

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

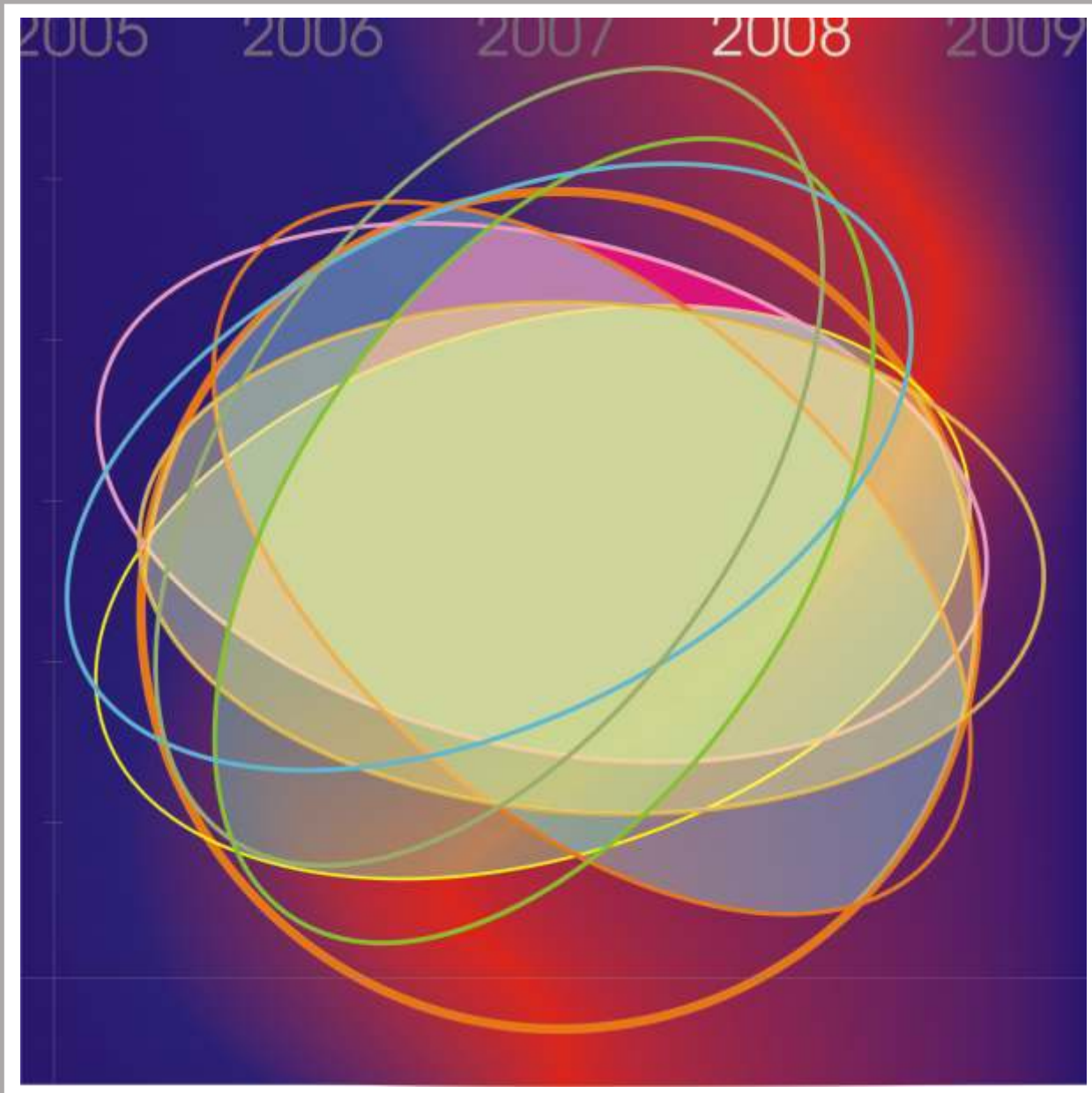
# TRADE AND DEVELOPMENT REPORT, 2008

## OVERVIEW



UNITED NATIONS

**EMBARGO**  
The contents of this Report must  
not be quoted or summarized  
in the print, broadcast, or  
electronic media, before  
**4 September 2008 17:00 hours GMT**





---

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT  
GENEVA

---

# TRADE AND DEVELOPMENT REPORT, 2008

## OVERVIEW



UNITED NATIONS  
New York and Geneva, 2008

---

## Note

---

- Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

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

---
- Material in this publication may be freely quoted or reprinted, but acknowledgement is requested, together with a reference to the document number. A copy of the publication containing the quotation or reprint should be sent to the UNCTAD secretariat.

---
- The Overview contained herein is also issued as part of the *Trade and Development Report, 2008* (UNCTAD/TDR/2008, sales number E.08.II.D.21).

