SOUTH CENTRE

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# OBSTACLES TO DEVELOPMENT IN THE GLOBAL ECONOMIC SYSTEM

Manuel F. Montes

# RESEARCH PAPERS

# 51

# OBSTACLES TO DEVELOPMENT IN THE GLOBAL ECONOMIC SYSTEM [1]

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**SOUTH CENTRE**

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[1] The author takes full responsibility for all the data, analyses, and views in this paper, none of which should be necessarily associated with the South Centre. This paper is a significantly re-edited and rewritten version of a longer paper, Montes (2013b) "Obstacles to Development in the International Economic Architecture," commissioned by the Overseas Development Institute (ODI). The author gratefully acknowledges the comments and suggestions from ODI staff in the original paper and the research assistance of Intisar Islam.

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# I. Obstacles to Development Arising from the International System

As the international community wades into the political discussions regarding the alternatives to the Millennium Development Goals (MDGs) after 2015 and the design of the Sustainable Development Goals (SDGs) as mandated by the Rio+20 conference, it is timely to consider the question of whether development is a matter mostly of individual effort on the part of nation-states or whether there are elements in the international economic system that could serve as significant obstacles to national development efforts. If there are obstacles in the international economic system, it is important that the post-2015 development agenda and the SDGs address the question of the elimination or the reduction of these obstacles.

The limited number of successfully developing countries since the 1950s has provoked a debate over whether the success of these countries required their success in eluding international obstacles to development. The following discussion does not have to take one position or the other. It evaluates features of the international system on the basis of how these features are conducive to enabling long-term investment toward economic diversification.

Terminologies of previous development orthodoxies litter the development literature - import substitution industrialization, basic needs, structural adjustment, Washington Consensus, and Millennium Development Goals (MDGs). Each of these orthodoxies tended to be a reaction to perceived weaknesses or missing elements from the immediately previous one. The most recent orthodoxy, as exemplified by the MDGs, is that development is about poverty eradication.

This paper takes as a starting point that poverty eradication is an overly narrow, possibly misleading, perspective on development. Poverty eradication is a desired outcome of development but its achievement is permanent only with the movement of a significant proportion of the population from traditional, subsistence jobs to productive, modern employment. The association of development with poverty reduction created for the donor community the pride of place in economic policy in developing countries. But this place can be at the cost of reducing the responsibility of donor countries in helping to maintain an enabling international environment for development in trade, finance, human resource development, and technology. In the MDGs, these issues are crammed into “MDG8,” the so-called global partnership for development, with a very selective and poorly defined set of targets.[2]

Development requires not just higher levels of income, nutrition, education, and health outcomes but in the first place involves higher levels of productivity and capabilities. Higher levels of productivity and capabilities are possible only with structural transformation of the economy. In turn, in most societies, such a structural transformation has been “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” (UNCTAD, 2011, p. 6). Structural transformation is only possible with substantial and sustained investment over decades in new activities and products, not just in anti-poverty programs.

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[2] See United Nations (2013) and the series of previous reports from this annual series which have attempted to interpret targets and monitor progress on MDG8.

Where the international economic system is hostile to investment in new, productivity-enhancing economic activities is where its elements create obstacles to development. One example of an externally based obstacle is aid volatility which has been shown to have highly negative impacts on macroeconomic performance and domestic investment (Kharas, 2008). The mechanisms in which the international system is hostile to investment in new, productivity-enhancing economic activities are elaborated on in Section II of this paper entitled "Commodity Dependence and Instability in Trade and Finance." This section discusses how patterns of economic interactions by developing countries with the international system undermine investment in new, productivity-enhancing economic activities. For example, it highlights recent trends in which the export structure in many developing countries have become less diversified, indicating investment being channeled into traditional sectors, instead of new activities.

The next three sections then group the nature of obstacles into three main areas: (1) mitigating the impact of external deficits and instability, (2) rebuilding domestic policy space, and (3) improving the development accountability of international governance. By re-categorizing the manner in which the international system hinders or prevents investment in new, productivity-enhancing economic activities in sections III, IV, and V, it becomes possible to think about the obstacles in terms of defective institutions, missing mechanisms, and impediments to domestic policy which can be overcome with changes in the international economic system. Some of these obstacles have the nature of "unfinished business" of reforms generally understood to be required in the international system but have not come to pass because of resistance by powerful interests. Others, such as the loss of policy space, could represent the cumulative impact of wide-ranging liberalization reforms in the wake of the debt crises of previous decades which now appear to be misguided. For example, the 2007-2008 financial crisis, centered in the developed countries and eventually engulfing the global economy, shines a light on the folly of believing that private financial markets left to themselves will innately facilitate long-term investments. The loss of policy space in developing countries reduced the state's ability to harness and channel the operations of private markets toward national development objectives. The details are in each of the sections.

Capital and technological investments are required to overcome the enormous productivity gap between developing and developed countries which characterises the world economy. In 2008, a ratio of the average Gross National Income (GNI) per worker in the OECD versus those in the least developed countries (LDCs) was 22:1 in favor of OECD (UNCTAD, 2010, p. 174). This imbalance has worsened by a factor of five in comparison to the earliest days of capitalist development. In the nineteenth century, taking the Netherlands and the United Kingdom (UK) as the richest countries and Finland and Japan as the poorest, the productivity gap was only between 2 to 1 and 4 to 1 (Chang, 2003).

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## II. COMMODITY DEPENDENCE AND INSTABILITY IN TRADE AND FINANCE

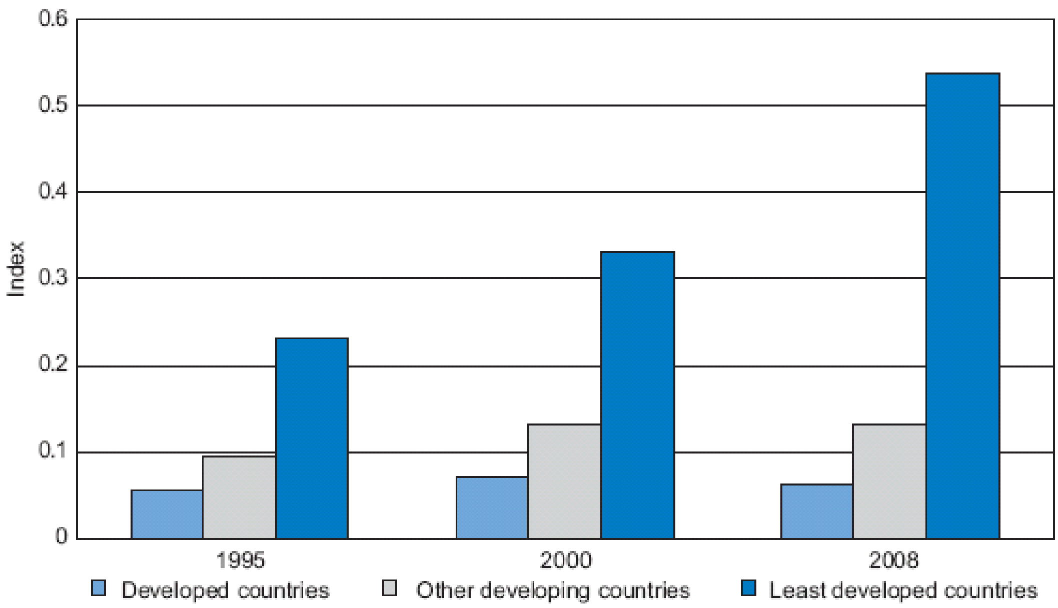
The international economic system is lacking crucial mechanisms for delivering long-term, stable resources required by developing countries to upgrade their capabilities. This is already partly reflected in the existence of MDG8, incomplete as it is, but has also been incorporated in many previous international agreements, for example in the Monterrey Consensus (United Nations, 2003).

