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Chapter 1

Globalization at a crossroads: key challenges for the twenty-first century

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1.1 INTRODUCTION

The global economic crisis of 2008-2009 exposed systemic failures in the workings of financial markets and major deficiencies at the core of economic policymaking. The rapid spread of the financial fallout in the United States throughout nearly the entire world, affecting jobs and livelihoods, underscored the interconnectedness of the global economy. The ongoing sovereign debt crises in Europe and the political wrangling over the public debt ceiling in the United States, similarly had ripple effects worldwide as visible in the turmoil in financial and currency markets during 2011 and 2012, severely complicating the economic recovery.

The economic and financial crisis came on top of several other crises. Skyrocketing but highly volatile world food and energy prices reflected a decades-long neglect of food agriculture and failure to reign in increasingly speculative energy markets. These crises, though having different root causes, have become closely intertwined with financial market volatility. Climate change is a symptom of the environmental crisis the world is facing. Its consequences are being felt in many parts of the world in the form of more frequent and severe droughts and excessive rainfall; its effects are compounding the other crises. These multiple dramas have unfolded simultaneously and have also exposed major weaknesses in the mechanisms of global governance, which seem inadequately designed to face up to these challenges.

While the strong desire for quick economic recovery is understandable, getting “back on track” would mean returning to an unsustainable path of global development. Sustained and widespread future prosperity will require major reforms in global economic governance and new thinking about global economic development. A central concern of the new thinking will be the need for a focus on sustainable development—entailing an approach that would balance material wealth improvements with protection of the natural environment and ensure social equity and justice—rather than a focus narrowly concentrated on economic growth and private wealth generation based on market incentives.

Global solutions will be required to deal with the global nature of the problems and, given the interdependence of these problems, policy responses will need to be highly coherent at various levels if the international community is to achieve the multiple objectives associated with fair and sustainable global development.

1.2 “THE TIMES THEY ARE A-CHANGIN’...”

The present challenges emerge at a time that may well represent a watershed in history. Four major changes in the global economy are likely to be dominant in the foreseeable future.

Changing power balance and inequality

First, there are important shifts taking place in the global economy with important implications for the balance of power in the world and global inequality. The rapid growth in developing Asia that is shifting the balance of global economic power is likely to continue (figure 1.1). At the same time, while quite a few developing countries (mostly in Asia) have experienced a significant “convergence” towards the living standards of the now advanced countries, others, especially in Africa, have fallen farther behind even despite relatively robust growth during the 2000s (figure 1.2).

As a result of strong growth performance in parts of the developing world, the number of the poor in the world living on less than \$1.25 a day decreased from 1.8 billion in 1990 to 1.3 billion in 2008, but nearly all of this reduction was concentrated in China. In sub-Saharan Africa, the absolute number of poor increased. At the same time, with few exceptions, income inequalities within countries have increased since the early 1980s.² Redressing this trend in global economic divergence, so as to prevent its

Figure 1.1
Shifting global economic power, 1950-2008

Figure 1.2
Persisting global income divergence, 1950-2007

becoming a source of new tensions and insecurity, will be a major challenge in the decades ahead.

Shifting demographics

Second, demographic changes in the coming decades will strongly influence increasing global interdependence. Currently, about 78 million people are added to the world's population every year. This means that, by 2050, the global economy would need to be able to provide a decent living for more than 9 billion people, of which 85 per cent will be living in what are now developing countries. Africa will account for about half of the absolute increase in population between 2010 and 2050 and be home to nearly one quarter of the world population by 2050 at present trends.

Progress in human development worldwide has helped to drastically reduce mortality rates and allow people to live longer. As a result, the world population is ageing rapidly. By 2050, one in three persons living in developed countries and one in five in what are now developing countries will be over 65 years of age. This will put pressure on pension and health systems. Further, the presence of declining and ageing populations in developed regions may result in much larger migration flows than occur today.

Developing countries will have to adapt to growing urban populations. By 2050, 70 per cent of the world's population is projected to live in urban areas and megacities and undergoing further growth will create problems of their own.³ This will make the creation of a sufficient number of decent jobs more challenging and, if the challenge is left unaddressed, persistent widespread poverty and inequality among urban-dwellers will be sources of social and political instability. It will also put increased pressure on education systems, not only to provide quality education to increasing urban youth, but also to prepare them better for changing requirements of more knowledge based societies while economic policies should be concerned not only with enabling sufficient job creation but also with the quality of those jobs. Vast and persistent youth unemployment, including among the better educated, now observed in many parts of the world may prove political and economic bombshells as witnessed, for instance, in the Arab world during 2010-2012.

