4. GLOBAL ECONOMIC GOVERNANCE

4.1 Introduction

Although the TDR has the term "trade" in its name, it has probably contributed as much to discussions on development-related international monetary and financial issues as it has to trade issues. This is because the interaction of trade and development cannot be analysed independently of financial and monetary issues. From its perspective of interdependence, the TDR has therefore regularly examined the performance of the international monetary and financial system. This includes an assessment of the functioning of the international financial institutions in terms of their impacts on developments in the world economy, and especially in developing countries. In this context, it also covers issues relating to trade financing and the balance of payments, as well as the debt situation in developing countries.

The TDRs have followed the evolution of the multilateral system and made proposals to make it more development friendly. They have regularly commented on the main features of IMF and World Bank lending policies and the way in which those policies have influenced macroeconomic and structural policies in developing countries. One central issue in this context has been the way in which the Washington-based institutions, through their conditionalities – and cross-conditionalities – have leveraged certain macroeconomic concepts. A particular concern raised by TDRs was their urging of many developing countries to engage in financial and capital-account liberalization as well as unilateral trade liberalization, often with serious repercussions for their development. Another issue raised by the TDRs has been the inadequate quantity and modalities of official lending to developing countries, which frequently forced them to undertake costly deflationary adjustment to external macroeconomic and financial shocks. A third issue has been the way in which the international community has dealt with external debt problems.

Over the years, the TDR became an increasingly "heterodox" voice in the international policy debate as economic "orthodoxy", and its protagonists – the IMF, World Bank, WTO and OECD – progressively shifted to "market fundamentalist" positions. Yet, as time passed, the Washington-based institutions modified their policy approach, albeit reluctantly and only partially, in ways that had earlier and repeatedly been suggested in the TDR. Examples are their eventual recognition of the need for a global – rather than "case-by-case" – approach to solving the debt crisis of the 1980s; a slightly revised attitude to capital controls to counter international financial instability; the attempted institutionalization of sovereign debt workouts; acceptance of the need for official debt relief in the poorest countries; a slightly revised view of the merits of industrial policy in support of structural change; and attempts to avoid procyclicality and socially detrimental effects of conditionality.

This section first reviews the TDR series in its assessments of the international trading system. It then traces the main lines of TDR analyses of the international monetary and financial system, and finally summarizes the main proposals made in various TDRs, from the point of view of development, with regard to improving the governance of both trade and financial relations in the world economy.

4.2 Governance of international trade and commodity markets

The TDR's main contribution to the debate on governance arrangements for international trade has consisted of an analysis of trade policy issues, including those related to the Uruguay and Doha Rounds of multilateral trade negotiations and the resulting WTO rules in terms of their specific relevance for development. The TDR has never advocated free trade as an objective in its own right, and has frequently expressed reservations about trade liberalization as an objective per se. Taking a pragmatic approach, it has consistently recommended gradual and selective trade integration as a key element of development strategies. It has therefore examined the design of the international trading system and its evolution from the point of view of the opportunities and constraints that system imposes on the development process.

4.2.1 Multilateral trading system

The early 1980s saw a rising tide of protectionism, which the TDR attributed to the changes in the macroeconomic policy priorities of the industrialized countries. The shift of emphasis from growth and high employment to combating inflation slowed the pace of global demand (see also section 3 above). TDR 1984 described the contradictory trends in the international trading system as follows: *On the one hand, trade has been liberalized as a result of a series of rounds of trade negotiations addressed primarily toward the reduction of tariffs and of quantitative restrictions that fall within the ambit of GATT. At the same time there has been a trend toward the increased use of protective trade measures of a discretionary character which has accelerated in recent years* (84: 4; also 85: 8).

The problem of protectionism in the developed countries remained an issue of particular concern for the TDR during the period of the Uruguay Round negotiations (1986–1994). The introduction of a vast array of non-tariff measures by developed countries in sectors where developing countries were particularly successful, including in agricultural products and labour-intensive goods, implied a reduction in the export potential of developing countries. Many of these countries had introduced drastic unilateral trade liberalization packages during the 1980s with the aim of solving their external debt problems and financing necessary imports of capital goods and technology from export earnings (88: Part One, ch.III; 89: Part One, ch. III, 91: Part One, ch. III).

Against this background, the TDR hoped for a successful outcome of the Uruguay Round: *It is important that the long-standing international policy commitment to 'make room' for the exports of manufactures from developing countries should be fully implemented, through a rollback of existing non-tariff barriers and other measures, so as to improve market access. The Uruguay Round offers an opportunity to achieve these objectives* (88: XV; also 92: VI). Moreover, the TDR expected that the conclusion of the Uruguay Round would also contain *specific provisions on differential and more favourable treatment for developing countries* (93: IX). However, this issue has remained unresolved until today.

On the other hand, the TDR frequently expressed doubts about the contention that *any form of protection is inimical to export success* for countries that are still in the process of building and upgrading industries to catch up with the more advanced economies: Many successful exporters among the developing countries *introduced across-the-board import liberalization only after, sometimes well after, the upturn of exports. This suggests that trade reform should follow a sequence in which protection is reduced substantially first on inputs used by export sectors, and on other goods only after export supply capabilities have been built up* (92: VI; also 93: IV). This implies that a development-friendly multilateral trading system should allow for sufficient flexibility for the pursuit of country-specific industrialization strategies. This issue would receive greater attention in subsequent years with reference to "policy space" (96: ch. III; 99: 132; 04: ch. III).

Soon after the conclusion of the Uruguay Round with the Marrakech Agreement in 1994, the TDR still expected significant improvements in the conditions for export-oriented investment (94: IX). But it also warned that *it would be unrealistic to expect the international trading system to evolve in the right direction unless the twin problems of unemployment and low wages in the developed market economy countries are tackled* (95: IX).

However, a comprehensive assessment by the TDR of the practical outcomes of the new Agreement a few years later indicated disappointing outcomes (99: ch. IV): *The predicted gains to developing countries from the Uruguay Round have proved to be exaggerated* (99: I). *Tariff levels and the frequency of tariff peaks are still high in many areas of export interest to developing countries* and *subsidization of agricultural output in the North not only shuts out imports from developing countries, but also leads to unfair competition in the latter's own markets. The panorama of protectionism is no better for industrial products* (99: IX).

A further assessment in TDR 2002, after the Doha Round of multilateral trade negotiations – also referred to as the "Development Round" – had already begun, confirmed the disappointing trends: *Trade liberalization has been limited and slow in textiles and clothing along with other labour-intensive manufactures, compared to the pace of liberalization in other sectors. High tariffs and tariff escalation have been compounded by other overt forms of protection, as well as by the adverse impact of anti-dumping actions and product standards. The growing number of non-tariff barriers, especially against unsophisticated manufactures, has reinforced the prevailing patterns of market access, which favour high-tech products over low- and middle-range products that tend to gain importance in the early stages of industrialization* (02: VI).

To demonstrate the impacts of improved market access, the TDR had estimated in 1999 *that an extra $700 billion of annual export earnings could be achieved in a relatively short time in a number of low-technology and resource-based industries. Agricultural exports could add considerably to this figure. All-in-all, the increase in annual foreign-exchange earnings could be at least four times the annual private foreign capital inflow in the 1990s* (99: IX).