## OVERVIEW

*Since 1999, many developing countries have registered strong improvements in their external balances, and their aggregate current account has swung into surplus. As a result, as a group they have become net exporters of capital to developed countries. Many of them, particularly a number of fast growing exporters of manufactures, owe this situation to their successful global integration and to a reorientation of their macroeconomic policies towards a greater focus on competitive exchange rates. In other countries, substantially increased earnings from primary commodity exports have also led to stronger current-account positions.*

*But the situation is fragile: uncertainty and instability in international financial, currency and commodity markets, coupled with doubts about the direction of monetary policy in some major developed countries, are contributing to a gloomy outlook for the world economy and could present considerable risks for the developing world. Many developing countries that have seen improvements in their terms of trade in recent years remain highly vulnerable to a possible prolonged global slowdown and an end to the commodity boom. For a number of them, higher prices of their net food and energy imports have already created a heavy burden, particularly for the poorer segments of their populations, seriously jeopardizing progress towards meeting the Millennium Development Goals (MDGs) set by the United Nations in 2000.*

*This is why development policies need to continue to focus on diversification and sustained industrialization based on higher investment in new productive capacities, especially in agriculture and manufacturing, and on the provision of adequate, reliable and cost-effective financing of such investment. Recent experience in several fast growing developing countries has shown that, from a macroeconomic angle, this does not always require a current-account deficit – that is, a net capital inflow – provided that domestic monetary policy and the local financial system offer a favourable environment for long-term financing of private firms. In many developing countries this requires a stronger focus on improving the conditions for reinvestment of company profits and for an enhanced role of the banking sector in financing investment. However, a number of poorer countries that are unable to boost export earnings owing to structural constraints continue to rely on foreign capital inflows to finance imports of essential capital goods. This implies that official development assistance (ODA) will need to be further increased, not only with a view to filling the existing financing gap to help meet the social and human development objectives of the MDGs, but also to help generate higher per capita income growth and employment for sustained development beyond the MDG deadline of 2015.*

## **The global outlook: a slowdown in developed countries and higher risks in financial and commodity markets**

The financial turmoil that erupted in August 2007, the unprecedented oil price increases and the possibility of tighter monetary policy in a number of countries presage difficulties for the world economy in 2008 and 2009. The impact of the sub-prime crisis has spread well beyond the United States, causing a widespread squeeze in liquidity and credit. And price hikes in primary commodities, fuelled partly by speculation that has shifted from financial instruments to commodity markets, adds to the challenge for policymakers intent on avoiding a recession while at the same time keeping inflation under control. The situation could become even more difficult if large movements in the exchange rates of major currencies add to the turmoil in the financial markets, a risk that has increased in the first half of 2008.

In this highly uncertain environment, output in the world economy as a whole is expected to grow by around 3 per cent in 2008, almost one percentage point less than in 2007, and in developed countries as a group, GDP growth is likely to fall to about half this rate. By contrast, growth in developing countries as a group can be expected to remain quite robust, at more than 6 per cent, as a result of the relatively stable dynamics of domestic demand in a number of large developing economies. However, possible restrictive monetary policy responses to increasing pressure on the overall price index from higher commodity prices could well lead to a further deceleration of growth in developed and developing countries alike.

For a large number of developing countries, the outlook depends primarily on future trends in the prices of their primary commodity exports. Although several structural factors support the expectation that prices will remain at a higher level than over the past 20 years, cyclical factors and delayed supply responses could well cause a weakening of some commodity prices, especially when the impact of speculation is taken into account. Just as such speculation has amplified the upward movement of prices, it may also amplify any downward movement. This could happen, for example, if forecasts for global demand growth need to be adjusted downwards in the course of the year as a result of further turmoil in financial markets or an abrupt change in the mood of investors in response to events on financial markets, such as a rise in interest rates or a stock market recovery. Additionally, if the liquidity crisis were to spill over to the market for emerging-market debt, some developing and transition economies – mainly in Eastern Europe and Central Asia – which carry a substantial stock of external debt and have large current-account deficits, could face a sudden increase in their financing costs and debt servicing problems.

### **Monetary policy: divergence may encourage speculation**

The meltdown in the sub-prime mortgage segment of the most sophisticated financial market in the world has exposed the fragility of today's global financial sector. Instead of reducing risk, complex financial instruments have served to spread the impact of risky investments across countries and markets. The recent crisis has shown once again that market discipline is ineffective in preventing recurrent episodes of "irrational exuberance", when financial firms attempt to extract double-digit returns out of economies that grow at much slower rates. And since financial crises can have major repercussions on the real economy, policymakers have no choice but to bail out parts of the financial sector when systemic threats loom. But such bailouts also underline the case for tighter prudential regulation.

The current international framework for monetary and exchange-rate policies offers opportunities for speculative activities that are highly profitable for a limited period of time, but ultimately destabilize the entire

---

system. The rapid unwinding of “carry trade” activities, aimed at extracting gains from nominal interest rate differentials, presents another threat for the global financial system. The financial turbulence, the speculative forces contributing to commodity price hikes and instability, and the apparent failure of foreign-exchange markets to bring about changes in exchange rates that reflect current-account trends suggest that there is an urgent need for reviewing the institutional framework of the global economy.