Larger urban populations will also change food and land-use patterns, a fact with potentially vast implications. Rising incomes and continued population growth have not only raised food demand, but also altered dietary patterns. This is reflected in increased per capita meat consumption, which has risen by about a quarter over the past decade. While meat is an

important source of protein, under existing production conditions, higher demand would lead to land-use shifts and further deforestation, higher energy use, rising food prices and regional food shortages. Because of rising incomes and spreading urbanization, per capita meat consumption increased from 34 to 43 kilograms between 1992 and 2010. Nearly all of this increase can be attributed to growing demand in Asia, and, to a lesser extent, Latin America. Combined with the growing world population, changing dietary patterns imply that food production needs to roughly double by 2050. Although, global food production has increased at a faster pace (about 45 per cent) than population (about 23 per cent), it has barely kept up with food demand and unequal distribution of the increased food availability was still leaving about 870 million people undernourished worldwide in 2010-12 (FAO, 2012). At the same time, however, almost one quarter of the world population was considered overweight or obese. Most people (65 per cent) live in countries where overweight is a bigger killer than undernourishment.⁴ Through its association with sharp increases in the prevalence of chronic diseases, like diabetes and cardio-vascular ailments, unhealthy food patterns are also pushing up health costs in developed and developing countries alike.

Hitting on environmental limits

Third, the growing world population and income have been supported in part by the degradation of our natural environment. Almost one half of the forests that covered the Earth are gone,⁵ groundwater sources are rapidly being depleted, enormous reductions in biodiversity have already taken place⁶ and, through the burning of fossil fuels, about 30 billion tons of carbon dioxide are currently being emitted each year.

All of these changes continue to take place at an accelerated pace. Growth of the world population, per capita income, energy and resource use, waste and the production of pollutants (including greenhouse gas emissions) have all increased exponentially since the first industrial revolution. A depiction of these increases assumes the shape of a hockey stick (figures 1.3a-d). The related increase in the level of human activity is threatening to surpass the limits of the Earth's capacity as a source and sink.

At present, 90 per cent of energy is generated through brown technologies that utilize fossil fuels, with this type of production being responsible for about 60 per cent of carbon dioxide (CO₂) emissions. According to the more cautious scenario (and with a probability greater than 50 per cent), for CO₂ equivalent concentrations to be stabilized at 450 parts per million

Figure 1.3a
Growth of world population, 1750-2039

Source: United Nations (2011b), based on data of United Nations Population Division.

Figure 1.3b
Exponential growth of world per capita income, 1820-2008

Source: United Nations (2011b: figure O1b), based on Angus Maddison, Historical Statistics of the World Economy 1-2008 AD.

Figure 1.3c
Rise in energy consumption since the first industrial revolution, 1850-2000

Source: United Nations (2009b: figure 2.4).

Figure 1.3d
Exponential rise in atmospheric carbon dioxide concentration, 1820-2010

Source: United Nations (2011b), based on Carbon Dioxide Information Analysis Center (CDIAC) online (<http://cdiac.esd.ornl.gov>).

(consistent with the target of stabilizing global warming at a 2° C temperature increase from pre-industrial levels), the use of fossil fuels would need to drop by 80 per cent by mid-century. At the same time, 1.4 billion people are “energy-poor”, that is, lacking access to forms of modern energy (electricity in particular), which in turn is hampering their economic opportunities and options to emerge from income poverty.

Modern agriculture, which underpins global food security, currently contributes about 14 per cent of greenhouse gas emissions, and the land-use and water management related thereto are not sustainable in many parts of the world. Deforestation is contributing an estimated 17 per cent of global emissions, while causing the loss of habitat, species and biodiversity in general.

The incidence of natural disasters has increased fivefold since the 1970s. This increase can, with a fair degree of certainty, be attributed in part to climate change induced by human activity. Deforestation, degradation of natural coastal protection and poor infrastructure have increased the likelihood that weather shocks will turn into human disasters, especially in the least developed countries.

Continuation along previously trodden economic growth pathways will further exacerbate the pressures exerted on the world’s resources and natural environment, approaching limits where livelihoods are no longer sustainable. Thus, business as usual is not an option. Even if we were to stop the global engines of growth, the depletion and pollution of our natural environment would continue because of existing consumption patterns and production methods. In fact, more economic growth, food production and modern energy generation are needed to address still-widespread poverty and ease pressures from ageing populations, among other challenges. Hence there is an urgent need to find new development pathways which would ensure environmental sustainability and reverse ecological destruction, while managing to provide, now and in the future, a decent livelihood for all of humankind.

Changing reality, stagnant governance

Fourth, economic processes are increasingly interconnected at the global level. More and more, both agricultural and industrial production take place through largely unregulated global value chains dominated by international companies. The global crisis of 2008-2009 and its aftermath have made clear how interconnected financial markets are and how quickly problems in one

part of the system can cause shock waves elsewhere. Climate change and increasing migratory flows are challenges with global ramifications. Yet, the policies, rules and institutions established to govern these processes are mostly national, while global mechanisms are strongly compartmentalized. Without reform, tensions will grow between decision-making processes at the national level and those at the global level. The question is how to reform the institutions responsible for global governance so as to make them better equipped to address these challenges coherently while allowing nations and their people to have the necessary space to determine their own destinies.

1.3 MULTIPLE CRISES, GROWING INTERDEPENDENCIES

The simultaneous occurrence of a financial and economic crisis, persistent food and energy insecurity, and the emerging environmental crisis is no coincidence. The pattern of globalization of the past decades has fortified the interdependencies of the major underlying factors that have led to these multiple crises.