But it was not only the disappointing results in terms of market access that perpetuated earlier concerns about the appropriateness of the WTO rules from a development perspective. The new multilateral trade rules were also seen as failing to offer sufficient flexibility for the implementation of national development policies similar to those that had proved successful in the Asian newly industrializing economies (NIEs) as well as in many developed countries (02: X). TDR 2002 was therefore critical of the *gap between the rhetoric and the reality of a liberal international economic order. Nowhere is this gap more evident than in the international trading system. Even as Governments extol the virtues of free trade, they are only too willing to intervene to protect their domestic constituencies that feel threatened by the cold winds of international competition. Such remnants of neo-mercantilist thinking have done much to unbalance the bargain struck during the Uruguay Round* (02: I).

Consequently, the Report stressed the continuing challenge to make the multilateral trading system more development-friendly. The outcome of the Doha Round of multilateral trade negotiations *will be judged by the extent to which developing countries achieve greater market access without their policy options being restricted* (02: XI; also 06: XIX). TDR 2006 found market access conditions still biased against developing countries, owing to *the use of non-tariff measures, particularly antidumping measures, which have emerged over the past 25 years as the most widespread impediment to international trade, and to exports from developing countries in particular* (06: VI).

With the stalling of the Doha Round, which was scheduled to be concluded in 2005, the TDR noted that *further discussions and negotiations will need to explore a range of options aimed at creating a new framework or new guidelines for special and differential treatment (SDT). This endeavour would probably need to start from the recognition that SDT for developing countries means redressing structural imbalances rather than giving concessions. Developed countries would need to agree to a new framework or new guidelines for SDT without receiving concessions in return* (06: XIX).

Thus, while the TDR always emphasized the merits of multilateral trade rules and disciplines in global economic governance, it also called for the need to apply those rules flexibly to developing countries. In this context, it drew attention to the fact that *in legal terms, WTO rules are equally binding on all participants, but in economic terms they are biased towards an accommodation of the requirements of the developed countries* (06: XX). TDR 2006 therefore argued that developing countries should be able *to modulate applied industrial tariffs levied on particular product categories in accordance with their path of technological upgrading as a key instrument of sectoral policy* (06: XIII).

4.2.2 Bilateral and regional trade arrangements

In its support for the principle of multilateralism in global economic governance, the TDR has repeatedly drawn attention to the drawbacks of regional and bilateral trade agreements involving developed and developing countries.

In the 1990s the TDR saw two main problems with such agreements: that they could *lead to significant trade losses for non-members* (90: VI), and that they could weaken efforts to improve the multilateral trading system (91: VIII). In a later analysis in 2007, the perspective leaned more towards the implications for developing-country members of such agreements that had multiplied rapidly since the early 1990s. The Report warned that bilateral or regional preferential trade agreements between developed and developing countries often bypass multilateral institutions and arrangements. It noted that this reflected a belief by the participating governments that a number of those agreements *could serve as a better vehicle for advancing their preferred agendas of economic liberalization and internationalization of investment and production* (07: VIII). It accepted that free trade agreements between developed and developing countries had the potential to provide the developing-country partner(s) with better market access to the developed-country partner(s) and may attract more foreign direct investment (FDI). However it also alerted developing countries to some potential disadvantages, as such agreements generally demand far-reaching liberalization of foreign investment and government procurement, the incorporation of labour and environmental standards, and, in many cases, *much broader and deeper liberalization of trade in goods than that agreed under WTO arrangements* (07: IX).

4.2.3 International commodity markets

Low and unstable primary commodity prices and the related terms-of-trade problem were among the central issues in North-South economic relations since the time of the first UNCTAD conference in 1964. The majority of developing countries then depended heavily on primary commodity exports for foreign exchange earnings, and four decades later commodity dependence persists in many countries, especially in Africa. The stabilization of such markets and the reduced economic dependence of many countries, especially African countries, on those markets have traditionally been major objectives espoused by UNCTAD. This is mainly because there is ample evidence that commodity price volatility is *one of the reasons why commodity-dependent economies have lower long-term average growth rates than economies with diversified production structures* (08: IV). Moreover, terms-of-trade losses as a result of weak commodity prices frequently imply real income losses for the poorest countries, which affect their ability to import essential goods with a given export capacity (82:15, 16, 38; 88: 92; 93: 20; 05: ch.III).

Against this background, commodity price developments and the functioning of international commodity markets have been followed very closely in every TDR. The very first TDR advocated a new development paradigm that would include, as one of its key elements, *a substantial improvement in the terms of trade of developing countries through appropriate commodity policies* (81: 5). Over the years the Report regularly pointed to the important role of output growth in developed countries as a key determinant of the evolution of the prices of most primary commodities. In recent years, fast and sustained growth in a number of large emerging economies, particularly China, has contributed to a structural increase in demand for primary commodities, which has changed both short- and long-term demand prospects. However, TDR 2005 found that *the basic problem of instability in these prices and* *their long-term tendency to deteriorate in real terms vis-à-vis the prices of manufactures, especially those exported by developed countries, remains unresolved.* When oil prices surged after 2002, oil-importing developed countries called for measures to stabilize those prices. On this occasion, the TDR noted again *that in the spirit of a global partnership for development the international community might consider mechanisms at the global or regional level that could serve to reduce the instability of prices of a wider range of commodities, not just oil, to mitigate its impact on the national incomes of exporting countries* (05: VIII, IX; 06: annex 1 to ch. I).

Three years later it became clear that such mechanisms were needed for two purposes: to mitigate the impact of falling and unstable prices on exporters of primary commodities, and to reduce the impact of unstable and rising prices on developing-country importers of such commodities, especially countries that depend on food imports. As stated by the TDR (2008: IV): *The surge in food prices in some countries calls for specific income transfers targeted to the most needy households* (which in poor countries require additional foreign assistance). *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*.

An issue of increasing importance for the functioning of primary commodity markets has been the impact of financial speculation. Such speculation was identified as an important factor in commodity price formation already in the 1980s (90: IV), but its impact has become a particularly important challenge for global economic governance in recent years. Since 2008, the TDR has devoted much attention to the "financialization" of primary commodity markets (08: ch. II; 09: ch. II; 11: ch. V). TDR 2011 noted that the growing participation of financial investors in commodity trading for purely financial motives has *caused those markets to follow less the logic of a goods market and more that of financial markets where herd behaviour often dominates* (11: XI). This new aspect of commodity price formation is a result of the fact that *financial investors in commodity futures exchanges have been treating commodities increasingly as an alternative asset class to optimize the risk-return profile of their portfolios. A particular concern with respect to this financialization of commodity trading is the growing influence of so-called index traders, who tend to take only long positions that exert upward pressure on prices. The average size of their positions has become so large that they can significantly influence prices and create speculative bubbles, with extremely detrimental effects on normal trading activities and market efficiency* (09: IV).

In the TDR's view, the problem with financialization is not only that it increases volatility and dangerously disconnects prices from fundamentals; it also creates problems for those who have a real economic interest in commodity futures markets: *Under these conditions, hedging against commodity price risk becomes more complex, more expensive, and perhaps unaffordable for developing-country users. Moreover, the signals emanating from commodity exchanges are getting to be less reliable as a basis for investment decisions and for supply and demand management by producers and consumers* (09: IV).