Dependence on commodity exports sustains the productivity gap between developed and developing countries. Abundant global liquidity and growing trade imbalances fueled a commodity boom in the 2000s which benefited many developing countries, including many LDCs. All previous global liquidity booms had ended with serious economic crises in developing countries (Akyüz, 2012a). The more recent commodity price boom did not introduce an enduring improvement in macroeconomic balances, especially for LICs. While in the 2000s LDCs experienced the strongest growth rates since 1970s, more than a quarter of LDCs actually saw GDP per capita decline or grow slowly in the 2002-2007 global boom (UNCTAD, 2010). Even in the middle income region of Latin America, Izquierdo et al. (2007) present evidence of insignificant structural improvement in fiscal and current account balances.

Previous commodity boom periods had similarly not been an occasion for structural change in LDCs. UNCTAD (2009, p. 145) suggests that between the 1970s and 1997, manufacturing as a proportion of GDP increased by less than two percentage points in LDCs as a group, a period which saw various episodes of commodity and global liquidity booms. When considering LDCs from Africa alone and including Haiti, manufacturing fell from 11% to 8% of GDP during the same period.

Developing countries had extensively liberalized their trade regimes in the 1980s. In the aftermath, UNCTAD (2010, p. 174) finds that some LDCs have more open trade regimes than other developing countries, and others are more open than even developed countries. These policies had been intended to facilitate economic diversification. Instead of the expected outcome, greater trade liberalization has been accompanied by greater concentration in the structure of exports (Figure 1).

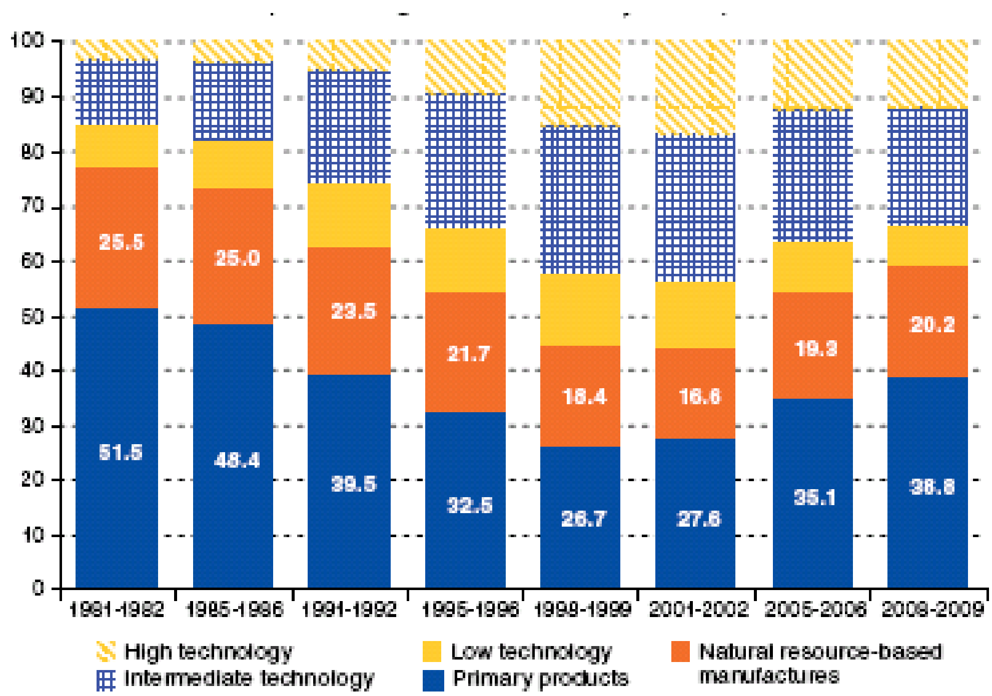
**Figure 1: Concentration of Exports**
(Indices of Concentration)




Source: UNCTAD, 2010, p. 17, Chart 8.

In Latin America and the Caribbean, the phenomenon of "reprimarización", a restoration of reliance on primary exports, is unmistakable (Figure 2).

**Figure 2: Structure of Exports, Latin America and Caribbean since 1980**
(percentages of total value)

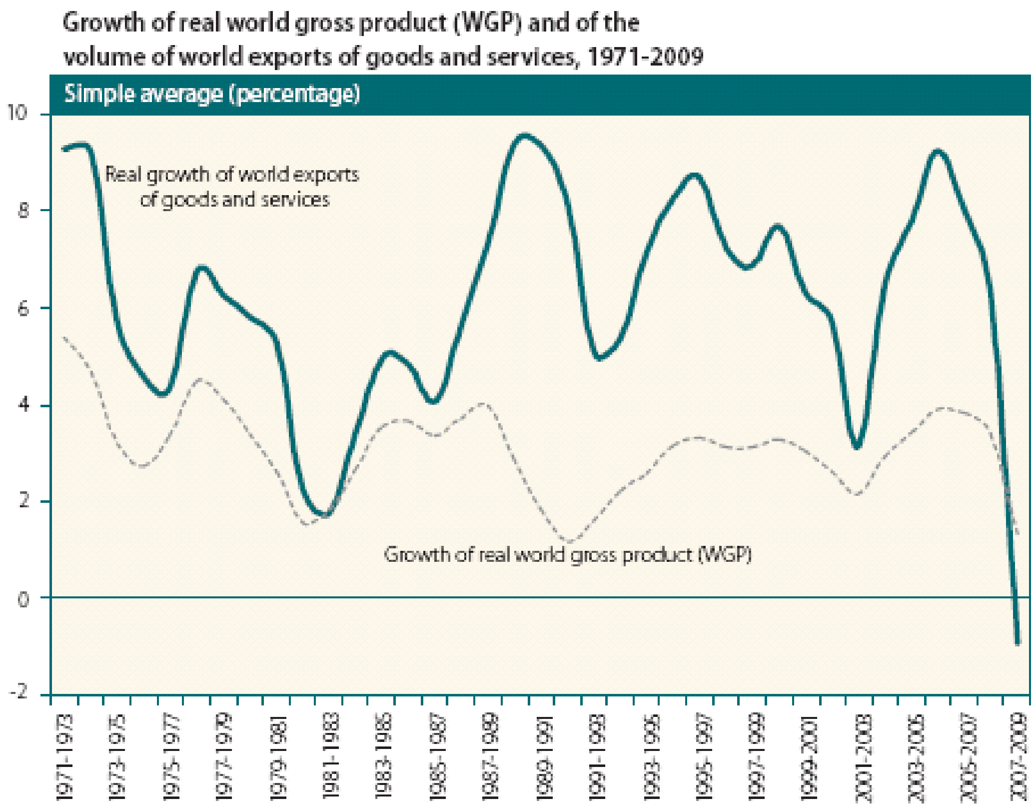



Source: Table II.12, CEPAL, 2010, p. 74.

Based on an analysis of the clustering of major breaks in the growth process in the developing world, Ocampo and Parra (2006) contend that unstable macroeconomic performance in developing countries is mostly explained by external events in trade and financing emanating from the economic performance and policies in the developed countries. In the case of smaller economies, these are more susceptible to growth collapses (Ros, 2005) and, external shocks are a larger proportion of their achieved economic size. Changes in external conditions set in train disorderly debt restructuring, disruptive balance-of-payments (BOP) adjustments, widespread private bankruptcies, social conflict and extensive institutional and political changes and policy experimentation which amplify these breaks in the growth process. Ocampo and Parra (2006) suggest that the 1950s and early 1960s can be seen as a "golden age" of development coinciding with a much lower incidence of international economic crises.

International trade is a major source of instability. Figure 3 traces a pattern of large changes in world trade growth from the 1970s which developing countries that have increasingly tied their fortune to the global economy have to contend with. The figure also suggests that the swings are coincidental with but much larger in amplitude than changes in global growth rates in which developed countries still account for a large proportion in the period of the graph. These trade shocks have been amplified by induced financing notably in Latin America after capital account liberalization (United Nations, 2008, pp. viii - x).