Unleashing global finance

The 2008-2009 global financial crisis emerged on the back of an intrinsically unsustainable global growth pattern. This pattern was characterized by strong consumer demand in the United States, funded by easy credit and booming housing prices. Far-reaching financial deregulation facilitated a massive and unfettered expansion of new financial instruments, such as securitized sub-prime mortgage lending, sold on financial markets worldwide. This pattern of growth enabled strong export growth and booming commodity prices benefiting many developing countries. Growing United States deficits in this period were financed by increasing trade surpluses in China, Japan and other countries accumulating large foreign-exchange reserves and willing to buy dollar-denominated assets, which in turn fuelled mounting global financial imbalances and indebtedness of financial institutions, businesses and households. In some countries, both developed and developing, domestic financial debt has risen four- or fivefold as a share of national income since the early 1980s. This rapid explosion in debt was made possible by the shift from a traditional “buy-and-hold” banking model to a dynamic “originate-to-sell” trading model (or “securitization”). Leverage ratios of some institutions went up to as high as 30, well above the ceiling of 10 generally imposed on deposit banks.

In the context of a highly integrated global economy without adequate regulation and global governance structures, this risky pattern of financial expansion implied that the breakdown in one part of the system thus would also lead to failure elsewhere. It is this systemic failure that was at the root of the Great Recession of 2008-2009. The deleveraging that followed the recent crisis brought down established financial institutions and led to the rapid evaporation of global liquidity directly affecting the real economy in developed countries, while the economies of developing countries were hit through collapsing global trade, plunging commodity prices and reversals of capital flows.

Debt, leverage, collateral value and expected asset prices have become dominant drivers of the global business cycle. The growing “financialization” has exacerbated an already strong pro-cyclical stance of market agents. This behaviour underlies the recurrence of self-inflating bubbles driven by expectations of rising asset prices and by and large detached from improved prospects of real income gains or losses or of the value of the underlying real assets. Intrinsic to financial market behaviour, lenders and investors would tend to underestimate risks in the upswing and overestimate these in the downturn. During the 1990s and 2000s, these attitudes were fortified by the financial innovations in the derivatives markets that promised security against downside risks. This led to ever-stronger fluctuations in asset prices: strong asset inflation and extended financial booms in the upswing and steep asset deflation and financial collapses during the downswing. This was already visible during the crises in emerging markets of the 1990s, and such factors turned a broad-based boom into a worldwide bust at the end of the 2000s. Typically, systemic financial crises are resolved by shifting much of the cost to tax payers and saddling governments with new debt, which then may constrain recovery of output and employment as became evident through the sovereign debt problems in Europe and the United States in the early 2010s.

The shift from an income-constrained to a financial asset-backed economy has been supported by the liberalization of international capital markets. Indeed, the links between domestic financial markets and capital flows are much stronger in developing countries, many of which opened their capital accounts prematurely in the 1990s. These flows have been strongly pro-cyclical. Their effects are often transmitted through public sector accounts, especially through the effects of available financing on government spending and through the effects of interest rates on the public debt service. But the stronger effects typically run through private spending and balance sheets. During booms, private sector deficits and borrowing

tend to rise and risky balance sheets accumulate, riding on perceived success, typically reflected in low risk premia and spreads. Reversals in such perceptions lead to a cut off from external financing and provoke sudden increases in the cost of borrowing, inducing downward adjustment.

The shift towards export-led strategies in the developing world has accentuated this pattern. The growing influence of financial calculation has meant that commodity price volatility operates in an even more exaggerated pro-cyclical manner, which is further amplified by pro-cyclical policies that, among others, expand fiscal expenditures during the boom and reduce spending when prices are down. The latter is reinforced by the conditionality linked to international financial assistance during crises, which involves orthodox, pro-cyclical macroeconomic stabilization policy packages.

These financial dynamics have far-reaching implications for the real economy. Episodes of exceptionally rapid economic expansion driven by financial bubbles can bring periods of growing prosperity, but they can also end very suddenly leading to deep recessions or even longer periods of stagnation. Vulnerability to a sharp reversal of flows varies, but in many emerging markets, it is often triggered by factors beyond the control of recipient countries, including shifts in monetary policies or the bursting of a housing and financial bubble in a major developed economy.

The suggestion that the growth of cross-border financial flows would trigger a greatly improved investment climate is belied by the global trend of weaker capital formation since the 1990s (figure 1.4) and the increased volatility of investment relative to that of output. This applies to both developed and developing countries. Financial booms and crises tend to give rise to lop-sided investment patterns. These investments often involve little more than rearranging existing assets through leveraged buyouts, stock buybacks and mergers and acquisitions, or are in sectors susceptible to speculative influences, such as property markets. Unlike earlier cycles, these booms have delivered few benefits in terms of rising wages and employment. However, increased access of households to credit has meant that consumer spending can increase, even with stagnant incomes, as (rising) levels of indebtedness substitute for (falling) household savings. But as balance sheets adopt smaller margins of safety, the system becomes more and more fragile.

With few exceptions, this heightened volatility has resulted in average rates of capital formation still well below those enjoyed in the 1970s. Infrastructure investment and additional manufacturing capacity appear hardest hit, both critical to improving the resilience of countries against

Figure 1.4
Increasing global financialization, declining fixed investment rate, 1970-2009

external shocks. Moreover, losses of investment, employment and income incurred during recessions are not fully recovered when the economy turns up, pulling down the longer-term average (United Nations 2008; Vos 2010).