The TDR recognized that international price stabilization mechanisms agreed multilaterally between producers and consumers, such as the various commodity agreements of the past, were unlikely to 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* (08: V). In addition, TDR 2008 called for an improvement in *international compensatory finance schemes*, with *more rapid disbursements and more financial resources for balance-of-payments or income support.* Such measures *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* (08: V).

4.3 The international monetary and financial system: a critique

4.3.1 Financial instability and the handling of financial and payments difficulties

In the early 1980s, the TDR observed a fundamental shift in the policy orientation of the Washington-based institutions. In 1984 it noted that, whereas the post-war system had been *designed to protect levels of activity to the greatest extent possible from external constraints and external monetary and financial disturbances*, the arrangements following the break-down of the Bretton Woods System were *geared toward ensuring freedom for international capital markets, which have assumed a dominant role in determining the availability of payments finance and the pattern of exchange rates* (84: 8).

In the mid-1970s, external finance was still playing an important role in cushioning downward pressures on import volumes, and therefore on output and investment. This was partly due to private financial flows and partly to official lending, such as through the so-called Oil Facility established by the IMF in response to the payments difficulties encountered by many oil-importing countries in the mid-1970s (82:43-45). But towards the end of the 1970s the international financial institutions were ill prepared to counterbalance the deflationary impact on developing countries of the events that shocked the world economy in the late 1970s and early 1980s and the procyclical behaviour of private actors (84: 6). The radical shift in the macroeconomic policy orientation of the major industrialized countries was accompanied by pressure on the IMF to limit quota increases and to impose stricter loan conditionalities, as the TDR observed in 1982 (82: 5). Thus, from the late 1970s onwards deficit countries were for the most part required to adjust their external imbalances by means of deflation, as the foreign exchange losses resulting from the combined effects of recession and higher interest rates in the first half of the 1980s were not compensated by increased external financing from official sources (84: Part Two, ch. III; 85: Part Two, ch. III).

On the other hand, the TDR soon realized that the dismantling of obstacles to international capital movements was increasing *the scope for the transmission of instability among different markets and causing the volatility of exchange rates to be more closely connected to movements in the prices of many other assets* (88: XII). According to the TDR, *financial innovation and deregulation of financial markets had the potential for instability* not only in national economies but for the entire international financial system (91: V; also 90: X). All this would become obvious in the subsequent two decades, as evidenced by the frequency of financial and currency crises, including the global financial crisis of 2008-2009 that had its origin in countries which, supposedly, had the most sophisticated financial sectors in the world.

In 1990, a time when policymakers and most of academia still subscribed to the merits of financial deregulation and liberalization, the TDR pointed to the need *for more collective control and guidance over international finance* (90: I). But these warnings *fell on deaf ears*. Indeed, the Report was obliged to comment eight years later, following the episodes of debt deflation in the United States, the European Monetary System (EMS) crisis in 1992–1993, the Mexican crisis of 1994–1995 and the East Asian crisis of 1997–1998: *Each time, the prevailing approaches have been based on the notion of the infallibility of markets and on an explanation of the crisis in terms of misguided domestic policies*. Meanwhile the systemic nature of financial instability continued to be overlooked (98: I).

Subsequent to the Asian financial crisis, the TDR sharpened its criticism of the way in which the international financial institutions were managing financial crises. In 1998 it noted: *Countries that year after year enjoyed growth rates of 8–10 per* *cent per annum, maintained full employment and went a long way towards eradicating poverty are now suffering a severe economic contraction*. *The international policy response has contributed to the severity of the crisis by failing to appreciate the full gravity of the situation, and by placing too much faith in conventional policy prescriptions*. High interest rates forced debtors *to cut down on their activity and liquidate assets, while economies were driven into deep recession* (98: II, III). The financial assistance coordinated by the IMF was criticized for coming too late, *usually only after the collapse of the currency,* and for taking *the form of bailouts designed to meet the demands of creditors and to prevent defaults*. TDR 1998 criticized such operations for not being particularly helpful to the countries themselves, but mainly serving to *protect creditors from bearing the costs of their decisions* (98: VIII). It also questioned the capacity of the IMF to adequately meet the needs of the system in terms of the possible volume of its lending in light of the increasing need to *stabilize currency markets and thus avoid the transformation of currency attacks into solvency crises* (98: VIII).

Criticism of the IMF's diagnoses before and after the Asian financial crisis and that of its policy prescriptions became more widespread. Furthermore, developing and emerging market economies revised their macroeconomic strategies in order to reduce their dependence on international capital markets and on IMF assistance.

4.3.2 Problems of conditionality and policy surveillance

One of the recurrent concerns of the TDR has been the influence of international financial institutions, especially the IMF, on policies of its member States. This concern has two aspects. The first is related to the fact that the IMF can meaningfully influence national policies only when a country asks for its financial support and thus becomes subject to IMF conditionality. The second is related to the nature of that conditionality.

Regarding the first aspect, the TDR has disapproved of the asymmetrical way in which the IMF exerts its surveillance function over its borrowing members, on the one hand, and its non-borrowing members on the other. In 1990, the TDR (Part Two, ch. I) noted that the record of multilateral surveillance was *extremely poor*. Whereas the IMF's position vis-à-vis the developing countries had been considerably strengthened, policies in the major industrialized countries were outside the scope of effective surveillance by the IMF.

Indeed, global surveillance procedures failed to prevent the international financial crises and currency turmoils of the 1990s, as pointed out in 1998 (ch. IV): *In part this failure reflects belated, and only partial, adaptation of existing procedures to the problems posed by large autonomous private capital flows. But perhaps more fundamentally, it is due to the unbalanced nature of these procedures, which give too little recognition to the disproportionately large global impact of monetary policies in a small minority of OECD countries* (98: 93).

Although the inadequacy of IMF surveillance in response to conditions produced by greater global financial integration and recurrent financial crises was widely recognized in the 1990s, including by the Group of Ten and the IMF's Interim Committee, there was little improvement. After the Asian financial crisis, the TDR noted: *Over the past two decades, the unwillingness of the advanced countries to defer to IMF on contentious monetary and financial matters which directly affect their own interests has meant that the Fund's surveillance of the policies of the most important players in the global system has lost any real purpose. Instead, there has been an intensification of surveillance of developing countries, which has now been extended to include financial sector issues, consistent with the diagnosis that the main flaws are to be found in debtor countries. One result has been the expansion of conditionalities attached to IMF lending to countries facing actual or potential crisis. This has given rise to serious concerns about undermining sovereign responsibility, even as the effectiveness of IMF surveillance is increasingly questioned* (01: IX; also 06: XXI).