The major central banks have shown considerable coherence in their response to the sub-prime crises by providing liquidity to affected banks and financial institutions. But their monetary policies are diverging more than ever. The Federal Reserve has been very aggressive in cutting policy rates, whereas other central banks have been much more timid, and some, including the European Central Bank (ECB) and the central banks of a number of emerging-market economies, have even raised their interest rates. These divergent policies may invite renewed speculation in foreign exchange markets instead of calming the system.

### **Global imbalances: need for coordinated international action**

An adjustment of some of the current-account imbalances that have shaped the world economy over many years is now under way. But a continuation of this trend hinges almost entirely on a slowdown of the United States economy and a depreciation of the dollar, while the adjustment process can only be painless for the world economy as a whole if domestic spending and imports in the surplus economies rise.

However, not all surplus countries have the same scope for increasing domestic demand. In China, for example, this is much more difficult than elsewhere, as private consumption is already rising fast and the economy is close to overheating. The appreciation of the yuan may nevertheless contribute to the global adjustment of trade balances. On the other hand, in Western Europe (especially in Germany) and Japan there is a much greater scope for domestic demand to expand. Overall, there is a strong likelihood of a sharp and prolonged downturn of the world economy as long as policymakers do not agree on ways to tackle global imbalances through coordinated and concerted action.

### **Macroeconomic stabilization: the risk of anti-inflationary overkill**

At more than \$140 per barrel in mid-2008, the price of oil reached a new peak in nominal and real terms. Oil price hikes in recent years have been accompanied by a sharp increase in the prices of most other primary commodities, and this has prompted calls for central banks to take strong action to prevent an acceleration of inflation. However, it may well be that the risk of galloping inflation is considerably overestimated, as the probability of a wage-price spiral occurring is much smaller today than it was in the episode of rising oil prices in the 1970s. Today, trade unions in most developed countries are either too weak to push for higher wages or they have learned from past experience. Consequently, the rise in unit labour costs, a key determinant of inflation, has been low in most countries.

In the current fragile condition of the global economy, measures to tighten monetary policy would exacerbate the global slowdown. Given the need to contain the macroeconomic impact of the sub-prime crisis and to raise domestic demand in surplus countries to ensure a smooth redressment of the global trade imbalances, any policy with contractionary effects will have to be applied very cautiously. In the present environment of rising commodity prices, a cooperative approach involving trade unions, employers, governments and central banks seems to be more appropriate for preventing a wage-inflation spiral than the use of monetary policy alone.



Developing countries could consider combining a broader range of policy instruments in responding to increasing food and energy costs, which are a much heavier burden on most household budgets in these countries than in developed countries and create an understandably strong pressure for wage increases. Indeed, the dramatic social and humanitarian consequences of the surge in food prices in some countries are jeopardizing progress towards meeting the Millennium Development Goals (MDGs), especially that of halving poverty by 2015. This calls for specific income transfers targeted to the most needy households. Yet many of the concerned countries cannot afford such additional social expenditure unless they reduce spending for other purposes, including urgent infrastructure investments. This dilemma suggests the need for additional foreign assistance to overcome this distribution problem in poor countries. It also demonstrates the importance, from both a macroeconomic and social perspective, of new measures aimed at achieving greater commodity price stability and of quick-response instruments to mitigate the impact of sharp commodity price fluctuations.

### **Primary commodity markets: new patterns and linkages**

In 2008, the prices of all commodity groups were much higher than their peaks of the mid-1990s, except for tropical beverages. This upward trend has been mainly the result of rapidly increasing demand from several fast growing developing economies. Price movements have also been influenced by the closer links between energy markets and agricultural commodity markets, particularly those for food crops, and by the closer links between primary commodity markets in general and financial markets. Thus the level and stability of commodity prices has become an important policy issue, not only from the traditional development perspective, but also from the perspective of the functioning of a highly integrated global economy.

Higher oil prices influence the final prices of other commodities, particularly food crops and vegetable oils, because they have led to increased competition for arable land to grow crops for biofuel production, as an alternative to oil. This trend has been reinforced by policy measures in the EU and the United States to accelerate the substitution of traditional fuels by biofuels. Together with extremely low inventory levels and the turbulence in financial markets, this has probably been one of the factors encouraging speculative demand for such commodities. The depreciation of the dollar is an additional factor contributing to the higher commodity prices in dollar terms. For instance, between May 2007 and May 2008 the index of non-fuel commodity prices in dollars increased by 41.9 per cent, but only by 32.7 per cent in SDRs and by 23.3 per cent in euros.

