II. Coherence in global policymaking: Multilateralism at a crossroads

A. Systemic imbalances in global finance and a new mercantilism

56. Companies gaining market shares at the expense of other companies are an essential ingredient of the market system, but the idea of nations gaining at the expense of other nations is much more problematic. All countries can simultaneously raise productivity and wages and the level of trade to improve their overall economic welfare, but they cannot all together increase their market share or their current account surpluses.

57. It is thus worrisome that many important players in the global economy are engaging in a race to the bottom in an attempt to gain market shares. Until now, the international community has not been able to agree on rules that could prevent "economic battles of nations", despite the fact that they are counterproductive in the long term.

58. This has brought into focus a phenomenon that could be termed the "new mercantilism". It is not only wages and social contributions that are under downward pressure to improve the "international competitiveness" of a country. Many Governments in Europe, for example, have been reducing corporate taxation and have granted generous subsidies to companies in an attempt to attract them. In the same way as a regional entity such as the European Union or a global sectoral institution such as WTO has tried to prevent this kind of unbridled competition that is attractive for the single player but cannot be successful for the area as a whole, the world has to find ways to limit such unproductive competition of nations.

59. The extraordinary deficit in the current account of the United States (more than $850 billion in 2006) and the surplus of several developed countries and China testify to the unsettled state of the global integration process. This situation is leading to increasing political pressure within the United States Congress to act unilaterally to protect the country from becoming swamped by imported goods. Paradoxically, despite much tension and negotiations, no decisive action plan has been launched to reduce the imbalances in the medium or long term. Diverse attempts to alter the course of currency markets ended in some changes in the real exchange rates of the countries involved, but most of these changes did not lead to the expected outcome.

60. Most of the financial crises in the post-Bretton Woods era of floating exchange rates have been characterized by nominal interest rate differentials and the resulting portfolio investment. As a rule, the quantity of inflows is big enough to increase the short-term attractiveness of the high-inflation country's currency, resulting in appreciation, which further raises the return on investment.

61. In what is a clear systemic failure, a revaluation of the currency of the higher-inflation country fundamentally undermines the normal functioning of the "exchange rate mechanism" in the short term. The high-inflation country's higher prices on the world market are not offset by a nominal depreciation, and the appreciation adds to the loss of competitiveness of that country and worsens the current account situation rapidly.

62. If exchange rates do not follow the purchasing power rule in the short term and destabilize the external accounts, the introduction of this rule as a political target is

the only way out. The presence of carry trade brings into question the widespread acceptance of floating as the only feasible solution to the problem of the external balance. Thus, the pressure on China to float its currency may actually end up with unexpected results. As China's interest rates are still rather low the renmimbi could be carried to high-interest-rate locations, and it would then depreciate and further increase China's competitiveness.. Such an outcome would accentuate global imbalances.

B. The case for a multilateral effort in global finance

63. For small open economies, and developing countries in particular, a stable and prospering external sector is of enormous importance. That is why the exchange rate is the single most influential price in these economies, as it dominates overall competitiveness and has a strong impact on the national price level. To avoid the fight for market shares through manipulation of the exchange rate, wage rates, taxes or subsidies, and to prevent the financial markets from driving the competitive positions of nations in the wrong direction, a new "code of conduct" is needed regarding the overall competitiveness of nations.

64. Such a code of conduct, reflecting a new spirit of multilateralism in global economic governance, would have to balance the advantages of one country against the disadvantages of other directly or indirectly affected countries. For example, changes in the nominal exchange rate deviating from the fundamentals (inflation differentials) affect international trade in exactly the same way as changes in tariffs and export bounties do. Consequently, such real exchange rate changes have to be subject to multilateral oversight and negotiations. The reasons for the deviation from the fundamentals and the necessary dimension of the deviation have to be identified by an international institution and have to be enforced by a multilateral decision-making body. Only if such rules apply can all trading parties avoid unjustified overall losses or gains of competitiveness and developing countries systematically avoid the trap of overvaluation that has been one of the most important impediments to prosperity in the past.

65. The exchange rate of any country is, by definition, a multilateral phenomenon, and any rate change in open economies produces externalities and multilateral repercussions. That is why the idea of a cooperative global monetary system is as compelling as the idea of a multilateral trading system. In the same way as intended by multilateral trade rules, a well-designed global financial system has to create equal conditions for all parties involved and help to avoid unfair competition. Avoiding competitive depreciations and other monetary distortions that have negative effects on the functioning of the international trading system is more important in today's highly interdependent world than at any other time in history.