Regarding the nature of IMF conditionality, the TDR criticized both the structural and macroeconomic conditions, as well as the cross-conditionality attached to IMF and World Bank lending and later also to the provision of official debt relief. Macroeconomic conditionality mostly implied requiring recipient countries to adopt a procyclical policy stance through a tighter monetary policy and fiscal retrenchment. As a complement to macroeconomic tightening, countries were expected to undertake "growth-oriented structural reforms" which would give broader scope to market mechanisms and private sector initiatives. They were to give greater emphasis to liberalization and deregulation and reduce the role of the State, including cutting the share of public consumption and investment. The TDR argued that such structural reform programmes overemphasized market forces, even in countries where many preconditions for well-functioning markets were not fulfilled. They also implied an intrusion into national policy autonomy in various areas, for example with regard to the privatization of State-owned enterprises, the dismantling of public institutions that supported the agricultural sector, and the liberalization of external trade and finance (93: III; also 94: Part Two, chs. II and III).

In the view of the TDR, these policy prescriptions, rather than helping countries to overcome recession, mostly served to make matters worse, particularly because they caused investment to stall and because they did not sufficiently acknowledge the external causes of payments crises (82: 2; 89: V; 93: 3). Moreover, the TDR observed that, based on the conventional perception that the reasons for macroeconomic and financial disorder and external indebtedness were mainly to be found in flaws in domestic policies, conditionality on borrowing countries intensified over time. It started to extend beyond financial sector issues to include non-economic matters as well, thereby increasingly undermining sovereign responsibility (01: Part Two, ch. III). When criticism of IMF conditionality grew in the aftermath of the Asian financial crisis in the late 1990s, the IMF's International Monetary and Financial Committee discussed the need to streamline and refocus its surveillance in line with the Fund's core competence in macroeconomic policy. However, TDR 2001 found that the way in which financial difficulties in some emerging markets were being dealt with in the first years of the new millennium did not indicate a break with past practice (01: ch. III).

More generally, the 2001 Report voiced the disappointment of an increasing number of observers and officials in developing countries and emerging economies that, *despite the initial emphasis of some policy makers in the leading industrial economies on the need for systemic reform after the Asian crisis, moves in that direction have subsequently stalled. Instead of establishing institutions and mechanisms at the international level to reduce the likelihood of such crises and better manage them when they do occur, there has been a very one-sided emphasis on reforming domestic institutions and policies in developing countries. By contrast, little attention is given to the role played by institutions and policies in creditor countries in triggering international financial crises* (01: VI, VII).

The financial crisis that began in 2008 again led to official pronouncements by the IMF that it would revise the terms of its conditionality. However, TDR 2009 showed that problems concerning conditionality remain as relevant as before. While IMF lending surged after the outbreak of the current crisis, the TDR found *that in almost all its recent lending arrangements, the Fund has continued to impose procyclical macroeconomic tightening, including the requirement for a reduction in public spending and an increase in interest rates* (09: VII).

4.3.3 Exchange-rate disorder

The TDR frequently expressed concern *that volatile exchange rates have significant unfavourable effects on international trade,* as wide fluctuations and long-term movements of exchange rates leading to overvaluation frequently cause protectionist pressures (88: XIII). It blamed this primarily on the disorder in the international exchange-rate system following the breakdown of the Bretton Woods system. TDR 2009 (ch. IV) also pointed to the weakness of an international reserve system that uses a national currency as the main reserve asset. Such a system always depends on monetary policy decisions by the central bank that issues that currency – decisions that are taken according to national policy needs and preferences, without considering the needs of the international payments system and the world economy. Another disadvantage of such a system is that, at times of current-account disequilibria, it imposes the entire adjustment burden on deficit countries. Only deficit countries that issue a reserve currency have no obligation to adjust to growing current-account disequilibria.

The Report attributed the ensuing problems for the world economy to the absence of appropriate multilateral arrangements to ensure greater exchange-rate stability of the major currencies. It also pointed to flaws in the policy advice of the international financial institutions on exchange-rate arrangements in developing countries (99: X). It suggested that this advice had been *at best confusing and at worst misleading*, because it did not consider the option of direct controls over capital flows. The TDR argued that under free capital mobility, neither freely floating exchange rates, as suggested in some cases, nor a completely fixed exchange rate or even a currency board system, as chosen in other cases, could insulate economies from instability of an external origin. *Freely floating rates, combined with capital mobility, undermine currency stability.* But with a completely fixed exchange rate or a currency board system, *the effects of capital inflows and outflows are transmitted to levels of economic activity and to goods and assets prices, and may include threats to banking stability* (98:X). Thus, *differences among pegged, floating and fixed regimes lie not so much in their capacity to prevent damage to the real economy as in the way damage is inflicted in the first place* (99: X).

In light of these considerations, various TDRs have made proposals for reform of the international exchange-rate system and for exchange-rate arrangements in developing and emerging economies. These are believed to contribute to greater financial stability and a macroeconomic and financial environment that is more conducive to investment in productive capacity and employment generation (see sections 4.4.5 and 5.3.2 below).

4.4 Recommendations for reform of the international monetary and financial system

In light of its assessments of the shortcomings of the global governance arrangements, the TDR has made many recommendations for reform, which have evolved over time. In several cases its recommendations anticipated changes in these arrangements that were later discussed and adopted in other forums.

Of particular importance in this regard were the contributions in TDRs 1990 (Part Two: The Internationalization of Finance), 1998 (Part One, ch. IV: The Management and Prevention of Financial Crises), 2001 (Part Two: Reform of the International Financial Architecture), and 2009 (chapter IV: Reform of the International Monetary and Financial System). But even prior to these Reports, as early as 1984 the TDR had proposed some principles for systemic reform in response to the unfavourable developments in international monetary and financial governance since the end of the Bretton Woods system and the greater instability and unpredictability of the financial system. Those principles could in a very similar form be equally applicable today: *A viable system needs not only to reaffirm the emphasis on employment and growth that underlay the design of the post-war systems* [of trade, money and finance] *but also to complete that commitment by establishing mechanisms to ensure adequate growth opportunities for all members of the system – the establishment of a development consensus* (84:11).

Since 1984, various TDRs have formulated elements of a reform agenda that is equally relevant today (84:11, 12; 86: annex to ch. VI; 90: Part Two, ch. I; 98: Part One, ch. IV). The following have been the main proposals:

- Surveillance and effective international coordination of economic policies in the major countries that have a strong impact on other economies, in order to avoid a deflationary bias in the system and the build-up of large current-account imbalances;
- Regulation and supervision of finance and international capital flows;
- Provision of adequate official financing that helps avoid payments problems and allows economies that encounter such problems to make necessary adjustments without sacrificing growth and progress in development;

- International mechanisms to prevent and manage financial crises, including debt reduction;
- Arrangements for maintaining stable exchange rates among the major international currencies;
- Greater coherence and consistency in the formulation of policies relating to trade and to finance so that they are mutually supportive in their promotion of full employment and development.

These themes are addressed below.

4.4.1 Policy surveillance and coordination

Following the Asian financial crisis, the TDR suggested that in light of the increasing financial instability and the impact of external factors on the payments situation of developing and emerging economies, new guidelines for IMF surveillance should specify circumstances in which the Fund should recommend the imposition or strengthening of capital controls (98: 95). This line of reasoning led TDR 2009 to suggest that IMF support for measures to manage the capital account as part of its surveillance function could ensure that debtor countries or governments are not "penalized" by no lending or excessively high interest rates. IMF endorsement of national policy measures is typically viewed by international investors as a sign of credibility of such policies (09: 120).