### **Primary commodities: unresolved problems of commodity dependence and price instability**

Uncertainty about key prices generally has a negative impact on the investment and production planning of both sellers and buyers, and renders macroeconomic, fiscal and financial management more difficult. This is why, from the perspective of those developing countries whose export earnings and national income are highly dependent on commodity markets, both the long-term trend of primary commodity prices and their volatility have always been a concern. Price volatility is one of the reasons why commodity-dependent economies have lower long-term average growth rates than economies with diversified production structures.

For every country, reducing dependence on a few primary commodities through diversification and industrial development is the best strategy in the long run to reduce vulnerability to commodity price shocks and unfavourable price trends. But diversification is a complex and time-consuming process that is not possible without capital formation and skills acquisition. It also depends on stable earnings from primary commodity



exports. From the perspective of consumer countries and the world economy as a whole, fluctuating commodity prices render policies aimed at macroeconomic stability more difficult. Given the problems created by unstable commodity prices, the global economic system would gain greater coherence if new efforts were made at the multilateral level to control price fluctuations on international commodity markets, while allowing smooth adjustments of relative prices that reflect market fundamentals and structural changes.

However, it is unlikely that international price stabilization mechanisms agreed multilaterally between producers and consumers, such as the various commodity agreements of the past, will again become a political option in the near future. It would therefore be useful to tackle the factors that cause large commodity price fluctuations in the first place and correct any undesired market outcomes. Stricter regulatory measures that help contain speculation on commodity markets could be one important step, since commodity market speculation typically exacerbates price trends originating from changes in fundamentals.

International compensatory finance schemes employed in the past to mitigate the impact of volatility on developing countries have proved insufficient. Such schemes would need to make more rapid disbursements and be equipped with more financial resources for balance-of-payments or income support. They should not only be able to cover shortfalls in export earnings but also higher import costs resulting from sharp increases in prices of essential commodity imports, particularly food and energy. These schemes might also include the provision of grants to be passed through to the most seriously affected producers or households in the poorest countries. In principle, it should be sufficient that the country has no control over the cause of the underlying price shock to be eligible for such assistance, and conditionality, if any, should be linked directly to the use of the financial resources provided under the scheme.

At the national level, institutional arrangements that serve as a buffer between prices on international commodity markets and earnings of domestic producers may facilitate the latter's investment decisions and the financing of measures to improve productivity. Experience with systems of income support in many developed countries could provide useful lessons, but the costs of these systems normally exceed the budgetary possibilities of developing countries. A possible solution would be for these countries to consider an institutional arrangement whereby they would retain part of the windfall gains from high commodity prices in national funds for release to domestic producers when international market conditions are unfavourable. If initiated in a phase of relatively high prices, such an arrangement would assure a smooth income stream for their producers without unduly straining budgetary resources.

The gains of developing countries from commodity exports and their impact on financing investment in support of diversification and industrialization also depend on how they are distributed. There are strong indications that in several countries a large share of the considerable gains from the higher prices of hydrocarbon and mining products have gone into profit remittances of the foreign enterprises involved in their exploitation. This means they are lost for capital accumulation in the country where they originate, unless they are reinvested by the foreign companies. But the latter may often not be in the interest of the exporting country either because, rather than contributing to diversification and industrial upgrading, such reinvestment in the same activities tends to perpetuate commodity dependence.

## **Current-account reversals: the roles of real exchange rates and terms of trade**

Higher commodity prices and better terms of trade have greatly contributed to improving the current-account balances of some developing countries in recent years. Another factor, at least equally important, has been the fast growth of exports of manufactures of a number of developing countries based on rapid productivity growth and favourable real exchange rates. As a consequence, developing countries as a group have been net exporters of capital for several years. Following the financial crises in Asia in 1997–1998, an

increasing amount of capital began flowing “uphill”, from poor to rich countries, to such an extent that many observers concluded that some developing countries had created a “savings glut” for the world economy.

Improvements in the current account, and swings from deficit to surplus, were initially driven by large exchange rate devaluations in emerging-market economies that are exporters of manufactures. In most of these countries, their current-account improvements began in the aftermath of the Asian financial crisis and were sustained as governments and central banks subsequently sought to maintain a competitive real exchange rate. For most countries whose trade performance is determined primarily by world demand for primary commodities the improvement in the current account began in 2003, when prices for oil and mining products started to increase.

The macroeconomic and exchange-rate policies that have played a major role in the improvement of the current-account position of many developing countries mark a departure from past strategies. In the past, both exchange-rate pegging and flexible exchange-rate regimes often led to real currency appreciation and growing current-account deficits. Over time, a worsening of the current-account balance increased the perception among international investors of greater currency risk, and at a certain point triggered a sudden and strong capital outflow. By contrast, the new strategy of many countries has been aiming at defending favourable competitive positions created by undervalued exchange rates and avoiding dependence on the international capital markets that is associated with a current-account deficit. As this strategy often requires intervention in foreign exchange markets, it contributes to a rapid accumulation of foreign-exchange reserves and higher net capital outflows from developing countries.