66. With respect to their external financing needs, developing countries can be divided into two groups: low-income countries (and some lower-middle-income countries) with limited or no financial market access, and middle-income countries with market access (often referred to as emerging market countries). These two groups of countries face different challenges. Most of the external finance that flows to the first group consists of concessional loans, grants and official development assistance (ODA). The main challenge for these countries is to mobilize adequate financing to sustain development and poverty-reduction programmes. The second group of countries, however, can issue sovereign bonds in the international markets,

and many can increasingly resort to their own developing domestic financial markets. In this case, the main challenge is to either reduce the high volatility that characterizes private capital flows to these countries or implement policies aimed at reducing the costs of this high volatility. For both groups to obtain the financing, they need to sustain growth or prevent erosion of recent achievements. Multilateral cooperation is more necessary than ever, be it for moral, political or financial coherence imperatives.

C. Sustainable financing for sustained development

67. The second half of the 1990s was characterized by declining ODA, but this situation was reversed in 2002, and by 2005 ODA from donors from the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) had risen to $82 billion (0.33 per cent of gross national income (GNI) of developed countries). Despite this recent trend, which was spurred by debt relief and other exceptional flows, the current and projected levels of ODA still fall short of the G-8 pledge to double aid to Africa by 2010, and donor countries as a group are still committing less than the agreed target of 0.7 per cent of GNI to aid. Notwithstanding the inconclusive evidence and arguments presented by aid sceptics as to the necessity and impact of ODA, for many least developed and low-income countries, ODA remains the only source of financing for a range of developmental and poverty-reduction policies and programmes.

68. Aid allocation, however, continues to be characterized by selectivity and instability. The top 20 aid recipients received more than half of net bilateral ODA, and less than 50 per cent of aid recipients received 90 per cent of all aid, with many poor low-income countries receiving very little assistance. A large part of the recent increase in aid was due to debt relief under the Heavily Indebted Poor Country (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI). Debt forgiveness represented 5 per cent of overall ODA flows in 1990, whereas in 2006 they stood at 30 per cent. A key component of the HIPC initiative upon establishment in 1996 was the notion of additionality. However, ODA less debt forgiveness declined from the start of the initiative to its lowest level in 1997, and only since 2003 has nominal ODA less debt forgiveness risen above the 1995 value to levels comparable to those in the early 1990s.

69. The fact that several developing countries have become lenders in the international capital markets reflects deeper inconsistencies in the current structure of the international financial architecture. Many middle-income and developing countries maintain undervalued exchange rates and accumulate international reserves because they want to be able to face potential crises without requiring support from or having to comply with policy conditionality by the international financial institutions. Hence, the mandates and the functionality of these institutions are subject to sustained scrutiny, as they risk marginalization, since major developing countries are making do without them, either by self-insuring or by proposing alternative institutions.

70. Reforming existing institutions in line with new realities and building consensus on crisis prevention mechanisms (such as debt sustainability analysis) and crisis resolution mechanisms (such as debt restructuring) could help in improving the efficiency and universal credibility of the international financial

system. Donors can play a major role in helping developing countries improve their debt management capabilities and also their capacity to record and disseminate information on the structure of total public debt.

71. Over the last few years, the IMF has developed the debt sustainability framework (DSF) for middle-income market-access countries and the IMF and World Bank have jointly developed a DSF for low-income countries. While the main objective of the DSF for market-access countries is to examine vulnerabilities and devise policies aimed at reducing the probability of a debt crisis, the DSF for low-income countries is also aimed at guiding IDA grant-allocation decisions. Although the increasing importance of domestic borrowing is often recognized, most debt sustainability analyses concentrate on external debt. An aggregate debt ratio where "riskier" types of debt have a higher weight than safer types would be superior to the current practice. Better information on debt structure and more research on vulnerabilities arising from different types of debt could help in designing such an indicator. This would in turn improve debt management and reduce the probability of debt crises through better tracking of debt risks.

72. The most important issue with the DSF for low-income countries has to do with its use of debt thresholds aimed at measuring a country's risk of debt distress and determining eligibility for IDA grants. According to the Framework, debt sustainability is driven by a combination of the country's debt ratios and the quality of its policies (as measured by the Country Policy and Institutional Assessment index, CPIA). Several concerns remain with respect to the use of the CPIA index. The thresholds are calculated by using an econometric exercise that may lead to sub-optimal outcomes, as the borrowing capacity of those at the top of each CPIA category may be underestimated and those at the bottom may be overestimated. The concept of good governance and institutions is inherently subjective and, since the World Bank is also making recommendations on issues of governance, the index may reflect how well countries are implementing that advice. Another concern pertains to the accuracy of the measure and the consistency with which it is measured across countries, and it may not offer the proper incentives and rewards for low performers and fragile states.