The process of financialization has exacerbated business cycle swings through its impact on commodity markets. Even though the precise impact is still subject to debate in the empirical literature, the growing importance of financial investment in commodity futures markets is generally seen to put an upward bias in commodity prices and to exacerbate volatility (see e.g. United Nations 2011a: box II.1; UNCTAD 2011; and United Nations 2012: box II.2). At the same time, this seems to have further strengthened the pro-cyclical co-movement of capital flows to developing countries and international commodity prices (figure 1.5 and Akyüz, 2011).

Exchange rate volatility is further exacerbating commodity price volatility. Most commodity trading is in United States dollars and traders tend to ask for higher prices in case of a depreciation of the world's major reserve currency (figure 1.6). The FAO estimates that for each 1.0 per cent dollar depreciation agricultural commodity prices increase by between 0.3 and 0.8 per cent depending on the commodity (Sarris, 2009). As the dollar

Figure 1.5
Net private capital flows to emerging and developing countries
and global commodity prices, 1998-2011

Source: UNCTAD Statistical database and IMF, World Economic Outlook, database (April 2012).

has been on a downward trend surrounded by substantial volatility, this has strengthened the upward shift in commodity prices since the early 2000s.

After the Asian financial crisis and spurred by export-led growth, developing countries have accumulated vast amounts of foreign-exchange reserves, for an important part to provide stronger buffers (“self-insurance”) against capital flow and commodity price volatility. International reserves held by emerging and other developing countries totalled more than \$7 trillion at the end of 2011, after adding another \$1 trillion in a single year (United Nations, 2012). These buffers indeed have helped many developing countries (but more so for some than others) to steer with some resilience through the 2008-2009 global crisis. At the same time, however, the reserve accumulation by developing countries has been part and parcel of the problem of the global imbalances and helped finance widening deficits in the developed world, the United States in particular. This, in turn has been a factor in the longer-term trend for the dollar to depreciate. The downward trend has been subject to substantial volatility, with periodical upward swings during episodes of financial turmoil when the dollar is sought as

Figure 1.6
International commodity prices (LHS) and the
United States dollar (RHS)^a

Source: UNCTAD Statistical database.

^a Nominal effective exchange rate.

a financial safe haven. When combined with economic slowdowns, as happened in the second half of 2011 and first half of 2012 for instance, a stronger dollar then exacerbates downward pressure on commodity prices and capital outflows from emerging economies.

Emergence of a debt-dependent trading system

Over the past 20 years, the volume of trade has grown on average by 9 per cent per annum with particularly rapid growth in the period 2002-2007, averaging 14.5 per cent per annum and faster still in developing countries. Four significant forces have helped shape the pattern of international trade in this period: the rise of export-orientated industrializing developing countries; the growth of intra-firm trade in global supply chains (itself made possible by new information and communication technologies and expanded capacity and skill in developing countries); rapid trade liberalization for goods and services, embodied in both multilateral and bilateral agreements; and the explosion of unregulated financial flows.

These factors are often treated separately, but in a globalized world they need to be seen as closely interconnected.

At one end of the global supply chains are mostly low-income countries that continue to be highly reliant on more traditional export sectors. Obtaining sustained gains from trade remains a challenge for these countries. In this sense, the contrast between East Asia and other regions is striking. The share of primary products, resource-based and low-technology manufacturing in the total exports of East Asia declined from 76 per cent in 1980 to 35 per cent in 2005. China alone reduced its share from 93 per cent in 1985 to 44 per cent in 2005. Other regions have been less successful in transforming the structure of their production for exports. South American countries still rely on primary products and simple manufactures (around 78 per cent of exports in 2005, down from around 90 per cent in 1983). In Africa, the concentration of exports in low value-added products is even greater (83 per cent in 2005). Volatility in commodity prices strongly influences the business cycle in these countries. Strongly booming world market prices of primary products, especially from 2006, and their subsequent collapse from the start of the global financial crisis, have made this fate once again painfully clear. Figure 1.8 shows that long-term growth rates of countries at the lower end of the global value chain are well below those at the higher end, and hence have been a source of perpetuating global inequality.

Creating more dynamic gains from trade also remains a challenge for many developing countries which did manage to diversify into the exporting of seemingly “high-tech” manufactures. In many cases, however, this apparent switch to high-tech exports hides the fact that many countries are rather engaged in mostly low-tech assembly activities than in the exporting of the final good itself. In many cases, production takes place within enclaves, connected though trade and foreign direct investment (FDI) flows to other parts of a corporate supply chain, but with only limited ties to the domestic economy.