This also confirms the more general finding that current-account reversals in developing countries with a high share of manufactures in their total trade are primarily driven by large real-exchange-rate changes, whereas for commodity-dependent economies, terms-of-trade shocks are the major factor. An increase in the current-account deficit as a result of an appreciation of the real exchange rate and a concomitant loss of competitiveness of domestic producers may be temporarily financed by a net capital inflow, but it will sooner or later require some form of adjustment, normally a real depreciation. Indeed, overvaluation has been the most frequent and the most “reliable” predictor of financial crises in developing countries. On the other hand, a depreciation of the real exchange rate is a necessary condition for an expansionary current-account reversal. A competitive real exchange rate is a key factor for increasing aggregate demand in the short run and achieving faster growth and higher employment in the long run.

However, there is a risk that governments will use exchange-rate manipulation in the same way as wage compression, subsidies and lower corporate taxation to artificially improve the international competitiveness of domestic producers. This kind of “new mercantilism” in the competition for higher market shares cannot achieve the desired results. This is because, while all countries can simultaneously boost productivity, wages and trade to improve their overall economic welfare, all of them cannot simultaneously increase their market shares or their current-account surpluses. Successive rounds of competitive devaluations are therefore unproductive and likely to cause considerable damage. This problem could be addressed by a framework of international rules similar to those governing the use of trade policy measures in agreements of the World Trade Organization (WTO).

### **Net capital flows, investment and growth: theory and reality**

The fact that developing countries as a group are net capital exporters contrasts with expectations based on mainstream economic theories, that with open capital markets capital would flow from rich to poor countries, attracted by higher rates of return. What is even more surprising in light of mainstream theory is that, on average, developing countries that are net exporters of capital also tend to grow faster and to have a higher investment ratio than developing countries that receive net capital inflows.

These facts have been considered “puzzles”, but they are no longer puzzling if one recognizes the limitations of the underlying theories: the savings gap model and the neoclassical growth model. These models are based on the assumption that investment is financed from a savings pool created mainly by household savings. Accordingly, entrepreneurial investment will be maximized by policies aimed at increasing household savings rates and capital imports (“foreign savings”), and improving the efficiency of financial intermediation by developing a competitive financial system and creating securities markets. Not only are the assumptions of these models far from reality, but also their predictions have been repeatedly refuted by empirical evidence. For example, many developing countries, particularly in Latin America, failed to achieve higher productive investment despite monetary and financial policies that attracted waves of capital inflows.

In an alternative view, based on the works of Schumpeter and Keynes and deriving from the experiences of post-war Western Europe and the successful catching-up experiences in East Asia, the financing of investment depends primarily on savings from corporate profits and the possibility of the banking system to create credit. Strong enterprise profits simultaneously increase the incentive of firms to invest and their capacity to finance new investments from retained earnings. This view better reflects the complexity and imperfections of the real world, where entrepreneurial profits immediately adjust to changes in demand, and entrepreneurial decisions based on profit expectations (rather than the level of savings) determine the level of investment in real productive capital. For example, a fall in the savings ratio does not lead to a fall in investment; on the contrary, since it implies an increase in consumer demand, it will increase profits and stimulate investment. By the same token, an improvement of the current account as a result of changes in relative prices in favour of domestic producers does not represent a reduction in the inflows of foreign savings that causes a fall in investment; on the contrary, it is equivalent to an increase in aggregate demand and in the profits of domestic producers, and tends to lead to higher investment. Thus, an increase in savings is not a prerequisite for either higher investment or an improvement in the current account. Rather, the causality works in the opposite direction: changes in the current account lead to changes in the level of investment and savings.

The consequences of the different theoretical approaches for economic policy could not be more different. When investment, output growth and employment are determined largely by profits of enterprises, economic policies have an important role to play in absorbing shocks and providing a stable environment for investment. By contrast, in the neoclassical model there is little room for economic policy, and where it offers economic policy options, they often point in the opposite direction to those suggested by the Keynes-Schumpeter model. Where the neoclassical model sees the need for private households “to put aside more money” or for developing countries to attract more “foreign savings” to raise investment in fixed capital, the Keynes-Schumpeter model emphasizes positive demand and profit expectations as incentives for domestic entrepreneurs, and the need for reliable and affordable financing for enterprises.

### **Financing of fixed investment: the role of company profits and the banking system**

Empirically, from a macroeconomic perspective, domestic resources are more important for investment financing than foreign ones. However, the latter can play a critical role at certain times and for certain countries, for instance to finance imports of capital goods when there are structural impediments to increasing export earnings. From the perspective of firms, self-financing from retained earnings is the most important and most reliable source for financing investment. In addition to self-financing from profits, bank credit is empirically the most important source of external financing for enterprises, particularly for new businesses and small and medium-sized firms.