However, the main concern continued to be the need for a reduction of asymmetries in surveillance (01: 70). In 1990, the TDR (Part Two, ch. I) observed that there had been a significant increase in interdependence among the major industrialized countries compared with the time when monetary arrangements were put in place in the immediate post-war era. The dependence of economic performance in developing countries on the policy mix and stance of the major OECD countries had also become stronger, and the capacity of financial markets and capital flows to generate global disturbances had grown (90: 136). Therefore the Report believed that the surveillance function of the IMF should be considerably strengthened in order to help attain the objectives of growth and stability, as provided in Article I of its Articles of Agreement. This would require that the burden of adjusting policy in the case of large current-account imbalances *is shared between deficit and surplus countries in such a way as to avoid bias towards deflation and high interest rates. Global targets and indicators should also be used to ensure that the world economy as a whole is neither deflated nor over-heated* (90: XII). The Report stressed that the surveillance function of the IMF had particular importance for the process of policy coordination. It should not be limited to exchange-rate policies but should also include adjustment processes, and, *it should be conducted on a multilateral basis before issues regarding policies and indicators are taken up in bilateral consultations* (90: 136).

TDR 2001 made a more concrete proposal in this regard: *A priority of the reform process must be strengthening surveillance mechanisms to achieve a minimum degree of coherence among the macroeconomic policies of the major industrialized countries. In view of the asymmetries in existing practices, one way forward might be to link surveillance procedures to a mechanism analogous to that used for settling disputes in international trade, where disagreements over the impact of macroeconomic and financial policies could be taken up and their resolution sought* (01: IX).

The need for policy coordination was again stressed in various TDRs in the run-up to the global financial crisis that began in 2008 (01: 66; 03: 20; 06: 64). But it was only after the crisis had erupted that the G-20 sought to ensure a more coordinated policy response. It was recognized that coordination of the fiscal stimulus programmes of different countries would enhance their overall impact on global demand and reduce the risk of protectionist reflex actions against "free-riders" (09: VI). However, as in previous instances, such as with the Plaza and Louvre Accords in 1985 and 1987 among the major industrialized countries, policy coordination occurred only on an ad hoc basis in episodes of acute crisis. This is why the TDR has called for more permanent and more effective arrangements for improved policy coordination, to be led by an international institution that would not only implement ad hoc measures for crisis management but also prevent the build-up of global crises (09: 129-130).

Another important recommendation made by the TDR was that, in order to achieve greater international policy coherence, international policy coordination should also take into account the needs of developing countries. These countries are affected by the macroeconomic policy stances of the major developed countries, which exert a strong influence not only on the volume and terms of trade, but also on the availability and cost of external finance (90: Part Two, ch. I). Moreover, in situations of weak global demand, a balanced programme of global expansion that includes greater provision of official finance to developing countries – and debt relief, where appropriate – could reduce the need for contraction of imports by those countries, while at the same time contributing to stabilizing global demand (87: IV; 88: V: 03: IV; 09: VII).

4.4.2 Governance of international capital flows

It is one thing to call for stricter financial regulation when there is general agreement that this is needed as a result of the financial crisis; it is another to call for stronger financial regulation when the broad general tendency is directed towards relaxing such regulation. The latter is what the TDR started to do more than 20 years ago. In 1988, it noted that the need to *establish appropriate frameworks and guidelines for markets* and to *contain harmful effects of large unpredictable changes* had increased as a result of *actions taken by major OECD governments as part of a thrust towards greater reliance on free markets* (88: XIII*). Prudential regulations need to be tightened to raise the cost of excessively risky operations in both credit and security markets. They also need to be harmonized, and applied in all major financial centres including those offshore* (90: XII). However, inaction in this regard was a major cause of the financial crisis of 2008, prompting the TDR to repeat these calls, this time in concert with many others (09: ch. III).

Having pointed to the need for regulation and supervision of finance and international capital flows to reduce financial and exchange-rate instability in earlier issues, the TDR addressed the related issues in more detail in the 1990s. In connection with its assessment of the Uruguay Round negotiations on financial services, the Report reviewed the governance of international banking and the work of the Basel Committee on Banking Supervision (92: annex I to Part Two). This work responded to developing countries' increasing demand for information, explanation and guidance on issues relating to global regulatory reform. Its relevance has been confirmed by the introduction of regulations within the Basel 2 framework in more than 100 countries.

TDR 1994 (annex to Part Two, ch. II) reviewed pre-existing international regimes for capital movements and made several new proposals. For example, the discussion of a tax aimed at slowing speculative international capital transactions as a means to reducing the negative impact of speculation on financial and exchange-rate stability goes back to 1988 (88: XIV; 90: XII). The possibility of such a tax, which was initially proposed by Nobel Laureate James Tobin in 1978 (Tobin, 1978), was examined in detail in the annex to TDR 1996. At the time, the TDR expressed some scepticism to the proposal due partly to considerations related to the difficulty in designing a practicable tax of this kind. However, following the eruption of the financial crisis in 2008, the idea of such a tax has gained widespread support in some major European countries, and suggests that this difficulty will simply be overridden by means of some probably arbitrary solution.

Moreover, the TDR soon recognized that the liberalization of international capital movements could lead to undesirable inflows. It therefore called for defence mechanisms aimed at reducing the vulnerability to financial and currency crises triggered by shocks generated outside a country's sphere of influence. In the absence of appropriate arrangements in the international governance system, especially global mechanisms for stabilizing capital flows, it emphasized the need for protective national policies. Accordingly, in the 1990s, before capital inflows into developing countries started to surge, and before the financial crises that would subsequently hit several emerging market economies, it commented on the usefulness of controls over capital movements. Based on historical experience of finance and capital flows to developing countries, it expected that policies based on the Washington Consensus would trigger a rapid increase of such flows, followed by a bust (see also section 5 below).

While the application of such measures and other forms of capital-account management are in the national domain, global governance matters in making them internationally acceptable. This is why TDR 1998 emphasized that, rather than imposing new constraints on capital-account management, international financial governance arrangements should provide for greater flexibility to allow governments to pursue various options in this regard (98: Part One, ch. IV; see also section 5.3.2).

4.4.3 Official financing

Regarding the role of official financing for developing countries and emerging markets, the TDR has recommended the provision of IMF lending for the purpose of bridging short-term payments difficulties resulting from the impact of unfavourable movements in the global economy. This included strong advocacy for lending in crisis situations to support trade, employment and growth. At the same time, the Report has been critical of bailouts for international creditors and investors. Another area of concern has revolved around the level, stability and conditions of official development assistance (ODA), especially for low-income and least developed countries.

After the collapse of the Bretton Woods system and the subsequent liberalization of international capital markets, followed also by widespread capital-account liberalization in developing countries, it was expected that the external financing requirements of developing countries would be satisfied by private capital inflows. But, as observed in several TDRs during the 1990s, only a minority of developing countries *has had access to these markets, while a majority has continued to depend heavily on official financing, including export credits* (96: IV; also 93: VIII; 99: X; 08: X). Greater provision of official financing was also deemed necessary in view of the increased outward orientation of most developing countries, and because *the private financial system operates in a pro-cyclical fashion, accentuating the deflationary impact on developing countries of events in the world economy* (84: 6).