**Figure 3: Growth Rates of World Trade and World GDP**

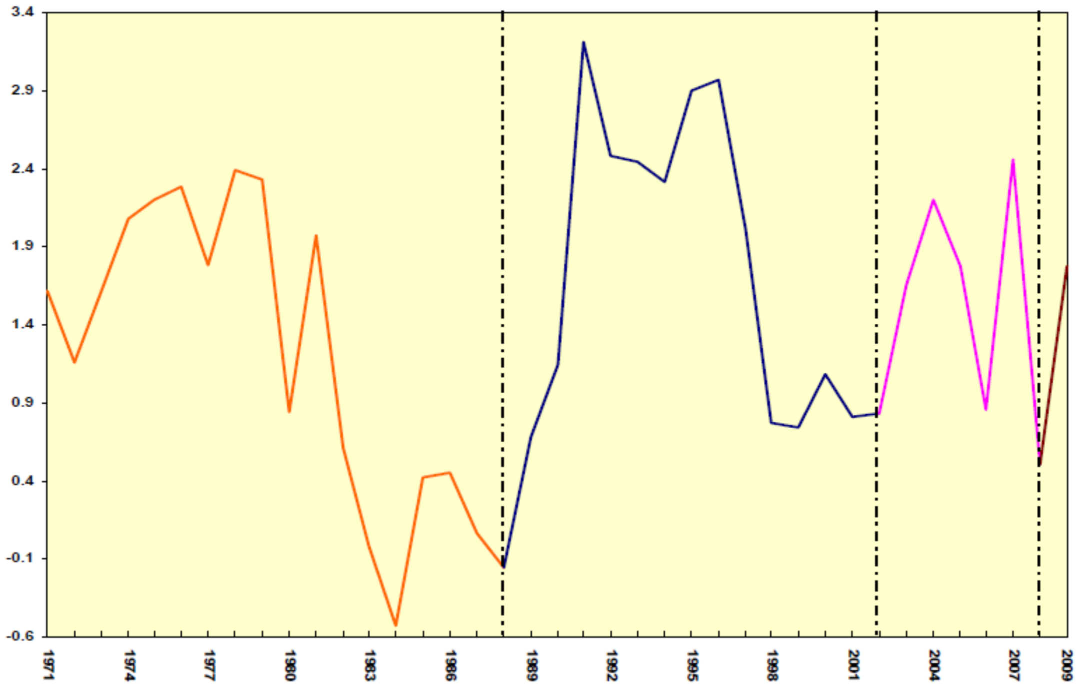



Source: United Nations (2010), Figure IV.1, p. 74.

In the case of LDCs, which have heavier dependence on commodity exports, commodity price volatility has significant impact (UNCTAD, 2010, p. 191) on investment and growth. But it is also important to highlight the impact of aid and financing volatility as a key driver of their external debt crises. Aid is as volatile as "private flows and the volatility increases with aid dependence" (Akyüz, 2008, pp. 15–16; also United Nations, 2005, Chapter IV). Kharas (2008) indicates that aid volatility imposes through the channel of macroeconomic volatility deadweight losses of 15 per cent to 20 per cent of the total value of aid, or about 1.9 per cent of GDP for the average aid recipient. Akyüz (2008, p. 16) deems aid for the most part to be more volatile than "either output or fiscal revenues", citing IMF-commissioned studies Robe and Pallage (2001) for volatility and procyclicality with respect to output (especially for African countries) and Bulíř and Hamann (2003), Bulíř and Lane (2004) and Hill (2005) with respect to fiscal revenues.

Instability in private financial flows to developing countries is another significant source of external instability for developing countries. Figure 4 demonstrates a pattern of three distinct boom-bust periods, measured through the pattern of net private capital flows to developing countries: the first ended with the Mexican debt crisis in 1982, the second with the Asian financial crisis in 1997, and the third with the Lehman collapse in 2008.

**Figure 4: Net Private Capital Flows to Developing Countries**
(per cent of GDP)

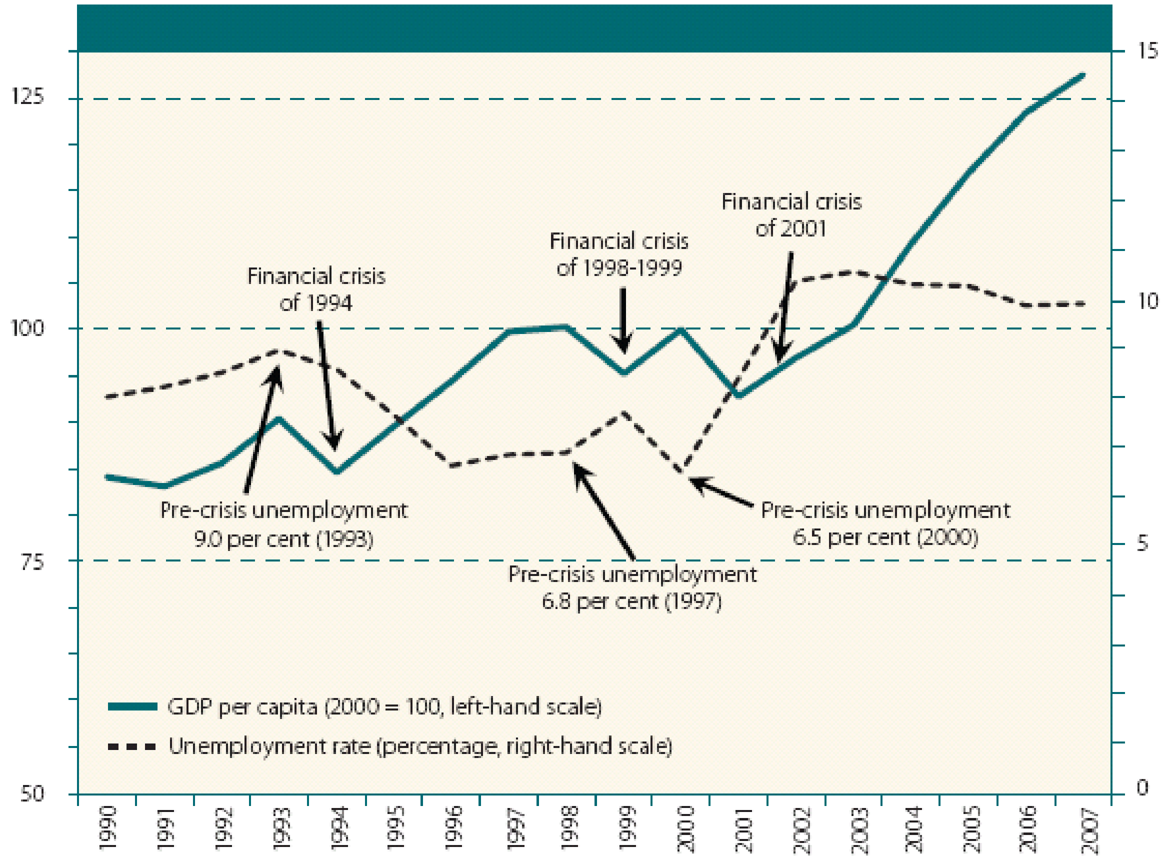



Source: Akyüz (2012a), Figure 2, p. 68.

Since the1997 Asian financial crisis, major emerging economies have accumulated international reserves by purchasing developed country financial assets either from their export earnings (in the case of net exporters) or from external borrowing (in the case of net importers) as a form of self-insurance against volatile private portfolio flows. These "investments" in developed country financial assets by the developing country authorities diminish the ability of these countries to undertake counter-cyclical policy and to build their domestic financial sectors. These "investments" also impose an opportunity cost in terms of forgone financing for domestic investment. This mechanism created the ironic pattern just before the 2007-08 crisis of developing country authorities being significant net investors in developed country economies (United Nations, 2010).

It is important to point out that macroeconomic volatility and periodic crises have long-lasting impact on growth and employment in developing countries, in contrast to the case of developed countries. Figure 5 demonstrates this in the case of Turkey, but similar patterns are found for Brazil, Chile, Indonesia and Malaysia (United Nations, 2010, Chapter V). Growth volatility and investment volatility interact strongly and undermine efforts to spark sustainable private investment. These crises also destabilize public sector balances.

