market fundamentalism is that it creates a false separation between economics and politics, and assumes that the market can, with minimum prerequisites such as peace and secure property rights, simply be left alone to create and distribute wealth (Hirschman, 1995). Such an approach stresses the importance of personal

<sup>65</sup> Stiglitz et al. (2009).

<sup>66</sup> Market fundamentalists would do well to listen to one of the leading twentieth-century liberal philosophers, Isaiah Berlin, who expressed his hope that “a world which is a reasonably peaceful coat of many colours, each portion of which develops its own distinct cultural identity and is tolerant of others, is not a utopian dream” (in Gardles, 1991), and I would add distinct economic identities as well.

freedom as a key attribute of the market economy. But this ignores the dangerous anti-democratic tendency of the market to privilege exit over voice in shaping the decision-making process. It can threaten the stability and effectiveness of the market through growing inequality and insecurity. Part of the required response is for those adversely affected to “voice” their disapproval, with the right to demand fairer outcomes and the space to present alternatives.

194. Thus, in addition to a stress on learning and diversity, promoting the idea of “freedom in a complex society” (Polanyi, 1944) also requires the values of voice and justice. The dominant principle of modern politics is that legitimate authority is based in some way or another on discussion which seeks the approval of those over whom it is exercised. Although democratic principles are central, there is plenty of scope for variation in the institutions of consultation, participation and accountability.<sup>67</sup>

195. Democracy is more than a set of formal institutions that can be put into place as a result of elections and a new constitution. It is, rather, a broad political culture of voice that requires time to evolve in such a way that it not only responds to the particular needs and preferences of the population that chooses it, but also ensures sufficient institutional independence to address unfair economic advantages and imbalances in economic power. The series of social and political reforms that have given rise to today’s western democracies were enacted, albeit discontinuously, over two centuries or more. But it should also be appreciated that democratic processes and both formal and informal systems for popular consultation are not unique to the western countries, and that the institutions of voice in developing countries may be less fragile if they are encouraged to take root in established national traditions.

196. In this report, particular emphasis has been placed on the building of developmental states. Doing so will involve a close interaction between economics and politics. How that interaction evolves will depend on local conditions and historical circumstances. However, taking the inclusiveness agenda seriously will almost certainly mean extending the rights of all citizens through greater voice, security and justice. Promoting these values, coupled with learning and pragmatism, is likely to reinforce a sense of trust and confidence in the institutions – both public and private – on which economic progress ultimately depends.

### **C. The role of UNCTAD**

197. The breadth and depth of the rebalancing challenge spelt out in this report points to the need for a transformative agenda that breaks with business as usual and looks, instead, to build new and inclusive development paths. The political backing and policy support for such paths will only emerge through a frank and open discussion of what has gone wrong over the past thirty years, as well as an understanding of what has gone right. That will, in turn, depend on recognizing, particularly at the international level, that there can be different ways of realizing more balanced outcomes, and that it is undesirable to insist that there is only one correct way to do so and to use international pressure to force countries along that path.

198. UNCTAD was created to address imbalances and asymmetries in the global economy, and to break the monopoly on economic thinking that dominated discussions at the international level in the early 1960s and that ignored or marginalized the specific needs of developing countries. Since then, the international development community has expanded a good deal and become much more diverse. UNCTAD is one institution in a

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<sup>67</sup> It is difficult to generalize about the links between democracy and development, but see, for example, Rodrik (2007) and Kozul-Wright and Rayment (2007).



large family of United Nations agencies, funds and programmes dealing with development issues. The rebalancing challenge, as set out in this report, will have to engage each and every agency in an integrated fashion. “One UN”, which has emerged from a system-wide effort to underpin the MDGs, points in the right direction, but the issues outlined in this report suggest that a fresh perspective is needed to move the development agenda forward and in more inclusive directions.