With regard to the provision of official financing for the prevention and mitigation of payments problems and for alleviating the constraints on development financing, the TDR frequently advocated allocations of additional special drawing rights (SDR) by the IMF in the 1990s (91: VI; 92: IV; 95: 45). Again in 2001 the TDR complained that *IMF quotas have lagged far behind the growth of global output, trade and financial flows* (01:VIII). In April 2009, the G-20, in its Global Plan for Recovery and Reform, finally *decided to significantly increase the IMF's resources, to provide additional lending through multilateral development banks and to support trade finance.* Yet the TDR argued that *the effectiveness of the announced international support could have been greatly increased if it had been linked to a reform of the system of allocation of SDRs,* in a way that it would yield greater benefits for those countries that are most in need of unconditional access to official finance (09: VI, VII).

Official development assistance in real terms had declined steadily throughout the 1990s. TDR 1999 (ch. IV) compared ODA levels with terms-of-trade losses and the effects of trade and financial liberalization and slower growth in the industrialized countries. It concluded that net capital inflows received by most developing countries fell far short of what would be needed to achieve an annual GDP growth rate of at least 6 per cent. This was considered to be a rate that would allow developing countries to overcome their social and technological handicaps and narrow the income gap with developed countries: *Even under relatively optimistic assumptions regarding growth in industrial countries and the terms of trade, the external financing needs of developing countries can be estimated to exceed recent net capital inflows by more than 40 per cent* (99: VII). Following the formulation of the Millennium Development Goals (MDGs) in 2000 and the Monterrey Consensus in 2002, ODA disbursements increased substantially, but the 2008 Report observed that many donors often were not on track to meet their ODA pledges. It still saw a considerable gap between actual ODA flows and the aid estimated to be necessary for implementing measures to attain the MDGs: *for a realistic chance of meeting the MDGs, ODA would need to be increased by $50-$60 billion a year above current levels* (08: XI).

Moreover, TDR 2008 highlighted an aspect that is rarely taken into account when the potential impact of aid on development is considered, namely the need to link ODA to investment in growth-enhancing productive capacities. Aid effectiveness had come to be increasingly viewed in terms of its direct contribution to achieving the MDGs; as noted by the TDR, *a larger proportion of ODA is being spent for health, education and other social purposes*. However, while recognizing that *this kind of ODA is essential and justified in its own right,* the Report emphasized that unless ODA helps boost investment and growth, *it is unlikely to be effective in reducing poverty in the* *long term, beyond the MDG target year of 2015* (08: XI). The Report proposed one possible way to increase ODA effectiveness: *to leverage ODA 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 interest they charge. At the same time it could help to build a better functioning system of domestic financial intermediation* (08: XI).

4.4.4 Management of financial and debt crises

(a) Dealing with sovereign debt

The debt problems of many developing countries in the early 1980s were treated by the international community for a long time as individual problems of each debtor country. Accordingly, the remedies prescribed focused on debt rescheduling and domestic adjustment, irrespective of the costs in terms of forgone output, and thus, debt servicing capacity itself. TDR 1985, by contrast, outlined the elements of an international strategy to solve external debt problems based on the recognition of an *intimate connection between the debt problem and the evolution of the external environment* (85: 3).

While the international financial institutions continued to deal with the debt problems on a "case-by-case" basis, the TDR insisted on a global solution. This was not only because the crisis was largely due to the malfunctioning of the global economy (see section 3 above), but also because a *process of action and reaction by individual creditors and debtors is likely to be disorderly. A measure of debt or debt-service forgiveness must therefore be part of the normal 'menu' of financial techniques* (87: VIII). The TDR always maintained that the external debt problems of developing countries had to be solved with the support of the governments of the creditor countries and the international financial agencies, but without placing an undue burden on the populations of the indebted countries or obstructing development. This should help debtor countries to avoid the need for import compression, improve their export capacity through accelerated domestic capital formation and strengthen their public finances. To this end, the TDR proposed the establishment of an *international debt facility* (88: VIII; also 90: VIII), and indicated various kinds of incentives the governments of creditor countries could provide to commercial creditors to achieve an orderly, concerted debt reduction (93: Part Three).

Based on a simulation model, TDR 1988 showed that full repayment of the debts owed by developing countries to private lenders in the mid-1980s was economically not possible, and that therefore debt relief was necessary. The Report emphasized *the mutual interest of creditors and debtors in removing the debt overhang* and estimated that a *30 per cent cut in commercial bank debt, together with new lending by multilateral agencies and vigorous efforts by debtors to invest and export,* was *the minimum needed to remove the foreign-exchange constraint and break out of the vicious circle*. It added that such a reduction of bank debt would amount *to about one-half of the discount at which their debt is currently traded on secondary markets* (88: VII, VIII; also 89: V).

It took several years before the international debt strategy was finally revised along the lines advocated by the TDR. The Brady Initiative finally offered a means of settling creditors' claims on indebted countries in an orderly way, putting an end to the most severe payments constraints. The subsequent introduction of new policy guidelines by the IMF and the World Bank led the TDR to state: *It is now accepted that reduction of debt and debt service must play a much greater role and that creditor governments must be involved in the process*. Even though the TDR recognized this as a significant step forward, it also identified its weaknesses and called for more action, because *the extent to which countries can engage in debt equity swaps and privatization without jeopardizing their public finances* was limited (89: X, XI). Moreover, the Report objected to the fact that the agreements under the Brady Initiative *were negotiated without authoritative estimates of the debt and debt service reduction required*. The *failure to assign to any international financial agency the role of "honest broker" has left the level of debt reduction to be shaped by the balance of negotiating strength rather than by objective needs* (90: VIII).

Against this background, TDR 1990 feared that *the task of breaking the vicious circle of poor growth, over-indebtedness and economic disorder* would continue *for a decade ahead* (90: I). Indeed, most developing countries would not return to growth rates commensurate with their stage of development before the turn of the millennium, when the global economy embarked on a long period of expansion.

In the TDR's analysis, increasing capital inflows in the 1990s were partly due to the Brady deals. This was because, first, they implied that a significant share of the debt that was owed to commercial banks was substituted by debt owed to governments, and secondly, because the initiative was viewed by actors on international capital markets as a sign of reduced risk of new capital flows to the debtor countries. Together with considerably higher interest rates in many of these countries and sharp interest rate cuts in the United States to contain the fallout from the Savings and Loan crisis, this attracted arbitrage – or "carry trade" – speculation with attendant bandwagon effects. The TDR warned of the unsustainability of such inflows in the mid-1990s, especially for Latin American, but also for some Asian economies (92: 51–52; 93: XI; 94: II, also 98: ch. III).

Following the experience of further financial and currency crises in Latin America, the Russian Federation and East Asia, TDR 1999 suggested that reform of the global financial architecture should aim at *a roll-back of the control that financial capital has established over trade, industry and employment* (99: X) in countries at all stages of economic development. It also called for the reform to include a greater role for official financing and recognition of the rights as well as the obligations of debtors.