The spread of intra-firm exchanges through global value chains explains much of the indicated growth of world trade, albeit with the final product still destined for a small number of markets, dominated by the United States. However, given that wages have since the 1980s been largely stagnant in the United States and sluggish elsewhere, this growth of trade has coincided with rising levels of household debt and dwindling domestic savings in a number of large industrial economies along with ever-widening global imbalances.⁷

These shifting patterns of international trade have been closely associated with a new global business strategy adopted by many larger firms in the

industrialized countries, which emphasizes a focus on “core competence” and a greater attention to shareholder value (Milberg and Schöller, 2008). This focus has driven firms to break up the production process and take advantage of low-cost offshore production for all but the highest value-added aspects of production. At the extreme this has created manufacturing firms that do no manufacturing at all, such as The Gap or Dell Computers. The focus on shareholder value has meant an increase in the use of profits for dividend payments, stock buybacks and mergers and acquisitions. In this context, offshoring has served the new business model in two ways. First, it has led to cost reductions and thus increased mark-ups over cost, despite the fact that firms face stiff price competition in product markets. Second, by limiting the scope of the firm and especially its domestic operations, offshoring has reduced investment needs, increasing its ability to return value to shareholders. This has supported the “financialization of non-financial corporations” in many industrialized countries, oftentimes at the expense of productive investment, while imports from developing countries were steadily rising. This interplay of financial and corporate dynamics has had far-reaching implications for the real economy, particularly in advanced countries. In many countries, the rise of the financial sector has coincided with the introduction of more flexible hiring practices and less secure employment conditions. Episodes of exceptionally rapid economic expansion driven by speculative financial flows have brought periods of growing prosperity, but have often ended very suddenly in recession or longer periods of slow growth. Moreover, as noted earlier, losses of investment, employment and income incurred during recessions have not fully recovered when the economy turns up. In developing countries, the new business model has provided both new opportunities and risks. By tapping into the global value chain one way or another, they have been able to diversify their economies and trading partners. At the same time, the more flexible business model has made them vulnerable to changes in strategies of multinational companies.

In all, however, the combination of these factors together spell considerable income and job insecurity, even under conditions of relatively strong expansion. A clear sign of this has been the failure in the majority of advanced industrial countries for the growth of labour compensation to keep pace with labour productivity, but the same trend is apparent in emerging markets as well. Increasing income inequality has been the flip side of this development.

Figure 1.7
Export specialization and GDP per capita growth, 1962-2000

Source: United Nations (2006).

Food, energy and climate crises

Growing global interdependencies also have left their imprint in strong and perverse feedback mechanisms that are undermining food and energy security worldwide and have deepened environmental problems. As detailed further in chapter 5 of this volume, the chronic food and nutrition crisis deepened at the start of the twenty-first century, as increasing and volatile food prices and, subsequently, the global recession undermined the food and nutrition security of the poor and threaten their livelihoods. The food security crisis was mainly the consequence of neglect of investment in agriculture in developing countries and inappropriate agriculture energy subsidization policies in developed countries. On balance, global food markets have become increasingly tight. This led to significant price increases during the 2000s and world market prices have become highly volatile because of their sensitivity to supply shocks and the growing influence of financial factors in commodity markets. More intense and more frequent adverse weather events, likely associated with climate change, recurrently cause poor harvests and enhanced price volatility, exacerbated

by the earlier described financialization of commodity markets. Prices of basic grains have been further pushed up by demand for those crops for use in heavily subsidized biofuel production in developed countries (see e.g. Vos, 2009). Stimulus of biofuel production in turn has been a response to the felt need to enhance energy security and substitute fossil fuels for renewable and cleaner primary energy sources. The climate change mitigating effect of biofuel use is being partly offset, however, by modern agriculture's own contribution to greenhouse gas emissions (see above and chapter 6 of this volume), while at the same time affecting food security.

People on the move

An estimated one billion people are considered international or internal migrants.⁸ International migration today affects every region of the world, with South-to-South migration as significant as South-to-North movements. Movements of people can be associated with multiple factors, including the search for better educational and job opportunities and working conditions, flight from poverty, conflict, human rights abuse, hunger, discrimination and environmental degradation and natural disasters. Unless reversed, the mega trends sketched above suggest migratory pressures should be expected to increase substantially moving forward. International migration is bringing benefits to both countries of origin and destination, including remittances, knowledge sharing and mitigation of labour shortages. It also comes with important costs to migrants themselves and the societies they live in, as migrants often face much less secure job situations, discrimination, and less than full access to health, education and other social services, while vast migration inflows has been a source of political and social tensions in many recipient countries.

1.4 SHIFTING DEVELOPMENT PARADIGMS?

Views about what types of international arrangements would best serve global and national development goals have changed with the shifts in the thinking about the factors conducive to growth and development in countries at low levels of development. In the 1950s and 1960s, development had been perceived in terms of a process of economic growth. Lack of capital and lack of industrial and entrepreneurial capacity were seen as major obstacles to growth. To overcome these obstacles, strong government leadership was seen to be critical to steer the development process in the right

direction by conducting the policies and mobilizing the resources needed to lift binding constraints on economic growth. This was to be achieved through, for example, public investments aimed at building infrastructure, trade protection and industrial policies designed to promote import substitution and develop entrepreneurial capacity, and through attracting development assistance in lifting foreign-exchange constraints. In the aftermath of the Great Depression, public management of the economy had emerged as a primary activity of governments, including in the developed countries. Building on Keynesian theoretical insights, Governments made employment, stability and growth important subjects of public policy and took responsibility for assuring their citizens a degree of economic well-being, with such steps leading to the creation of the welfare state. In Europe and Japan, industrial policies were key elements in post-war reconstruction.