199. The thread connecting UNCTAD mandates, from UNCTAD I to UNCTAD XIII, is the way in which trade and development have been shaped by the interdependent forces linking nations at different levels of development. The originating mandate set out a programme of work which has evolved as subsequent conferences have sought to address the new threats and challenges facing developing countries. But, like any foundational charter, the Final Act of UNCTAD I provides a reference for shaping subsequent changes. In that regard, four points stand out in defining UNCTAD’s continuing role and relevance:

- (a) Economic development and social progress should be the common concern of the whole international community.
- (b) Addressing imbalances, particularly at the global level, that hinder trade and development requires cooperation among all countries.
- (c) Offering alternative policy perspectives to deal with those imbalances needs to be sensitive to the individual characteristics of countries and their different stages of development.
- (d) International financial, monetary and investment policies should be designed as part of an integrated framework to take full account of the trade, investment and development needs of developing countries.

200. On this basis, UNCTAD has developed a rich and varied body of independent research, and has been able to remain ahead of the curve in identifying emerging trade and development challenges, even when this has meant going against conventional wisdom. Our policy proposals have always paid particular attention to international measures and collective actions supported through multilateral arrangements and international development cooperation, while insisting that their implementation at the national level must respect the diversity and specificity of local conditions. As a result, UNCTAD has not shied away from the political biases and asymmetries that have, at times, undermined the effective governance of an interdependent global economy. Indeed, highlighting the importance of policies, and the role of international economic institutions in promoting one set of policies and ignoring others, has served as an important correction to the view that globalization is an autonomous, irresistible and irreversible process driven by the impersonal forces of markets and machines.

201. The scale, complexity and urgency of the rebalancing challenge outlined in this report cannot be overstated. This is familiar territory for UNCTAD. What is different this time is how closely interconnected the crises in finance, food and fuel, along with growing demographic pressures and the mounting threats from a warming world, have become. Together, these have already caused untold hardship across the world economy, and continue to stretch the social, economic and environmental fabric towards breaking point. It is a truism that policymakers, at the national and the international level, failed to see this coming. It will require the full and dedicated commitment of the entire international community to put things back on track.

202. UNCTAD will approach the challenge of rebalancing the global economy from its integrated approach to development policy in an interdependent and open world economy. The crisis has made it abundantly clear that the imbalances that have built up in recent years – whether between a hypertrophied financial sector and a stagnant real economy,

between greater openness and diminished macroeconomic options, between countries that sell more than they buy and those that consume more than they produce, between less regulated markets and more restricted social opportunities, between the technological haves and have-nots, or between rising living standards and environmental decay – can no longer be tackled separately or sequentially or by countries acting alone or even in tailored alliances of the favoured few. The immediate challenge of containing the damage from financial meltdown, establishing a sustainable recovery and preserving an open international economic system will necessarily have to address some hard questions about reforming global governance, revitalizing international development cooperation, and strengthening the provision of global public goods.

203. UNCTAD's mandate is sure to evolve as it addresses new threats to inclusive development – whether from gender inequality, climate change, or the urbanization of global poverty – as well as the changing features of the global economy, whether the Northern debt crisis or the rise of emerging economies, which have a direct bearing on prospects for trade and development. However, in doing so, our attention remains firmly fixed on the asymmetries and biases in economic power and influence which continue to limit those prospects even as the call grows for developing countries to assume more responsibilities for achieving a sustainable and stable future. Durable solutions will only emerge if the economic gaps that persist within and across countries begin to close and in ways that allow all boats to keep on rising.

## References

The text refers to a large number of UNCTAD flagship publications, with assigned years; these include the *Trade and Development Report* (TDR), the *Least Developed Countries Report* (LDCR), the *World Investment Report* (WIR) and the *Economic Development in Africa in Report* (EDAR). Mention of UNDESA refers to various years of the *World Economic and Social Survey* produced by the United Nations Department of Economic and Social Affairs.

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**Report of the Secretary-General of UNCTAD to UNCTAD XIII**  
**Development-led globalization: Towards sustainable and inclusive  
development paths**

**Corrigendum**

**Paragraph 60**

The first sentence *should read*

60. An early sign of the problems with this growth model was the rising “global imbalances” between deficit (largely the United States) and surplus (more dispersed but led by China, Germany and Japan) countries, which emerged in the mid-1990s and escalated dramatically in the new millennium.

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