It is very important that a substantial part of firms’ earnings be reinvested in productive capacity, rather than being used, for example, for luxury consumption or speculative activities. As the availability of internal

funds is a key determinant of investment, measures that increase the liquidity of firms and encourage the retention of profits may help to spur investment. Possible measures include a range of fiscal incentives and disincentives, such as preferential tax treatment for reinvested or retained profits, special depreciation allowances, and high taxation of income from speculative activities.

The impact of such measures on productive investment can be amplified if banks are encouraged to make loans more easily available for investment. To the extent that investment can be financed by the banking system, which has the power to create credit depending on the amount of liquidity provided by the central bank, the prior existence of savings balances in the financial system is not a prerequisite for investment. But in order to prevent a monetary policy that focuses on the stimulation of investment from becoming inflationary, it has to be combined with institutional arrangements and additional policy instruments to maintain price stability. In particular it calls for an incomes policy that prevents excessive nominal wage increases and a flexible fiscal policy that responds to cyclical changes in aggregate demand. This has been a successful recipe in the newly industrializing economies (NIEs) of East Asia, where policy interest rates generally have been slightly higher than the rate of inflation but lower than real GDP growth rates. By contrast, they have been higher than GDP growth rates in most countries in Latin America and Africa, where monetary policy has tended to focus entirely on avoiding inflation, with the result that investment ratios and growth rates remained low. It is only since the beginning of the new millennium that an increasing number of countries in the latter regions have also adopted more expansionary monetary policies and achieved better growth performance.

### **Cost and availability of investment finance: policies matter**

An investment-friendly monetary policy would also help to reduce the costs of bank financing. These are determined by the cost of refinancing by banks, the average amount of loan losses that banks have to bear, and the degree of competition in the banking system. When interest rates are too high, they have a negative impact on the most important sources of financing for investment: company profits and bank credit. This is probably the main reason why the financial reforms undertaken by many developing and transition economies in the 1980s and 1990s generally failed to improve investment ratios. As reforms were undertaken in the context of a restrictive monetary policy aimed at achieving and maintaining low inflation, they were generally accompanied by an increase in interest rates.

Financial deregulation undertaken since the mid-1980s in many developing countries, coupled with liberalization of the capital account, brought about an expansion of banking activity and a fast increase in net inflows of foreign capital, but it seldom led to the expected sustained increase in bank lending to private enterprises for investment purposes. Instead, it led to a boom in lending mainly for consumption and real estate acquisition. The process often ended in financial and banking crises, in the course of which governments and central banks had to rescue the banking system at considerable fiscal costs. The expectation that financial liberalization and opening up of the domestic financial sectors to foreign banks would introduce more competition, which would eventually reduce interest spreads and the cost of credit, did not materialize either. Spreads and lending rates have remained generally high, to the detriment of corporate and investment financing. Even after banking crises, commercial banks apparently find it more profitable and less risky to extend consumption and housing credits, or to purchase government securities, than to provide longer term loans for investment projects or new business activities.

Banks and other financial institutions influence the pattern of economic activity by the way in which they allocate financial resources among different types of borrowers and economic activities, according to their own objectives and strategies. However, their choices are not necessarily in the best interest of the economy as a whole. The unwillingness of banks to provide long-term investment credit, combined with

high interest spreads and lending rates, often reflects a perception of high credit risk and difficulties in collateralizing such loans. Therefore, when developing countries with weak financial systems undertake domestic governance reforms, as frequently advocated, priority may need to be given to dealing with those institutional shortcomings that represent major obstacles to the provision of long-term credit for investment at reasonable interest rates. These shortcomings tend to differ from country to country but are likely to concern property rights, provision of collateral and enforcement of credit contracts, and effective competition in the banking sector.

In most countries, access to bank credit still depends heavily on the size of the firm, so that new, innovative and small enterprises, in particular, often encounter severe financing constraints even when they are able to pay high real lending rates. Financing from securities markets is usually available only to a small number of large private corporations or public entities. But access for firms to reliable, adequate and cost-effective sources for financing productive investment is precisely what matters for the success of financial policies in developing countries.

Clearly, in allocating credit, every financial system has to discriminate between borrowers and projects to be financed. But, as has been seen from various outcomes of financial reforms and numerous episodes of financial crisis, the market mechanism does not always produce optimal allocation of credit. Governments can play a role in directing credit to sectors and activities that are strategically important for the economy as a whole, for example through the direct provision of credit by public financial institutions or by intervention in financial markets, through such measures as interest subsidies, the refinancing of commercial loans, or provision of guarantees for certain types of credit.