The first generation of development economists, many of whom were associated with the United Nations system, such as Paul Rosenstein-Rodan, Michal Kalecki, W. Arthur Lewis, Gunnar Myrdal, Hans Singer, Raúl Prebisch and Jan Tinbergen, likewise thought in terms of broad, integrated macrostrategies (Meier and Seers, eds., 2001) and saw development as a transformational process. Poor countries would need to move away from a dependence on primary exports and the rural economy and develop manufacturing industries in order to foster more dynamic growth processes; major investments in infrastructure and new activities would be needed to create the right initial conditions. To describe the non-marginal changes that would need to occur, these economists used metaphors like the “snowball” (Lewis), the “big push” (Rosenstein-Rodan), “dynamic linkages” (Hirschman) and the “take-off” (Rostow). Different views existed on how best to induce the necessary change, but the dominant one was that the developmental state should be the prime mover.

In the 1950s and 1960s, some modifications to the General Agreement on Tariffs and Trade (GATT) and the International Monetary Fund (IMF) policies aimed at accommodating developing-country interests. In 1955, for example, developing countries were granted special treatment in the GATT, allowing them to protect particular industries and introduce quantitative restrictions so as to address balance-of-payments difficulties. In 1963, the Compensatory Finance Facility was introduced by the IMF for countries suffering sudden shortfalls in export revenues. Rather than facilitate industrial capacity building over the long-run, these exceptions to multilateral trade rules addressed mainly short-term adjustment issues. The European Economic Community also granted trade preferences to

its former colonial territories and set up a fund to offset commodity price fluctuations (Stabex), thereby moving further away from the original GATT principles towards a multiplicity of uncoordinated preference regimes (Toye, 2010).

A number of developing countries managed to successfully navigate their way amid such hurdles in international rules-setting and pragmatically implemented sets of policies promoting modern growth strategies. High rates of economic growth were achieved in large parts of the developing world, sometimes with sustained success, as in parts of Asia. The industrial development that was behind high tariff protection and other Government support also led to substantial average welfare increases in Latin America during the 1950s and 1960s, followed, however, by relative stagnation starting in the 1980s and 1990s. Yet, the many instances of failure to create industries in developing countries that could survive on their own after decades of state support, to effectively overcome foreign-exchange constraints, to generate sufficient employment and to reduce poverty and inequality, led to reassessments of development policies and cooperation. The “basic needs approach to development”, for instance, suggested reorienting Government intervention towards more direct support for employment generation and securing access for all to social services (ILO, 1976). Similar approaches emphasized interventions on behalf of the poor to reduce income inequality and increase gains from aggregate economic growth (Chenery and others, 1974).

Inequities in the rules and mechanisms for global economic governance were seen by some as constituting another key factor accounting for the lack of success of the development effort, which perception led to the struggle in the 1970s for a New International Economic Order (NIEO). Under this banner, there were calls for, *inter alia*, more national policy space for developing countries, regulation of foreign direct investment (FDI), international commodity agreements to protect the purchasing power of developing-country exports, lowering of the costs of technology transfers, more development assistance and greater voting power for developing countries in the multilateral institutions (Jolly and others, 2004). However, none of these proposals would become dominant in actual policy approaches.

In the meantime, significant shifts took place in the global context. The confidence in the dollar's peg to gold ebbed during the late 1960s, with persistent, and widening, United States balance-of-payments deficits and with European countries running increasing surpluses while remaining

reluctant to revalue their exchange rates. This situation also exposed the inherent weakness of a global reserve system effectively linked to the national currency of just one country. The system of fixed exchange rates and capital controls was abandoned, but the dollar standard remained in effect. Exchange rates were allowed to float—or not—by country choice and major countries agreed to hold dollar reserves in the United States.

The lifting of many restrictions on cross-border financial transactions led to a surge in private capital flows, including to developing countries. As real interest rates were low in the period of high inflation of the 1970s, international borrowing from private sources, lending banks in particular, became an attractive external financing option for governments in many developing countries, especially middle-income countries, compared with aid flows and multilateral bank lending which were often subject to restrictive policy conditions. As private capital flows proved strongly procyclical and as borrowing conditions abruptly changed at the end of the 1970s, many developing countries ended up saddled with unserviceable debts. The debt crisis had come to be perceived as another failure in the development effort, reflecting unsound fiscal management and failure to create dynamic export sectors which could have kept debt service-to-export ratios within sustainable bounds.

Influenced by these events, another, diametrically opposite approach—commonly referred to as the “Washington Consensus”, inasmuch as it reflected the policies of the multilateral institutions and decision makers based in Washington, D.C. (Williamson, 1990)—gained prominence in the 1980s and 1990s. It argued for reconsideration altogether of a role for governments in managing economic development for governments were viewed as having distorted markets through their interventions and poor management of public finances. In this context, development policies would need to become more concerned with macroeconomic stability and to rely much more on deregulated markets and private initiative not only in productive activities but also in the provisioning of social services. The market reforms would be conducive to “getting the prices right” and provide the necessary incentives for businesses and households to improve efficiency and invest in a better future. Different levels of success in achieving development were no longer explained by differences in initial conditions, but rather by whether the “right” policies (market-friendly, fiscally sound) or the “wrong” ones (interventionist) had been conducted.