The year before, the TDR had elaborated recommendations for the prevention and better management of financial crises. It suggested that the most effective way to prevent widespread defaults and bankruptcies as a result of an attack against a currency would be to apply, at the international level, the same insolvency principles and procedures as those provided in the bankruptcy legislation of many countries. *The procedures allow for a standstill on debt servicing in order to provide the debtor with a breathing space from its creditors. The debtor thus has an opportunity to formulate a debt reorganization plan, and equal treatment for creditors is also guaranteed. During the reorganization the debtor is provided with access to the working capital needed for its operations* (98: VIII, IX). This proposal for a statutory approach to deal with external debt problems preceded by several years a very similar proposal by the IMF (in 2002) under the heading, "Sovereign Debt Restructuring Mechanism" in an attempt to compel all commercial creditors to agree on debt restructurings.

Indeed, as early as 1986, the TDR had suggested such a mechanism as part of a solution to the sovereign debt crisis of the 1980s (86: annex to ch. VI). The Report argued that *the lack of a well-articulated, impartial framework for resolving international debt problems creates considerable danger that international debtors will suffer the worst of both possible worlds: they may experience the financial and economic stigma of being judged de facto bankrupt, with all the consequences that entails regarding creditworthiness and future access to financing. At the same time, they are largely without the benefits of receiving the financial relief and financial reorganization that would accompany a de jure bankruptcy handled in a manner similar to chapter 11 of the United States bankruptcy code* (86: 141).

In order *to safeguard debtor countries from the over-reaction of financial markets,* the TDR further proposed the introduction of rules that would allow a debtor country to decide a standstill on its debt repayments when facing *an attack on its currency once its reserves or currency fall below a certain threshold.* This decision should *then be submitted for approval to an independent panel of experts within a specified period* (98: IX). In addition, it proposed that the IMF provide *"lending into arrears", which would require much smaller sums than bailout operations. Such a procedure*, it argued, would not only be *similar to GATT safeguard provisions allowing countries to take emergency actions* in trade matters (01: ch. VI), but it would also be *in entire harmony with the spirit of bankruptcy laws, the binding force of which is recognized by all civilized nations*[4] (98: IX).

However, proposals of this kind *met with strong opposition from some of the major economic powers and market participants, who favoured voluntary arrangements between debtors and creditors*, and *governments in some debtor countries have also been reluctant to back this proposal for fear of impairing their access to international capital markets*. The TDR nevertheless insisted that *without statutory protection for debtors, the balance of power will continue to weigh heavily in favour of creditors* (01: VIII). In the same vein, some years later, it emphasized that *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* (08: XIII).

(b) Official debt relief

With regard to the difficulties of least developed and low-income developing countries in servicing their debts owed to official creditors, the TDR regularly reviewed the terms of debt reorganization by the Paris Club, the institution that handles the rescheduling of official debt owed mainly to OECD countries.[5] As the debt problems of many poor countries persisted, despite frequent adjustments of these terms in the course of the 1980s and 1990s, the TDR over many years advocated greater flexibility in the provision of debt relief provided to individual countries to restore sustainability of their remaining debt. In addition, it called for a widening of the eligibility criteria and a greater degree of concessionality on the remaining debt (88: IX, X and ch. III; 89: VII, X; 91: IV; 93: Part Three; 95: II).

However, it was only in 1996 that the G-8 finally recognized the need for a bolder approach to deal with the debt problems of the low-income countries. This led to the Heavily Indebted Poor Countries (HIPC) Initiative of the IMF and the World Bank, which began implementation in 1996. Although the TDR welcomed this Initiative as a major step forward, the analyses of its results in the subsequent Reports were rather sobering (96: ch. II; 97: II, 50; 06: 53, 54). In the years following the launch of the HIPC Initiative, the TDR became increasingly critical of the slowness of its implementation, the limitations of its coverage and the conditionalities attached to the provision of debt relief (06: ch. II). Moreover, the TDR pointed out that the Initiative ignored the problems of many countries in servicing their increasing debts owed to the multilateral financial institutions (96: ch. II; also 93: X; 95: II). It saw debt relief not only as a solution to a financial problem, but also as an instrument for launching a process of sustained development. It therefore advocated the inclusion in the HIPC of all poor countries, no matter what their level of indebtedness, as well as the provision of debt relief to developing countries that are not eligible under the HIPC initiative but which have an unsustainable level of debt (08: XI: also 99:X).

It took until 2005 before the G-8, in an attempt to give *an additional push to resolve the debt problem of the poorest countries*, announced the Multilateral Debt Relief Initiative (MDRI), whereby multilateral financial institutions undertook to cancel the entire debt of countries that had fulfilled the requirements for full bilateral debt relief under the HIPC Initiative (06: ch. III).

However, in the TDR's assessment, *the sustainability of the external debt situation remains highly vulnerable to shocks, and the fallout of the global economic crisis since 2008 is again impairing their ability to service their external debt without compromising their imports.* TDR 2009 therefore recommended that *a concerted multilateral effort to increase bilateral aid flows* and *a temporary moratorium on official debt repayments* be *integrated into fiscal stimulus packages* undertaken in donor countries (09: VII).

4.4.5 Reform of the exchange-rate system

In light of the shortcomings of prevailing exchange-rate arrangements, there was repeated discussion of the need to fill the institutional gap left by the breakdown of the Bretton Woods system. Various TDRs offered proposals aimed at achieving greater exchange-rate stability and avoiding misalignments that lead to current-account imbalances. In 1984, the TDR recalled that under the Bretton Woods system the *monetary arrangements embodied in the IMF were founded on the principle that exchange rates should not be influenced by speculative pressures. Par values were not to be defended at the cost of unreasonably high unemployment but could be adjusted to correct a fundamental disequilibrium. More important was the determination of the members of the IMF to eschew recourse to exchange rates as an active instrument for obtaining full employment. In brief, the monetary arrangements sought to ensure that exchange rates reflected countries' underlying competitiveness in trade as well as to prevent these rates from being disrupted by private capital movements or "beggar-thy-neighbour" policies* (84: 3). But TDR 1990 also underlined the need to avoid the mistakes of the Bretton Woods regime by providing sufficient flexibility to allow exchange rates to adjust to changes in differentials in inflation and productivity growth (90: 133).

That TDR also suggested that governments should *commit themselves to defend a publicly announced* *pattern of exchange rates, which should be internationally agreed and compatible with high levels of activity and employment* (90:XII). Regarding exchange rates among the major reserve currencies, it specifically recommended an arrangement similar to that practiced at the time in the European Monetary System, with adjustable pegs, predefined obligations and intervention rules. Such a system, the Report added, should be complemented by strengthened multilateral surveillance and coordination of the policies of the major industrialized countries (90: Part Two, ch. I). Noting that there was no serious discussion on how the IMF might help rebuild a stable exchange-rate system among the G-3 currencies, TDR 2001 reiterated these recommendations by endorsing the idea of formally established target zones (01: 66).

Regarding exchange-rate arrangements in developing and emerging economies, TDR 1998 (ch. IV) emphasized that currency stability should not be sacrificed in the interest of free capital mobility. It repeated its earlier recommendations for managed exchange-rate regimes and the role of capital-account management techniques in support of exchange-rate stability. It noted that, if applied unilaterally, *managed exchange-rate regimes are vulnerable to large accumulations of short-term external debt and to other potentially volatile capital inflows. Such regimes are likely to be sustainable only if accompanied by active management of external liabilities, which may often entail recourse to capital controls* (98: X, XI). And even then, the capacity of small and open economies to stabilize their exchange rates are quite limited, especially when, in crisis situations, there is a threat for the currency to depreciate more than desirable for a stable current account (04: ch. IV).