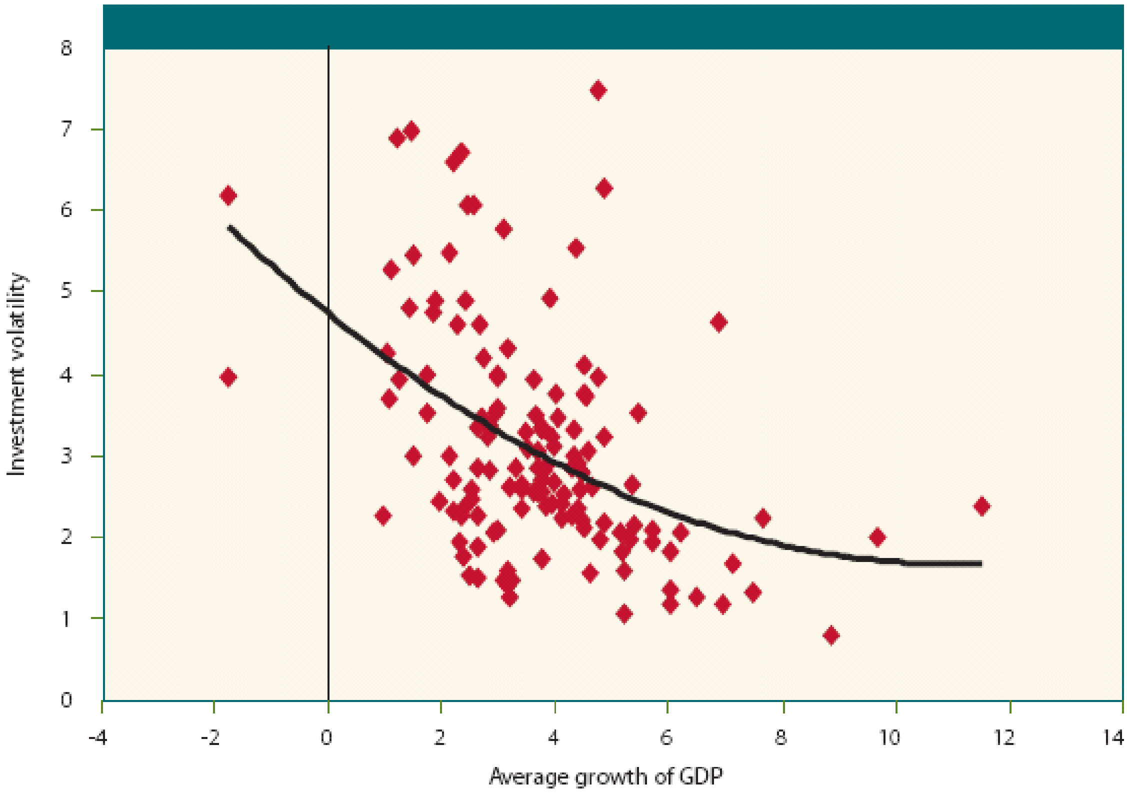
**Figure 5: Medium-term employment impact of crises in Turkey**




Source: United Nations, 2010, Figure II.4, p. 31.

Investment volatility closely tracks variability in GDP growth rates (Figure 6). In middle-income countries (MICs) where private investment has a larger macroeconomic impact, the causation could flow both ways, either originating from the instability of financing or the cyclicality of growth itself determining the timing of private investment. In the case of LICs and LDCs, the government impact on the macroeconomy is larger. Instability in government spending, both in current expenditures and infrastructure investment as a consequence of commodity price changes and ODA instability, causes investment volatility.

**Figure 6: Growth of GDP and investment volatility among developing countries, 1971–2000**




Notes: Investment volatility is measured as the coefficient of variation of gross capital formation – the standard deviation as a per cent of the mean - and the average GDP growth rate is measured in per cent.
Source: United Nations (2010), Figure III.5, p. 61.

Based on this brief survey, one could summarize the obstacles posed by the international economic system to development objectives:

1. Development requires the significant and long-term investment in new activities and the absorption of substantial segments of the population in these activities.
2. Outcomes and policies in international trade and finance have undermined macroeconomic stability in developing countries. Periodic crises induced from the international economy have thwarted the needed investment.
3. An enabling environment for long-term investment in developing countries will require two things: (1) the reform of international mechanisms, including possibly the introduction of missing ones and (2) a capacity of developing countries to reduce and insulate themselves from harmful international influences.

## III. MITIGATING THE IMPACT OF EXTERNAL DEFICITS AND INSTABILITY

Instabilities in trade and financing coming from the international economy have a strong impact on investment and growth stability in developing countries. This section surveys proposals to mitigate these influences. For developing countries the sources of instability can be grouped into the following areas: (1) commodities and (2) trade and (3) external finance, including ODA and private flows. These areas are the key sources of macroeconomic instability in developing countries.

### III.1. Commodities

In the case of commodities, developing countries fall into different categories, from differences in commodity needs and whether the country imports or exports them.

In the case of food as internationally traded commodities, the main problems have been the following (Khor, 2012; South Centre, 2007 and FAO, 2010):

(1) A pattern of decades-long insufficient investment in food production and in rural areas, which has in turn been linked to an over-emphasis on external trade to cover domestic food requirements and low prospective returns on investment in the face of continuing agricultural subsidies in developed countries;
(2) A publicly subsidized shift to biofuel production since the early 2000s, which has now significantly reduced the capacity for food production;
(3) Increasing dependence on events emanating from the financial markets for the determination of international prices of basic food.

For petroleum, minerals and metals, the question of commodity booms and busts and the differentiation between short-term and long-term trends are critical (Erten and Ocampo, 2012). Financial markets have also been seen to have had an important impact in the volatility of prices in these sectors.

Booms and busts in commodity prices have strong macroeconomic and investment effects on commodity-dependent exporters. Busts in commodity prices (or increases in international food and energy prices) provoke periods of external borrowing on the part of commodity exporters (or net importers of food and energy). In 1963, the IMF established a compensatory finance facility which permitted non-conditional financing for periods of falling commodity prices to be paid back when commodity prices recovered. It was the largest special IMF facility and accounted for a quarter of total IMF credit extended between 1976 and 1985 (Kumar, 1988).
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In the 1990s, the compensatory non-conditional financing from the IMF for shocks that were purely external in nature were increasingly in conflict with SAPs and poverty-reduction and development policy reform programmes. By 1998, the IMF facility was effectively folded into the poverty-reduction strategy programmes, which transformed them into conditional financing carrying interest, a modality inappropriate to the purpose and expensive to potential users. Following the 2009 G20 summit, rules were amended to relax conditionality procedures and raise access limits. What is still lacking is a stable, non-conditional, international facility for compensatory financing for external shocks.

## III.2. Trade

Given the high rates of growth in global trade since the end of World War II, Lewis (1979) in his Nobel lecture suggested that moving towards export-led growth would be a reasonable gamble. This challenge had been taken up by most developing countries since the start of the 1980s. While the volume of trade is much higher than in 1980 and the size of the developing economies as a proportion of the total world economy has increased, only a few countries have succeeded in changing the structure of their economic relationship with the global economy in the period of intensified trade engagement since the 1980s (as also reflected in Figures 1 and 2 in the previous section).

In some countries, such as China – which is counted among those whose gamble into export-dependent[3] growth has "paid off" – there are serious concerns that this pattern of growth is unsustainable (Akyüz, 2012a) and that a reorientation towards domestic demand is already required. It is ironic that the unprecedented growth rates in output and income recognised by Lewis (1979) were those achieved in the era of import-substitution and internationally sanctioned state controls over private capital flows. Export-reliant growth for most countries did not lead to the required scale and timing of economic diversification.

The most dynamic system and rule-making arena has been in free trade agreements (FTAs) and bilateral investment treaties (BITs) involving reductions in tariff rates, lower state regulation, and strengthened protection for intellectual property and investors' rights. The process of negotiation and accession toward Economic Partnership Agreements (EPAs) with the European Union is one of these growing issues. EPAs, which have been agreed and begun to be put into force in many Caribbean countries, require participating countries to eliminate tariffs on 80 per cent of the value of trade within 15 years.