Sustained rapid economic growth in a number of countries in developing Asia was held up in the 1980s and 1990s as exemplifying the success of

the market-oriented, export-led development strategies advocated by the Washington Consensus. In reality, however, the development policies behind these growth successes, especially in their early stages, resembled much more the recipes associated with the dirigiste paradigm of early development thinking and were not unlike the policies that had, in earlier times, promoted modern development in Western Europe and Japan. These development policies involved, *inter alia*, agrarian reforms, investments in human capital, selective trade protection, directed credit and other government support for developing industrial and technological capacity while exposing firms gradually to global competition.

Many other developing countries were strongly hit by the debt crisis and had to turn to the IMF and the World Bank for structural adjustment loans which came attached with strict conditionality regarding fiscal adjustment and the initiation of market-oriented policy reforms. Trade liberalization and capital-account liberalization were key components of the reforms. Together with a further lifting of remaining restrictions on cross-border capital flows, this approach set off a new wave of growth in private capital flows to developing countries and further strengthened the trend towards production within global value chains.

The advance of deregulated financial globalization and the pro-cyclical nature of private capital flows also enhanced the risk of financial crises—crises witnessed by many emerging market economies during the 1990s and early 2000s. As these crises inflicted hardly any hurt on the economies of developed countries, many analysts determined their cause to have been the policy mistakes made by the governments of the (Asian and Latin American) countries affected. The crises served to expose the limited capacity of the IMF to signal the risks whose build-up could lead to financial crises, as well as its limited lending capacity and consequent inability to come to the rescue when a crisis of significant magnitude did strike. Developed-country governments, especially that of the United States, had to contribute resources in an *ad hoc* fashion to make up for this deficiency. Few saw the emerging market crises as evidence of growing systemic risks with potentially global repercussions and of the need for a fundamental reform of the IMF to enable it to fulfil its function as guardian of the financial stability of the global economy (see, for example, De Gregorio and others, 1999). Although the IMF did move to strengthen its early warning information system, little else was done to build in better safeguards against financial crises. In fact, after the Asian crisis of the late 1990s, further measures were taken to liberalize financial sectors worldwide, giving greater scope to

financial innovation and permitting high leverage ratios. Successful Asian exporters with large trade surpluses had already been accumulating dollar reserves on an increasing scale before the financial crises in their region, and continued on an even larger scale thereafter, motivated in part by the desire to provide greater self-insurance against future external shocks and crises. The reserve accumulation undervalued the currencies of the countries concerned, contributing to widening trade deficits in the United States, while at the same time helping to finance those deficits. Asian trade surpluses were thus recycled through the financial system in the United States which recycled portions back again to emerging market economies in the form of cross-border financial investments. This dynamic helped keep inflation and interest rates down worldwide and contributed to strong global growth during much of the 2000s; at the same time, however, it also inflated asset bubbles, induced excessive risk taking in financial sectors and was conducive to widening global imbalances, thereby planting the seeds of the global financial crisis of 2008.

The World Trade Organization (WTO) within which the GATT was subsumed in 1995, became the most substantial addition to the mechanisms of global economic governance during the period of the 1990s. The WTO moved towards setting tighter common rules designed to reduce barriers to international trade. Under the WTO, trade negotiations were broadened to encompass issues of importance to development prospects, such as trade in agricultural products heavily subsidized by developed countries; and some types of industrial policy for development, especially for the poorest countries, were permitted. While the WTO has become a near universal body, negotiations under the so-called Doha Round have stalled not only owing to disagreements over the issue of creating more space for developing countries to enable them to use subsidies and other measures in support of the build-up of their export industries, but also because of the question of how to level the playing field for developing countries in respect of intellectual property rights so as to ease their access to technology, among other controversial areas. Meanwhile, a proliferation of economic partnership agreements and bilateral and regional free trade agreements has been complicating the multilateral trading system and generating inconsistencies, thus making achievement of a fairer trading system all the more challenging.

Adopted at the turn of the new century, the United Nations Millennium Declaration conveyed the rediscovery of the insight that market-based growth strategies were insufficient by themselves to solve the problem of widespread poverty and that well-functioning institutions and effective

social policies were needed to ensure adequate provisioning of health care and education and to prevent the social exclusion of many. The decision to put Poverty Reduction Strategy Papers (PRSPs) at the centre of debt relief initiatives for the poorest countries was a reflection of the same insight. Nonetheless, trade and financial liberalization and fiscal prudence remained central to policy reforms in developing countries and the policy conditionality attached to multilateral lending. Policy shifts were more visible in the social arena, as reflected, *inter alia*, in the human development focus embodied in the Millennium Development Goals (MDGs) that emanated from the Millennium Declaration (see chapter 2 of this volume) and the greater priority in national development policies for education and health spending, the introduction of innovative cash transfer programmes and support for microfinance schemes. Despite the existence of a broader development strategy as embodied in PRSPs, these social policy changes were often not well coordinated with economic policies (see e.g. Gottschalk, 2005; Vos and Cabezas, 2006; and Vos, 2011).