73. Furthermore, the DSF is based on the primacy of debt servicing and does not explicitly include an evaluation of needs in respect of reaching the MDGs. As stated in the United Nations Secretary-General's follow-up Report to the Millennium Summit: "… we should redefine debt sustainability as the level of debt that allows a country to achieve the MDGs and reach 2015 without an increase in debt ratios." Other considerations have also been cited, for example by the United Nations Commission on Human Rights, which is drafting guidelines for external debt relief to ensure that the need to service foreign debt does not undermine obligations for realization of fundamental economic, social and cultural rights. Meanwhile, the growing legal and political interest in concepts such as odious debt and responsible lending adds yet another dimension to the concept of debt sustainability and its applicability as currently defined.

74. Another important trend in development finance relates to the increasing importance of corporate versus sovereign borrowing. In 1996, only 20 per cent of long-term external debt was owed by private borrowers. In 2006 that share had doubled to 41 per cent. The increase in corporate borrowing has been especially important in Eastern Europe and Central Asia. In 2006, firms from this region

contracted new debt for $135 billion and they accounted for 40 per cent of total corporate debt of developing countries, up from an average of 19 per cent over the period 1996-2003. East Europe and Central Asia is the region with the highest external debt ratio and accounts for over a third of the global debt stock of developing and transition economies. Of long-term debt ($743 billion), 89 per cent was owed to private creditors and 63 per cent was held by private borrowers.

75. The accumulation of foreign exchange reserves (reaching $522 billion in 2006) has put the countries in the region in a relatively safe position in case of future financial or debt stress. Nevertheless, by relying more on the international markets, corporate borrowers may have increased their exposure to interest rate and currency risk, and this exposure raises several policy challenges. The most important among these is to assess the public sector's contingent liabilities arising from private sector borrowing. Governments need to pay particular attention to the rapid increase in foreign currency borrowing by domestic banks. Although there are no indications that the banking sector as a whole has over-borrowed in recent years, some banks in Eastern European and Central Asian countries have borrowed heavily in international capital markets and on-lent those funds in the domestic market. This could lead to currency mismatches either in the banks or in the ultimate borrowers' balance sheets and thus increase financial fragility.

76. The international community will come together in Doha in 2008 to review the implementation of the range of commitments made in the areas of finance, trade and investment in the Monterrey Consensus. This should result in greater attention to the important interplay between external debt and other, new elements of strengthened financial policy space for developing countries. A major objective of an international financial architecture better adapted to the realities of the new century should be the development of safer debt instruments (such as GDP-indexed and commodity-indexed bonds). Multilateral institutions could play a role through policy advice and by promoting the coordinated issuance of such instruments by a number of countries to provide benchmarking. Multilateral development banks could issue loans with repayment schedules linked to GDP growth as a way of promoting the idea of indexing debt payments to economic performance. The structure of the new financial architecture should focus on crisis prevention but should not rule out that even an improved system would not be crisis-free and hence should also include mechanisms for crisis resolution along the lines of the now defunct proposal for a sovereign default restructuring mechanism.

D. Redressing asymmetries in the multilateral trading system

1. Doha at the crossroads

77. At a multilateral level, the Doha Round of WTO trade negotiations launched in November 2001 was intended to offer an opportunity to mainstream development into the multilateral trading system and to correct existing imbalances in the trading regime. A development-oriented outcome is imperative for realizing Millennium Development Goal 8 of "an open, equitable, rule-based, predictable and non-discriminatory" multilateral trading system. Today, however, the system stands at a crossroads.

78. Following the Sixth WTO Ministerial Conference in December 2005 in Hong Kong, China, the Doha Round has entered its most crucial phase. There is an urgent

need to find solutions on key issues, namely agricultural market access, domestic support in agriculture, industrial tariffs and services. Ambitious structural adjustment in agricultural policy is important to enable a balanced and development-focused outcome. It remains imperative that substantial development content with additional commercial opportunities for developing countries be included on a contractual basis in the final outcome of the Doha Round. Five key elements of a development package must be delivered to ensure the credibility of the system:

(a) Firstly, the Doha Round must result in significantly enhanced and additional real market access and entry for developing countries' exports of manufactured goods, commodities and services in their major markets so as to enable them to grow and prosper. This implies tariff elimination, removal of tariff escalation and peaks, and providing access in services sectors engaged in by developing countries, especially in modes 4 and 1, and addressing non tariff barriers. The provision of duty-free and quota-free treatment to all LDCs for all their products on a lasting basis, as agreed at the Sixth WTO Ministerial Conference, and which remains to be implemented fully, is symbolic of this emphasis;