Credit allocation can also be influenced by stricter control of lending for consumption or for speculative purposes, which could induce banks to extend longer term loans for investment purposes. In instances where high lending rates reflect perceived risks, government guarantees for loans to finance promising investment projects of firms that otherwise may have limited access to longer term bank credit (or may be able to obtain such credit only at extremely high cost that would make their investment unviable) could be envisaged. While this may entail fiscal costs when a project financed this way fails, these costs have to be weighed against the total increase in investments that can be made only because of such guarantees, and the dynamic income effects (including higher tax revenues) which these additional investments may generate. They should also be weighed against the fiscal costs of large rescue operations for the banking system, as became necessary following the uncontrolled increase in credit for consumption and speculative purposes that took place in many countries after financial liberalization.

### **Public banking: reconciling commercial and development objectives**

Public sector banks, particularly development banks, could play an important role in ensuring access of firms to reliable sources for financing productive investment. In the light of past experience, the debate about the role of public banks has often centred on the argument that State ownership of such institutions, which are not subject to market discipline, may increase the opportunities for corruption and patronage, rather than on an assessment of their economic merits. But private banks are not immune to corruption and patronage either, especially when they are linked to conglomerates that rely on them for cheap finance. On the other hand, it is clear that public and development banks can fulfil their developmental role only if they are governed by clear mandates and strict rules of accountability, accompanied by regular performance monitoring.

It is important to remember that, from the perspective of financing for development, it is not only the microeconomic profitability of an investment project that matters, but also the external benefits the project



generates for the economy as a whole. This consideration is generally accepted for infrastructure projects and their public financing from budget receipts or with the support of development banks. But it is equally rational for public financial institutions with expertise in specific sectors to contribute to the financing of private productive and innovative activities in agriculture, industry and services when those activities generate important external benefits and social returns but are unable to obtain the necessary financing from commercial sources of finance.

One way to bring both commercial and development considerations to bear on credit allocation could be through joint financing of certain investment projects by private and public banks. Whereas the commercial bank would contribute its expertise in assessing the viability of a project from a private sector perspective, the public financial institutions would make a judgement from the point of view of the project's overall developmental merits, and through its participation in the financing it could reduce the risks to the commercial bank. It might also serve to leverage public financing with private financing, and reduce the risk of patronage on the part of both the private and public financial institutions involved. This kind of arrangement has precedents in some developed countries in the 1950s and 1960s as well as in several emerging-market economies more recently.

### **Official development assistance: substantial rise but a shortfall persists**

Another aspect of investment financing in support of diversification and structural change in developing countries is their foreign exchange requirement for imports of capital goods. This is a problem in particular for poor commodity-dependent economies, which typically rely on official loans and grants from bilateral and multilateral donors. Following the Monterrey Consensus of 2002, most bilateral donors providing official development assistance (ODA) set ambitious targets for increasing their ODA as part of efforts to meet the MDGs. But despite a substantial increase in disbursements, most donors are not on track to meet their ODA pledges. Moreover, there is still a considerable gap between actual ODA flows and the aid estimated to be necessary for implementing measures in pursuit of the MDGs.

There is broad agreement among donors and beneficiaries that it is not only the amount of ODA that matters, but also how effectively the funds from donors are being used. Improved aid effectiveness has been increasingly associated with better institutions and policies. Although views differ as to what constitutes good institutions and policies, and despite weak evidence that such a correlation actually exists, the provision of ODA has increasingly become conditional on fulfilling numerous criteria of good governance. Aid effectiveness is also often viewed in relation to procedures for implementing it. In this regard, as discussed in UNCTAD's *Least Developed Countries Report 2008*, aid management policies that enhance mutual accountability of donors and recipient governments could help reduce transaction costs and strengthen States' capacities for effective use of foreign aid. But equally important is the development effectiveness of the aid resources provided by donors. In determining a yardstick for such effectiveness, it is useful to distinguish between social and human development objectives on the one hand, and growth objectives on the other.

---

## Social and economic aid: getting the right balance

Traditionally, the objective of ODA has been per capita income growth, with attendant effects on human development. With the Millennium Declaration, human development objectives have come to the forefront. Meanwhile growth has lost prominence as an explicit objective of development policy in an intellectual and policy environment that seems to be governed by the implicit assumption that, in a liberalized and globalizing economy, growth and structural change are generated automatically by market forces. Accordingly, aid effectiveness is increasingly viewed in terms of the contribution of ODA to the achievement of the MDGs. Consequently, a larger proportion of ODA is being spent for health, education and other social purposes.

This kind of ODA is essential and justified in its own right. However, for poverty reduction to be sustainable it cannot rely exclusively on the redistribution of a given income; it also depends on increases in domestic value added and per capita incomes. Unless ODA helps boost growth, it is unlikely to be effective in reducing poverty in the long term, beyond the MDG target year of 2015. ODA for investment projects in economic infrastructure and in the productive sectors is essential to support domestic efforts to raise levels of real income and employment and to shift income distribution in favour of the poor.

Another way to increase ODA effectiveness could be to leverage ODA with domestic financing. For example, this may be done through the creation or strengthening of institutions that would channel ODA into public and private investment projects financed jointly with domestic financial institutions. This could facilitate access of potential domestic investors to long-term financing and reduce the credit risk of domestic banks – and thus the spreads they charge. At the same time it would help to build a better functioning system of domestic financial intermediation.