African countries have offered instead to liberalise 60 per cent over 20 years. The European Commission rejected the proposal. In many countries in Africa, between 50 per cent and 70 per cent of exports to the EU "are made up of only one product – petroleum accounting for 90 per cent of Nigerian exports; gold and diamonds are 96 per cent of Botswana's exports; coffee is 67 per cent of Burundi's exports" (South Centre, 2010, p. 2). The challenge posed by the EPA tariff coverage is that African countries must rapidly establish competitive industries in other products and sectors within 15 years. The danger is that the EPA will "lock African countries into their current patterns of production i.e. low levels of manufacturing capacity" (South Centre, 2010, p. 2).

The structure of economic openness should depend on the level of development, something the present free-trade paradigm does not recognise (Akyüz, 2009b). This would have to involve a degree of non-reciprocity, so that countries could shield some economic activities from external competition until they are competitive. This could involve low or no tariffs on imports for machinery and other inputs to new production activities while having protective tariffs for activities that are being developed.

[3] China's exports destined for developed countries are heavily dependent on imported inputs from other developing countries (Akyüz, 2012a). China's domestic demand is less dependent on imports and could have an impact on the export performance of other developing countries.

WTO obligations limit policies that have been traditionally applied for structural transformation and catch-up, a situation Chang (2003) has characterized as "kicking away the ladder" since the now developed countries had the scope to apply these policies in their own development.

Disciplines on investment measures under the Agreement on Trade-Related Investment Measures (TRIMS) inhibit WTO Members from imposing domestic content requirements on investors. Intellectual property rights enforceable under the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) through trade sanctions hinder reverse engineering and other activities to adapt foreign technologies to local conditions. Moreover, the threat of trade sanctions on key exports discourage initiatives that would test the limits of the corresponding restrictions even when such actions could potentially reduce the import bill or the foreign exchange outflow and/or are supportive of the start-up of new economic activities.

There are few signs that these developing country obligations, undertaken in exchange for promised but unrealised actions on the part of developed countries particularly in the elimination of agricultural subsidies, can be moderated or renegotiated soon, under the WTO's Doha development agenda. The WTO Bali ministerial meeting in December 2013 did not advance these issues.

Based on these considerations, the following elements are important in reshaping the international trade regime:

1. *There is an urgent need to dramatically shrink, if not eliminate, subsidies* in developed countries that disadvantage developing countries through trade. The most flagrant of these are agricultural subsidies.
2. *The principle of non-reciprocity on the basis of development level* must *be revived and strengthened in trade*. This is an application of the principle of common but differentiated responsibilities in the area of trade.

The principal challenge is the revival and elaboration of non-reciprocity based on the level of development, which can take many forms. One well-known approach is the provision of longer adjustment periods. Unfortunately, conditions for accession often ignore the applicant country's level of development. Moreover, adjustment periods have been stated as a fixed number of years, rather than being based on the development level, as is the case at present for the intellectual property exemption for LDCs. Another problem is that exclusions from international disciplines, such as those for environment and research and development (R & D), actually tilt the playing field in favor of developed countries since these have more resources and human capacities to undertake such interventions. The underlying issue is that the expansion of international commerce requires a steady increase in the number of countries that can participate in trade without increasing their debt to other countries. Restoring flexibility in the setting of tariff rates by developing countries is critical.

This can be done within a framework of progressive trade openness in the long term by returning to earlier approaches of measuring openness based on average rates across tariff lines. This will allow countries to raise or lower tariff rates according to which industries they seek to promote at a particular stage of development. The current approaches of setting percentages of tariff lines that either must be bound or set to zero within a particular timeframe are either inimical to development or require high government capabilities to undertake rapid sectoral development interventions if the country is to escape being locked into its current pattern of production.

### III.3. Financial flows

At the global level, capital and financial market liberalization were expected to enable developing countries to acquire increased access to investment financing (United Nations, 2010, Chapters 2 and 5). Based on investment rates on fixed capital, there is no evidence that the increased volume of capital flows can be associated with increased investment. Instead, since the 1980s, in response to the removal of capital account controls, private flows have been mostly short term leading to increased volatility and uncertainty, which appears to have undermined the long-term investment critical for structural transformation and development.

ODA, which can be a significant proportion of budgetary resources in poor countries, has also proved very volatile and inflicted macroeconomic volatility. The required reforms can be grouped into two main categories (Akyüz, 2009a): (1) crisis prevention and (2) crisis resolution.

#### *i. Crisis prevention*

Crisis prevention mechanisms are crucial to reducing the vulnerability of developing countries to external financial instability, while preserving their national policy autonomy to set their pace of trade integration. Three areas require attention for crisis prevention (Akyüz, 2009a; see also United Nations, 2009 and Ocampo, 2011):

1. Effective multilateral discipline over financial, macroeconomic and exchange rate policies in systemically important countries.
2. Establishment of an international reserve system not based on a national currency or currencies.
3. Effective regulation and supervision of financial markets and capital flows.

To achieve the first goal, the international system must establish monetary and financial disciplines on reserve-issuing economies. Large swings in macroeconomic policies and financial conditions in developed economies have imposed boom–bust cycles on developing economies. “International spillovers from macroeconomic, exchange rate and financial policies in advanced economies are much more damaging . . . than shocks from their trade policies. But, unlike trade, there is no effective multilateral discipline in money and finance” (Akyüz, 2009a, p. 12). Because of the absence of obligations on the part of the US as a reserve-issuing country, there was no mechanism, including in the IMF, to prevent the explosion of risks in the US financial sector whose failure has caused a global crisis.

A fundamental change in the reserve system is the second key requirement of crisis prevention. Effectively, the current global reserve system depends on the national currency of the USA. Liquidity booms and busts experienced by developing countries have been induced by policy changes in the USA in pursuit of its own macroeconomic imperatives. The system is also inherently unstable due to the “Triffin dilemma”, which requires the reserve-issuing country to run current account deficits to provide liquidity to underpin increasing global trade. This system had been anchored in a fixed rate of gold convertibility and unsurprisingly collapsed in 1971 when the USA abandoned convertibility because of the threat of the running out of its gold stock.

The Asian crisis in the second half of the 1990s demonstrated the inherent instability of the system and the vulnerability of developing countries to financial flows. Instability in international financial flows has resulted in developing countries undertaking significant self-insurance by accumulating reserves. This is itself a source of additional instability since it generated financing for deficits undertaken by the USA in the lead-up to the crisis.

The current crisis has restarted discussion on increasing the use of the Special Drawing Rights (SDRs) of the IMF to uncouple global liquidity from the US dollar. There are technical and governance issues that must be addressed in increasing the use of SDRs (United Nations, 2010; 2012; Akyüz, 2009a) but this approach provides the most accessible path to reducing dependence on a national currency and removing a source of imbalances leading to a crisis.

The effective regulation of financial markets and capital flows is the third pillar of crisis prevention. The present crisis demonstrates that financial claims are highly vulnerable to cumulative processes that do not correct themselves except through discontinuous crises with large policy and social dislocation. Moreover, financial instability emanating from large financial centres has adverse international spillovers, in both the boom and bust phases.

In practice, applying common but differentiated responsibility in international financial regulation will require that developing countries do not undertake the same degree of financial liberalization of financial services under the WTO; at a minimum, this will require that the positive list approach in listing international services to be liberalized must be continued. In practice, developing countries must also protect their sovereign right to impose controls on capital flows as provided for in the IMF's Articles of Agreement. The IMF (2012) recently published an "institutional view" of capital account liberalization and management which recognized this right. Developing countries will need to exercise this right in the face of the generally "hostile" (Gallagher, 2011, p. 12) view that IMF staff have of capital account management tools since the 1990s.

### *ii. Financial crisis resolution*

Financial crises have been occasions of dramatic development reversals in the developing world. Avoiding these reversals will require orderly and equitable approaches to crisis resolution which the international system does not provide at present.