(b) Secondly, the Doha Round should bring about improvements in multilateral rules that address and remove existing asymmetries and enhance the fairness and equity of the multilateral trading system. Substantially reducing and removing trade-distorting agricultural subsidies is indispensable for levelling the playing field for fair competition in agricultural trade. An appropriate pacing and sequencing of market opening, as well as institutional and regulatory reform, are also important, particularly on services, accompanied by flanking policies and support for building domestic supply capacity;

(c) Thirdly, the development dimension signifies an adequate and sufficient degree of policy autonomy for economic governance that would allow countries to effectively manage and regulate their domestic economic policies in the light of national development and public policy objectives, within the multilateral framework of rights and obligations under WTO. This translates into such measures as more operational special and differential treatment and less than full reciprocity; preserving tariff revenue; promoting domestic nascent industries and pre-empting de-industrialization; preserving long-standing trade preferences; safeguarding food security, livelihood security and rural development; providing for use of policies and measures to foster commodity sector production, diversification and competitiveness; universal access to essential and infrastructure services; access to essential drugs; implementation-related issues; and concerns of small and vulnerable economies;

(d) Fourthly, development solidarity is required from the international community for developing countries for undertaking adjustment and meeting implementation costs, building trade-related infrastructure, and supplying capacity-building for taking advantage of trade opportunities. In this context, Aid for Trade is an essential complement to trade liberalization in the trading system. If it provides for additional aid, it can play an important role – along with improved market access, balanced rules and sound domestic policies – in helping developing countries realize sustained gains from trade;

(e) Fifthly, it is important to ensure coherence and a positive interface between regional trade agreements (RTAs) and the multilateral trading system. In respect of the never-ending tide of regionalism, robust progress in and a successful conclusion to the Doha Round is the best guarantee against the continuing erosion of the multilateral system. Specifically, the WTO rules on RTAs, under negotiation in the Doha negotiations, need clarification and improvement so as to improve compliance and better take into account developmental aspects of RTAs.

79. The universality of WTO membership is essential for the legitimacy and governance of the trading system. Accession of 29 developing countries and countries with economies in transition is thus a systemic priority. However, experience has shown that relatively deep liberalization and stringent reform commitments, including WTO-plus commitments, have been requested from acceding developing countries. It is crucial to ensure fair and equitable terms of accession commensurate with the acceding country's trade, financial and development needs, and provision of increased support in all stages of the accession negotiations.

80. A notable trend in the international trading system is that, with the decline in tariffs as a result of eight multilateral trade negotiations, the relative importance of non-tariff barriers has risen, both as instruments of protection and for regulating trade. The nature of the non-tariff barriers most applied has also changed: measures intended to protect local consumers have increased, while measures meant to protect local producers have declined. In many developed countries, regulatory policy now focuses on protection of the environment, public health and safety, and often includes higher standards for the domestic market than existing international standards. While these regulations do not contravene WTO rules directly, they open avenues for protectionist abuse and also entail greater compliance costs than would otherwise be the case.

2. Proliferation of regional integration agreements

81. Another notable feature of the international trading system is the worldwide proliferation of regional integration initiatives, in particular RTAs. The number of operational RTAs, whether South–South, North–North or North–South, is expected to grow to 400 by 2010. Currently, trade between RTA partners accounts for nearly 45 per cent of global merchandise trade. Given the growing number, membership and trade coverage of RTAs, their impact on the international trading system will be significant. Careful attention needs to be paid to the scope of such agreements and their development impact on developing countries, especially the tendency towards deeper liberalization, a WTO-plus agenda, and an inward-looking approach that hampers trade with third parties and undermines the multilateral trading system.

82. When properly managed, regional cooperation can offer another avenue to protect the weakest participants against unfettered market forces and unpredictable shocks. Regional liberalization cannot be expected to deliver substantial development gains by itself, but it can support innovative approaches by extending cooperation to common or well-coordinated policies in the monetary and financial area, industrial development, infrastructure and employment. Effective cooperation on these fronts could not only enhance developing countries' output growth and trading capacities, but also strengthen their influence on global economic governance.

83. The close association between regionalization and industrialization in Western Europe and East Asia has often been cited as part of a virtuous development path. In this respect, the European Union is an excellent example of regional cooperation for other regions. It holds certain lessons in terms of institution building and the development of common policy approaches that can usefully inform formal cooperation among developing countries. On the other hand, the regional integration experience in East Asia, which has taken place without formally agreed policy cooperation, provides a lesson of growth and structural change at the regional level, which can be helpful in identifying the real driving forces behind economic dynamics.