From the perspective of TDR 2001, the 1990s had produced ample evidence that even with the best management of their exchange rates, *developing countries cannot unilaterally ensure appropriate alignment and stability of their exchange rates as long as major reserve currencies are subject to frequent gyrations and misalignments and international capital flows* [are prone] *to large swings beyond the control of recipient countries* (01: VII, VIII).

In 2004, the TDR recalled that one condition for successful integration of developing countries into the world economy is that those countries should be *able to manage their exchange rates in a way that allows them not only to sustain competitive rates over the longer term, but also to retain enough policy space to be able to make orderly adjustments when faced with exogenous shocks* (04: VII). On the other hand, *attempts by many countries to keep their currencies at an undervalued rate may end up in competitive devaluations, which can be disastrous for the world economy, as the experience of the 1930s has shown* (04: IX). Since exchange-rate movements can affect international trade in a similar way as trade policies, the TDR called for a framework of multilateral oversight and disciplines similar to those governing trade in agreements of the WTO as the most appropriate solution to this problem (04: 132; 07: V; 08: VI).

Based on this line of reasoning, it proposed the creation of a multilaterally agreed framework for exchange-rate management that would focus on stability of the real exchange rate at a level that is consistent with a sustainable current-account position. The pattern of nominal exchange rates would, in principle, be determined according to purchasing power parities. Subsequently, nominal exchange rates would be systematically adjusted according to differentials in unit labour costs or central bank interest rates (11: ch. VI). The TDR based this concept on the precedents of the Bretton Woods system and the European Monetary System, where *the implicit rule was that the exchange rate of a national currency with the international currency was determined by the purchasing power of that currency expressed in all other currencies*. It acknowledged that *this rule may be difficult to introduce at the time the system starts, because of the problem of determining the initial purchasing power parities of each currency, but it would be straightforward and simple once the system is on track.* It also recognized that *some additional criteria may need to be applied that reflect structural features related to the level of development of different countries* (09: XII).

Such a multilateral system, the TDR argued, would

- Curb speculation and destabilizing capital flows at their source, because the main trigger for currency speculation is the inflation and interest rate differential. Higher inflation and higher interest rates would be compensated by a devaluation of nominal exchange rates, thereby reducing the scope for gains from carry trade.
- Help prevent fundamental and long-lasting trade imbalances and subsequent debt traps for

developing countries, as real exchange rates would be more stable.

- Imply symmetric intervention by countries facing strong depreciation pressure and those facing the corresponding appreciation pressure. Countries would automatically receive financial assistance through swap agreements or through symmetric intervention.
- Reduce the need to hold international reserves to defend exchange rates, and this could be combined with a stronger role for special drawing rights (SDR) if allocations were made according to a country's need for international liquidity to stabilize its real exchange rate at a multilaterally agreed level.

Such a system would be able to achieve sufficient stability of the real exchange rate to enhance international trade and facilitate decision-making on fixed investment in the tradable sector; and it would be sufficiently flexible to accommodate differences in the evolution of interest rates across countries.

4.5 Coherence in global governance

The counterpart to the concept of interdependence as an analytical approach is the notion of coherence. It relates to:

- Coherence in the design of national policies across countries, which requires coordination of national macroeconomic policies and international policy surveillance (section 4.4.1 above);
- Consistency between national policies and international arrangements, especially with regard to trade relations (sections 4.2.1 and 4.2.2); and
- Coherence in the assignments and performances of international institutions, especially with regard to trade, on the one hand, and monetary and financial relations on the other.

With regard to the notion of a "global partnership for development" and coherence in development policy, TDR 2004 noted that *a feasible development agenda requires a more complex analytical and policy framework than that offered by the 'openness model'. A fundamental question is how to reinforce coherence between national development strategies and global processes and disciplines, as well as policy coherence among and within the various sectors of the global economy that impact on development prospects of developing countries* (04: VI and ch. IV).

In this context, the TDR has frequently raised the issue of the loss of policy space for governments of developing countries in pursuing their national development strategies. To the extent that such loss results from international commitments made in the area of trade, TDR 2006 pointed to an asymmetry in their effect on countries at different stages of development as *multilateral rules and commitments governing international economic relations are, in legal terms, equally binding on all participants, but in economic terms they are biased towards an accommodation of the requirements of the developed countries*. Therefore *an appropriate balance between national policy space and international disciplines and commitments requires strengthening the development dimension in the multilateral trading system* (06: XX).

Regarding coherence in the operation of international institutions, the TDR reckoned, as early as 1988, that *if market forces are to operate effectively in international trade, a greater degree of international monetary and financial cooperation will be required* because of the impact on trade relations of *speculative behaviour on foreign exchange and other financial markets* (88: I, XIV). Especially wide fluctuations of exchange rates that have characterized the world economy since the mid-1970s *lent support to the notion that exchange rate instability has a ratchet effect on protectionism* (88: XIV). Six years later, the Marrakech Declaration[6] indeed emphasized the need for greater global coherence of policies in the fields of trade, money and finance. However, subsequently no major reforms were undertaken in this regard. This caused TDR 2004 to reiterate that *existing modalities in the multilateral trading system do not address the problems of trade performance that originate in the monetary and financial system. There are no mechanisms under the existing system of global economic governance for dispute settlement or redress regarding these impulses*.

As a possible solution, the TDR proposed for the trading regime, *a review of the balance-of-payments provisions of the GATT* (04: IX). But it also pointed to another asymmetry in global economic governance, namely that, *contrary to the existing institutional structure in international trade, current international monetary and financial arrangements are not organized around a multilateral rules-based system that applies a specific set of core principles to all participants. This asymmetry has particularly strong adverse impacts on developing countries, because self-centred national monetary and financial policies can have much more damaging effects than those caused by trade and trade-related policies* (06: XX).

Thus, in qualitative terms, and from the perspective of development, the scope of multilateral disciplines in the current pattern of global economic governance appears to be too narrow in the area of international monetary and financial relations, but may well be too broad in the area of international trade. This is so because the rapid pace of globalization in monetary and financial relationships has not been accompanied by an equally rapid change in multilateral monetary and financial rules and disciplines (06: XX). The introduction of multilaterally agreed rules for exchange-rate management, as proposed in recent TDRs would thus help to strengthen coherence between the international trading system and the international monetary system.

Given the problems created by unstable commodity prices for capital formation and diversification in commodity-dependent economies, the TDR also suggested that *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* (08: IV, V).

Another aspect of coherence in global governance is the influence of countries at different stages of development. The governance arrangements in the international financial institutions still reflect, for most part, the constellation in the world economy of the early 1950s. This is why, since the beginning of the new millennium, the TDR has strongly supported the claims of developing countries for *much greater collective influence in the multilateral financial institutions and on their decision-making practices.* However, as consensus has often been lacking among these countries on several issues of the reform agenda, it also stressed that *effective reform of the international monetary and financial system will ultimately depend on the willingness of developing countries to organize their efforts around common objectives* (01: X).