The standard approach has been fraught with controversy. IMF-led programmes involve new financial injections and public sector austerity, which are mainly intended to keep debtor countries up to date on their debt service obligations with external private creditors. These programmes insist on keeping the capital account open, even with significant capital outflows and losses in reserves. Under these programmes, the burden of adjustment falls almost exclusively on debtor countries. These programmes often require the public sector to assume the external debt obligations of the private sector. These have often included the debt obligations of subsidiaries of foreign companies resident in the debtor country. This approach exempts external creditors from market discipline and propagates moral hazard in private financial lending activities to developing countries.

The underlying objective of crisis resolution must be to restore as quickly as possible the ability of the affected country to resume economic activities, as is the case in crisis resolution in domestic contexts. This will require the sanctioning of standstills during the period of debt-resolution negotiation and the provision of resources for critical current account needs (Akyüz, 2009a). Beyond a standstill, a growth-oriented resolution could also require restrictions on capital account flows and import restrictions during the period of debt resolution in order to conserve foreign exchange.

The absence of an orderly, non-arbitrary process of sovereign debt resolution is an important development obstacle. Countries are subjected to litigation which ties up their external economic transactions; a proper crisis-resolution mechanism will include a standstill on such litigation. There is a need to involve neutral parties in the resolution process, such as arbitration panels made up of experts, as in the WTO's dispute settlement process. The lead role played by the IMF in these episodes is riddled with conflict-of-interest dilemmas since the IMF and its sister organization, the World Bank, are themselves creditors.

## IV. REBUILDING DOMESTIC POLICY SPACE

The radical application of Structural Adjustment Programs (SAPs) and Poverty Reduction Strategy Papers (PRSPs) in the developing world hinged essentially on reliance on private incentives and markets to address social problems and underdevelopment based on profound suspicions concerning the capacity of other institutions, particularly the government, to deal with these issues. The MDG framework assigned to public authorities the important and enclave responsibilities in spending on social sectors, to the extent that these were aligned with the MDGs. However, this framework also upheld the original policies of lowering tariff and tax rates and strict fiscal deficit ceilings, the emphasis on achieving international competitiveness, and the progressive opening of the capital account. Nayyar (2011, p. 19) characterized the resulting division of responsibilities thus: "In fact, the emphasis on social development meant that governments in LDCs relied on external resources to finance expenditure on social sectors but did not mobilise domestic resources to finance investment in infrastructure, agriculture or productive activities".

The global deregulation of financial markets has made financial markets the principal arbiters of real sector outcomes unlike in the 1950s and 1960s. The Bretton Woods economic system assigned a definite priority to the real sector, as opposed to the financial sector, as the driver of growth.

Since the 1980s, international priorities have shifted away from policies that promote expanded employment, trade, and production. As discussed in the previous section, FTAs, exemplified by negotiations in the EU's Economic Partnership Agreements, tend to restrict the scope of developing country authorities to build domestic industries as a basis for expanded external trade. The accompanying shift in the practice of international economy policy towards a decisive control by private financial markets over economic decisions as a result of national and international policies towards financial deregulation has reduced public resources and mechanisms for addressing international boom-bust cycles. Financial markets have captured enormous influence on commodity prices and access to credit.

The original use of the phrase "policy space" in an official document was in paragraph 16 of the Accra Accord of UNCTAD XII (UNCTAD, 2008). In that formulation, policy space is defined in terms of the impact of international rules and arrangements. Policy space is essential to have the scope for introducing "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" (UNCTAD, 2011, p. 41).

There are two sources of restrictions to policy space in developing countries: (1) constraints arising from international commitments and (2) restraints originating in the overall status of openness to the international economy. In an ethos that privileges openness, these two sources, of course, interact. For example, the openness of commodity-dependent economies makes them more susceptible to the procyclicality of international prices. During price booms, many commodity-exporting countries have greater access to take on external debt, and many do so. During periods of commodity-price downturns, these economies are more subject to conditionalities in standby programmes with international financial institutions, which have most often resulted in restrictions on policy space in the name of enhancing openness to the international economy. Nissanke and Ferrarini (2004) propose state-contingent debt contracts – contingent on commodity prices – as an ex ante debt relief mechanism.

### IV.1. International commitments

Taking on international obligations is a sovereign national decision. In theory, these commitments sustain the value of the multilateral system for all participants in the system, although some benefit more than others. In exchange for a derogation of sovereign powers, global rules protect countries from arbitrary treatment in economic matters, such as treatment of their exports in foreign markets. The issue of international commitments arises when they are inequitable in nature, application, or practice[4], meaning they demand more in terms of performance and contribution on the part of poorer and weaker economies compared to developed economies. Beyond inequality among classes and people, inequitable rules among nations are an obstacle to development and poverty eradication. “It is also clear that unfair rules of the game in the contemporary world economy would encroach upon policy space so essential for development” (Nayyar, 2011, p. 19).

In trade, developed countries have retained their agricultural subsidies. Developing countries have fewer resources to sustain agricultural subsidies and have taken on commitments to limit restrictions on agricultural imports. Newly acceding countries to the WTO have been required to place a ceiling on and to eliminate agricultural subsidies. In the WTO, existing members have the right to impose obligations on countries seeking membership which they themselves do not fulfill. There is a wide range of sizes of economies, markets, and levels of development in the WTO. Developing countries trying to draw from GATT’s well-defined tradition of “special and differential treatment” (SDT), have found it difficult to make measurable progress in the Doha Declaration’s agreement “that all special and differential treatment provisions shall be reviewed with a view to strengthening them and making them more precise, effective and operational” (WTO, 2001, paragraph 44).

It is worthy to note that in the original Millennium Declaration (United Nations, 2000, paragraph 13), UN Member Countries declared: “We are committed to an open, equitable, rule-based, predictable and non-discriminatory multilateral trading and financial system,” thus incorporating equity as a standard for the international system. When the MDGs were formulated, in theory drawn from the Millennium Declaration, the standard of equity was not carried over and target 8A under MDG8 requires only to “[d]evelop further an open, rule-based, predictable, non-discriminatory trading and financial system”. A clear lacuna in the international system is the poorly developed conception of what equity in the design, application and practice of a rule-based international trade and financial system entails.

In the case of external imbalances, the international financial system provides for enforceable adjustments only on debtor countries, the category most populated by developing countries. Adjustment programmes for debtor countries are the favored domain of policy conditionality, which has garnered extensive international discussion within the framework of aid effectiveness. Under SAPs, occasioned by the developing country debt crises of the 1980s, conditionality proliferated. These conditionalities reached extensively into development policies and strategies, going beyond what might be considered donors’ legitimate concerns to prevent the wasteful use of resources provided to debtors in support of

[4] Here “practice” refers to the degree states adhere to international obligations, including to the extent that they can be effectively sanctioned when they do not perform on their obligations.

their adjustment programmes. The OECD-led aid-effectiveness effort initially appeared to incorporate ambitious intentions to reform the system of conditionality toward genuine partnership between donors and recipients and the realization of "country ownership" of development programmes.

The framework for country ownership starts with debtor/recipient countries taking the lead in deciding and designing their own development programmes. In practice, the design of many of the programmes involved aligning country policies to policies favored by international financial institutions (UNCTAD, 2011). An earlier, delicately worded, finding of a report of the World Bank's (2004, p. viii) evaluation office on PRSPs states: "The Bank management's process for presenting a PRSP to the Board undermines ownership. Stakeholders perceive this practice as "Washington signing off" on a supposedly country-owned strategy".

A very important form of policy space constriction comes from the growing area of bilateral investment treaties (BITs) and private investor protections incorporated in the FTAs. Developed countries, notably the United States and European countries, have required investor protection in negotiating FTAs and EPAs. Under BITs, private investors obtain standing to lodge disputes directly against states for violations of investors' rights, which have been interpreted broadly to include policies that impact expected future earnings. This permits the private parties, mostly international companies, extraordinary influence over policies of their host governments, beyond domestic political processes and accountability. While both developing and developed countries are party to these treaties, the asymmetry derives from three factors: (1) the more limited resources of developing countries, (2) the much greater number of international companies which are headquartered in developed countries, and (3) the greater need for development interventions in poorer countries. Obligations under these treaties would subject developing countries to penalties in the exercise of public policy, for example, such as the imposition of restrictions on capital outflows during a BOP crisis (Montes, 2013a).