In the past, the relative needs of countries, which could be measured by levels of per capita income and human development indicators, or the degree of their fiscal or foreign-exchange gap, only had a limited influence on the geographical distribution of ODA. Yet aid effectiveness could be improved by directing further increases in ODA grants to the poorest countries that have the greatest difficulty in initiating a self-sustaining process of investment and growth.

## Debt relief: the need for additionality

A considerable financing gap appears to persist with respect not only to MDG-related activities, but also to investments that will be beneficial for growth and structural change beyond the MDGs, let alone for tackling new challenges for developing countries as a result of climate change. For a realistic chance of meeting the MDGs, the level of annual ODA would need to be \$50–\$60 billion higher than current disbursements, to complement efforts by developing countries to finance additional investment from domestic sources.

Debt relief has played an important role in ODA, particularly since 2003. However, there is no clear evidence that it has been additional to other forms of aid, as called for in the Monterrey Consensus. Such additionality is indispensable because the reduction of the debt stock has a very limited effect on the capacity of governments to increase their expenditure in the period in which it is granted. Full additionality would not only improve the chances of beneficiary countries to meet their growth and social objectives, including those set by the MDGs, but it would also increase their ability to do so without encountering an unsustainable debt situation in the future.



Past debt relief efforts have largely by-passed the considerable development needs of low-income countries that have relatively low debt levels either as a result of prudent external financing strategies or because they have not undertaken essential public sector investments. In order not to discriminate against such countries, it would be appropriate to allow other poor countries to benefit from the Multilateral Debt Relief Initiative, including those that have sustainable levels of indebtedness. Moreover, it may also be necessary to consider providing debt relief to developing countries that have an unsustainable level of debt but are not eligible under the Heavily Indebted Poor Countries debt initiative.

### **Debt sustainability: borrowing for the right purpose**

It is often during periods of economic boom that borrowing and lending decisions are taken on the basis of overoptimistic expectations. This consideration is particularly important at the current juncture, as a large number of developing countries have strengthened their current-account positions and lowered their external debt ratios. They have been able to achieve this partly through better macroeconomic policies and debt management, but mainly as a result of a favourable external environment, characterized by high commodity prices and low interest rates, a scenario that may not last forever.

The challenge is therefore to build on recent improvements in debt indicators, and economic indicators more generally, and accelerate the process of investment, growth and structural change while maintaining a sustainable debt situation. The first step towards achieving debt sustainability is to borrow for the right reasons and not borrow too much during “good times”. Debt should be used only to finance projects that generate returns that are higher than the interest cost of the loan. And foreign-currency-denominated borrowing should, in principle, be limited to projects that can either directly or indirectly generate the foreign currency necessary to service the debt. To the largest extent possible, and especially when the projects do not depend on imports, developing countries should seek to finance them from domestic sources. Therefore external debt strategies should be closely related to renewed efforts to strengthen domestic financial systems and to macroeconomic and exchange-rate policies that aim to prevent unsustainable current-account deficits.

### **External indebtedness: dealing with vulnerability to external shocks**

A major constraint on countries that have access to international financial markets is their vulnerability to the effects of the high volatility of these markets. Shocks that may lead to a liquidity crisis in the developing world often depend on external factors that may originate from policy decisions of developed countries. The use of innovative debt instruments that reduce the vulnerability of developing countries to shocks or unfavourable developments in the international economic and financial environment could help maintain debt sustainability. Such instruments could include issuance of external debt in domestic currency, which would reduce the foreign exchange risk, and of GDP-indexed bonds that allow lower debt service payments when capacity to pay is low. The creation and dissemination of these instruments could be facilitated by support from the international community for developing uniform standards and achieving the required market size.

Implementing national policies to reduce the risk of a debt crisis is especially difficult for low-income countries. These countries often depend on external resources to finance not only projects in the productive sectors of their economies and large infrastructure projects, but also the development of their health and

---

education sectors. Although these social sectors may yield high returns in the long run, they are unlikely to generate the cash flows necessary to service the debt in the short and medium term. This suggests that, since low-income countries cannot sustain high levels of debt, most of their external support should take the form of grants.

Finally, it must be accepted that, even with improved debt management and better and safer debt instruments, debt crises are bound to occur. Thus the international community should not abandon the idea of creating a mechanism aimed at speedy resolutions of debt crises and fair burden-sharing among creditors and debtors. The latter would also help to improve risk assessment of creditors. Because of their particular vulnerability to external shocks originating in international financial and commodity markets, developing countries should also evince a particular interest in reform of the international monetary and financial system. Such reform should aim at minimizing destabilizing speculative financial flows and at strengthening institutions and mechanisms in support of macroeconomic policy coordination.



Supachai Panitchpakdi  
Secretary-General of UNCTAD