The international community must acknowledge the role of these asymmetries as obstacles to development, recognising that national policy space is indispensable for all countries, developed or developing. Scoring trends using indicators of these asymmetries would be a valuable activity for civil society and international research institutes.

## IV.2. Nature and degree of economic openness

International trade and investment provide important advantages to developing countries. However, the nature and degree of economic openness themselves have a direct impact on the amount of policy space available to authorities in developing countries.

The most significant loss of policy tools in developing countries have come from liberalization of the capital account. The degree of capital account openness severely restricts the scope for monetary policy and exchange rate policy. While it would be preferable to use exchange rate policy to achieve exchange rate stability in order to meet trade and domestic industrial development objectives, surges in external capital flows can overwhelm the resources of monetary authorities to intervene in exchange rate markets. With fully open capital accounts, authorities also lose the ability to use interest rates to determine credit availability and adopt a countercyclical policy.

Under the IMF Articles of Agreement, capital controls remain a sovereign right of Member States. However, Member States have given up some of these rights via BITs. They have also given up many of the tools to regulate capital accounts as part of SAP commitments.

In many emerging markets, authorities have shown reluctance to recover capital account management tools. In the years after their economic crises in the late 1990s, capital accounts in Asian countries are more open than they were before (Akyüz, 2012a). For many countries in Latin America, accepting exchange appreciation through open capital accounts has played a role in meeting inflation targets but this is at the sacrifice of medium- and long-term goals in productivity growth, employment and industrial development.

There is a channel through which open capital accounts increase the risk of lending to developing countries, which is contrary to the widely held view that open capital accounts reduce the risks to lenders by offering greater assurance of being able to recover their claims. Because most developing countries cannot borrow abroad in their own currencies, "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" (UNCTAD, 2011, p. 41).

Developing countries must recover a capacity to regulate their capital accounts. Among regulations on capital account, "macro-prudential" tools and policies apply to protecting the prudential integrity of their domestic financial system. However, a significant proportion of capital flows, such as portfolio positions in the local stock markets and the foreign purchase of local bonds, are not undertaken in the banking system (though banks may serve as conduits for these transactions) and are not normally part of financial supervisory activities. In fact, because previous BOP crises have been followed by widespread collapses in financial sectors in developing countries, it would be advisable that even "macro-prudential" policies be undertaken beyond prudential purposes with a view to avoiding a build-up of external indebtedness and an increased risk of BOP crises. Macro-prudential controls do not fully cover the situation where the domestic non-banking private sector borrows from external sources unsustainably as was the case in the run-up to the Southern Cone crises in the early 1980s and the Asian crises of the 1990s.

Capital controls are the most critical when countries are facing a payments crisis since international reserves are necessarily finite. As discussed in the section on crisis resolution, developing countries must have the capacity to impose orderly standstills and have access to external finance in these situations.

At the international level, improved regulation of source markets and greater stability in exchange rates and interest rates in reserve-issuing countries have the potential to reduce capital surge pressures in developing countries significantly and facilitate capital account regulation.

## V. IMPROVING THE DEVELOPMENT ACCOUNTABILITY OF INTERNATIONAL GOVERNANCE

Global economic interdependence requires instilling accountability in international governance mechanisms to the needs of development. Narratives based on a belief in developing countries' self-interest in unilateral liberalization and formulations about creating a "level playing field" have tended to justify diminished accountability on the part of developed countries in genuine development.

### V.1. Updating voice and representation to reflect global economic structure

One approach that has garnered enormous energy on the part of reformers is that of changing voting weights and management structures in existing international institutions. Here, even generally agreed overdue efforts have proven to be difficult. A 2010 package to double the IMF's equity capital which featured a shift of six percentage points of total quota to developing countries and substitute two of the 24 IMF directorships from European to developing countries is stalled and an obstacle to future additional reforms.

In the 2000s, there were predictions mainly from analysts (for example, Kose et al., 2008) working in Bretton Woods institutions that the developing economies had 'decoupled' from rich countries. These discussions tended to suggest a diminished vulnerability of developing countries to a potentially large financial adjustment in the wake of rapid credit expansion and macroeconomic deficits[5] in the US economy in the mid-2000s. The sharp and immediate impact on developing economies of the Lehman collapse in 2008 through trade and financial retrenchment have raised doubts on cyclical decoupling as a basis for international economic cooperation and coordination (Akyuz, 2012b). The new threat, beginning in the second half of 2013, comes from the potential reversal of capital flows away from developing countries sparked by the retreat from quantitative easing policies in the United States (Akyuz, 2013). Developing countries are well-acquainted with this drill of the reversal of capital flows after a period of capital abundance causing widespread international payments difficulties. Because developing countries are adversely impacted by purely domestic policies of developed countries, international mechanisms must guarantee sufficient voice to developing countries, as a matter of good governance, in critical international institutions such as the IMF.

Beyond cyclicality, much has been made of the changing structure of the global economy, with developing countries accounting for a greater proportion of global output and trade. In one sense, these observations have not found their way into reforms in voting weight and influence in international bodies, most particularly the Bretton Woods institutions. In another sense, these increased proportions could have been fully anticipated since higher growth rates in developing as opposed to developed countries would eventually result in their accounting for a bigger proportion of global income. For some countries, such as China and India, the trend towards contributing a larger share of world output is in the direction of

[5] The idea of a diminished vulnerability of developing countries assuaged fears that policy consultations by IMF staff with a Member Country, the United States, were inadequate to facilitate a timely and orderly adjustment in its deficits.

regaining the share they enjoyed in the 1500s before the onset of European colonization (Montes and Popov, 2011). Asian economies have not yet regained these historical shares. China accounted for around 20% of world output in 1500 and it has barely reached 10% today. The per capita incomes of the leading developing countries are still only 25% or less than the per capita incomes of developed countries.

The numbers speak to the need for enlarging the role of the population variable in designing the mechanisms for global economic governance. They insinuate that in per capita terms the gap between developing and developed countries remains wide even for the most successful countries. One argument for expanding voice for developing countries in international governance is precisely that assuring representation to those with the greatest need for convergence offsets the international community's imperfect knowledge about how to shrink the per capita development gap.

The proper question to ask is whether the global environment could have been better arranged to provide faster growth and catch-up for developing countries than has in fact happened. We know that recently there have been disturbing trends, such as the tightening of restrictions enforced through trade sanctions on access to modern technology for developing countries. Many developing countries that managed to increase their manufacturing output in previous decades have fallen back into relying on commodity exports (Figure 2), whose prices are volatile, and on remittance earnings. As demonstrated above, a worrying pattern is that the diversity of export products of developing countries has significantly declined since the 1980s when liberalization and deregulation policies became paramount. The final destination of most finished goods is still the developed countries.

Thoroughgoing reforms intended to address the deficiencies of international governance structures must first address the conundrum that many current arrangements violate standard norms of good governance and policy accountability. Voting weights in the Bretton Woods institutions, which, *effectively* take on the gatekeeping function for developing countries to gain access to external aid and finance, are out of kilter with the structure of the world economy. The 2008 package of voice and quota reforms, finally ratified in March 2011, provided for only a 2.7% increase in voting weight for emerging and developing economies as a whole. The increase in the weights of faster growing developing countries was achieved by reducing that of less successful developing countries. There was no change in the number of seats on the board. Many experts and developing countries regard the package as inadequate (Bryant, 2008). Discussions continue on the design of the quota formula, which determines which countries are currently 'over represented' and must give up voting weight. The downward adjustment of the voting weights of European countries has been contentious.

The credibility of these institutions is undermined by the prodigious influence of developed countries in setting policy standards. For example, the IMF adjustment programmes in the Republic of Korea pointedly included measures to ease foreign investment entry in line with the interests of dominant industrial groups in the USA and Europe. In the wider context, the importance of these interests lies behind the resistance to capital account regulations and in favor of the *liberalization of trade in financial services* at the multilateral level.

### V.2. Accountability and representation

The rise of the G-20 as a high-level caucus of global economic decision-making to respond to the global financial crisis represents a test case of the impact of increased participation of developing countries in global processes of rule- and policy-making. The role of the G-20 is conceptually equivalent to that of the G-8 with the addition of developing country participation. As a caucus, the G-8 and G-20 do not make official decisions; these agreements only take effect when endorsed in official bodies such as the Executive Boards of the Bretton Woods institutions. As a caucus, the G-20 is meant to facilitate decisions in the existing official bodies. Without a permanent secretariat, the G-20 has nevertheless become the locus of an expanding agenda and the target of solicited and volunteered proposals from international organizations for improving the international mechanisms. For example, 'development' is now a G-20 agenda (ODI, 2009). The items for discussion in the June 2012 G-20 meeting in Mexico included sustainable development, green growth, climate change, employment and the social dimension of globalization, food security, anti-corruption, micro-credit and inclusive finance, local bond markets, multilateral trade aside from items on economic recovery and financial architecture. The Mexico meeting occurred when the Eurozone was in an existential crisis; the meeting managed to urge "Euro Area members of the G20 to take all necessary policy measures to safeguard the integrity and stability of the area, improve the functioning of financial markets and break the feedback loop between sovereigns and banks" (Mexican G20 Presidency, 2012, paragraph 6). These are intentions at the core self-interest of Eurozone countries. Side events around the G-20 meeting included a 'B-20' of business leaders from Member Countries and a labor ministers meeting.

Until the April 2009 London meeting, the G-20 had an initial flurry of success in coordinating expenditure and financial rescue programmes in response to the crisis. It has settled into a moveable agenda, dependent on the ambitions of its annually changing presidency. In the meantime, progress on the most urgent items – coordination for financial re-regulation and economic recovery – has stalled and reflects the political limits faced by developed country authorities. Developing country heads of state have religiously attended meetings in the exclusive grouping but have not built a reputation for espousing systemic reforms.

Thus there is much uncertainty over the G-20's potential role to push forward a reform agenda consistent with system coherence or with redressing imbalances against developing countries, even with the participation of the key developing countries. The representation of the developing countries – emerging MICs – in the G-20 is the subject of much dispute.

As the conceptual equivalent of the G-8, G-20 extends the preference of developed countries' authorities to settle economic issues among significant economic players outside more representative venues, including the International Monetary and Financial Committee (IMFC). The design of post-World War II global economic governance placed the consideration of these issues at the Economic and Social Council (ECOSOC) of the United Nations, on the principle that representation and accountability should go hand in hand. In recognition of this conundrum, the G-20 has paid special attention to establishing a relationship with the UN.

There have been numerous proposals for creating new bodies to overcome weaknesses in international governance, such as a Global Economic Coordination Council (GECC), supported by an International Panel of Experts proposed by the Stiglitz Commission (United

Nations, 2010, p. 87). A more direct way is the reform and strengthening of existing institutions, which will require a renewed willingness on the part of dominant economic countries to use these bodies. Restoring an effective oversight of ECOSOC over agencies and mechanisms of global governance can be a clear goal in a post-2015 development agenda.

### V.3. South–South and regional cooperation

As has been partly documented in the first section of this paper, the increased economic interdependence has been characterised by a pattern of uneven development. This worsening trend is sustainable neither economically nor environmentally, nor can it be feasible politically over the long-term (Vos and Montes, 2014; UNCTAD, 2011; and United Nations, 2010).

There has been new interest in the potential of economic linkages among the developing countries and greater reliance on regional mechanisms, along the lines of the original intentions of the Generalized System of Trade Preferences (GSTP). The GSTP discussions recognised the need to embed policies to expand and diversify trade among developing countries within a framework of economic diversification and industrial development (UNCTAD, 2011, p. 88). Regional mechanisms hold the promise of better coordination among regional economies in the treatment of foreign direct investment (FDI), to avoid self-defeating competition and to facilitate complementary location of production activities, but there has been limited success in this regard. Lowering technical barriers to trade at the regional level would make trade more accessible to small- and medium-scale enterprises. Among developing countries, there is also potential in exploiting economies of scale in providing trade credits, insurance and other trade-related services, facilitating regional technological sharing among countries with relatively similar levels of development, and coordinating development of infrastructure to facilitate regional trade.

The greatest barrier to increased regional cooperation, despite many announcements to the contrary, has been overcoming a mindset privileging trade and investment linkages with the developed economies. In Africa, actions by the USA and the EU to provide trade accommodation to the region *qua region* throws a spotlight to previous local intentions to expand regional integration. As mentioned earlier, many proposals coming from outside the region have the potential to derail regional integration. MFN provisions in the EPA proposals, for example, would extend to EU countries should African countries agree to greater trade openness among themselves. Provisions that require sourcing of inputs to production from developed countries, such as textiles, reduce the scope for regional integration. In 2011, the African Union (2011) proposed that the benefits of non-reciprocal preference schemes be accorded regionally or all members of customs unions, irrespective of the development status of countries involved. The purpose is to ensure that trade can support LDCs and their regional groupings to overcome their low manufacturing capacities. The EU, for example, applied for a waiver at the WTO to provide Moldova with non-reciprocal preferences with the rationale that Moldova being the poorest country in Europe does not have the competitive strength to take reciprocal obligations of an FTA with the EU. A similar waiver had been made for Western Balkan countries. A South Centre background document suggests WTO compatibility of the proposal can be achieved either through a waiver or by appeal to the enabling clause.

The threatened extended period of slow growth in the developed world as a result of the global crisis increases the pressure on developing countries to find other sources of growth through increased trade within the South and regional cooperation. A reorientation of growth strategies toward increased reliance on domestic demand – as opposed to export reliance – is logically a spur to a new emphasis on expanding South–South and regional trade and investment links because the most accessible markets for genuine developing country products are in other developing countries.

## VI. CONCLUSION

While developing countries hold primary responsibility for their own development, the fortunes of their economies are extensively dependent on the international economy. The international system can serve as an obstacle to development in two ways (1) missing, defective, or perverse international institutional arrangements and (2) restrictions on national policies from the proliferation of international obligations and policy rules. We have argued that international cooperation over poverty reduction is not enough. This approach to development cooperation can be misleading.

On the issue of international mechanisms, the paper emphasized the following areas:

1. Strengthening compensatory finance for commodities-dependent developing countries;
2. Strengthening special and differential treatment in WTO rules and enlarging the non-reciprocal content of trade agreements, including FTAs to permit developing countries greater ability to diversify their domestic economies;
3. Restoring flexibility in the setting of tariff rates, within reasonable ranges, to enable developing countries to raise or lower tariff rates in line with shifting priorities to develop specific sectors, as opposed to permanently bound tariff ceilings;
4. Creating effective arrangements to reduce the probability and size of international financial crises;
5. Establishing orderly and equitable international financial and debt crisis resolution mechanisms.

In protecting and enhancing space for national policies in developing countries, the paper presented proposals including:

1. Revising the structure of international commitments so that, on the grounds of equity and common but differentiated responsibilities, developed countries bear a greater burden than at present in international obligations and restrictions in the area of domestic subsidies, aid conditionalities, and macroeconomic adjustments; the most problematic of these are developed countries' agricultural subsidies;
2. Reforming current approaches to BITs and FTAs that limit the ability of developing countries to undertake changes in policies and regulations which might change the profit expectations of foreign investors;
3. Restoring the capacity of developing countries to regulate their capital account.

The international economic system labours under the constraint that the highest decision-making bodies in key institutions, such as the IMF, do not provide sufficient voting weight and policy influence to countries most affected by their operations. One effort underway but under enormous political obstruction is to update voting weights in line with the changed economic structure. Even the G-20, where important developing countries sit, has been unable to advance progress.

With the approach of 2015, by which year the MDGs were to have been achieved, there is a general view that "[s]ome framework, even if it is a point of reference, is essential beyond 2015" (Nayyar, 2011, p. 12). What should this framework contain? Will the international community seize the opportunity to commence a process, which admittedly will take years to complete, to eventually eradicate the obstacles to development in the international economic system?

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