1.5 WHERE DO WE GO FROM HERE?

The experiences of the past decades have shown that there are no simple recipes for development success. Clearly, none of the dominant paradigms within the realm of development thinking that have emerged over time can take credit for having served as a blueprint for successful development. What worked in certain past contexts may not work equally well elsewhere. For one thing, the world has become increasingly integrated and the space available to countries for jump-starting their development in relative isolation has become commensurately smaller. The expanding role of FDI and global value chains in driving world production, trade and technology development has limited the scope for wielding old-style industrial policy instruments by national governments; and multilateral trading rules have imposed restrictions on domestic support measures for developing export industries. Further, freely flowing private capital flows have made macroeconomic stabilization much more challenging. Rules for intellectual property rights and quality standards have increased the cost for many developing countries of absorbing new technologies, becoming globally competitive and introducing greener production processes to combat and adapt to climate change. This does not mean that there is no policy space at all, but rather, that the narrowed scope in this regard is posing much greater challenges to policymakers today.

As the global food, energy, environmental and financial crises have exposed the systemic flaws inherent in the functioning of deregulated global markets, a tide has turned in the thinking about public policies. By intervening in the ways required by the crises, Governments have dealt a blow to the conventional wisdom underpinning the Washington Consensus. Their actions have led to a reassessment both of the role of the state in driving national development processes and of how national policies should be coordinated at the regional and global levels in order to engender outcomes consistent with objectives of global financial stability, shared prosperity and sustainability of the world's natural environment.

The present core set of institutions and rules for managing the world economy were established more than 60 years ago. Since then, the world has changed beyond recognition while the mechanisms for achieving global economic governance have either changed little or adapted but slowly. Because of the complexity and interconnectedness of today's global challenges, a new balance must be found between international rules-setting and the provisioning of global public goods, on the one hand, and the creation of the space needed by nations to determine their own destiny, on the other. The task will not be easy: it will require a new kind of thinking and the striking of a new balance between decision-making processes at the national level and those at the global level.

National development strategies

There are no simple recipes for development success. Sustained, rapid economic growth in a number of countries in Asia was held up in the 1980s and 1990s was, as indicated, strongly influenced by interventionist policies of the dirigiste development paradigm.

In the present-day context the space for repeating such experience has become much more limited. The national development strategies laid down in the PRSPs mostly kept market reforms and liberalization and opening to global markets as the mainstay of economic policies. Greater policy shifts were visible in the social arena, entailing greater priority for education and health spending, the revisiting of user-fee schemes, the promotion of programmes believed to reduce poverty, for example, in microfinance and land titling, and the introduction of innovative cash transfer programmes, which provided incentives to poor and vulnerable populations to invest in human development by making receipt of the transfers conditional on keeping children in school or on use of health facilities by mothers

and children. Yet, typically, social policies remained largely marginal to economic policies. Macroeconomic policies, for instance, remained narrowly focused on stabilization of price levels, government budgets and current-account deficits instead of on stabilization of employment. This has not only limited the scaling up of MDG-oriented public spending, but has exacerbated the impacts of external shocks on employment and income growth, causing increased economic insecurity and placing a larger burden of adjustment disproportionately on the poor and vulnerable. Similarly, trade and financial policies remained committed to further integration with global markets, enhancing competitiveness and growth objectives, but in most instances yielding few benefits in terms of employment creation, poverty reduction and enhancement of economic security.

As a result, many countries are not on track to achieve the MDGs by 2015, the deadline set by the international community. Moving forward, these goals should remain a focus, because even if all of them were to be achieved by 2015, significant human development challenges would remain: millions would still need to be lifted out of extreme poverty, and important educational needs extending beyond access to primary schooling and the high prevalence of acute and chronic diseases would still need to be addressed.

Indeed, a post-2015 framework would need to do significantly better given the fact that the still-large human development deficits will need to be overcome in a context of persistent food insecurity, the threat of climate change, population ageing and other demographic shifts. In today's context, the more successful development experiences suggest that the way forward would start with designing national *sustainable* development strategies tailored to country-specific conditions; it would be “pro-poor, pro-growth, and pro-environment” as argued in chapter 8 of this volume.

A more enabling global environment

Effectively implementing such strategies will not be feasible without a more enabling global environment. National development strategies will need to be supported by stable aid flows, especially for low-income countries with limited access to other sources of financing; by a fair multilateral trading regime allowing the countries space for building domestic production capacity and pursuing sustainable development goals; and by stable and predictable international financial markets. Such coherence between the

national and the international arenas of policymaking is not present under today's rules and mechanisms for global governance.

Over time, a highly fragmented aid architecture has emerged. This has raised transaction costs and undermined national policy space. Each donor tends to undertake its own identification missions, negotiate the terms of the projects to be sponsored, impose its own accounting methods, define its own conditions, and conduct its own monitoring and evaluation. This not only increases the direct cost of providing aid but also tends to affect the institutional capacity of recipient countries, which complicates the pursuit of coherent, long-term development policies by Governments. Aid fragmentation has also rendered the flow of resources less predictable and more volatile, thereby making the management of budgetary processes highly dependent on aid flows all the more challenging. The delivery gap in respect of fulfilling the commitments to support the MDG agenda has become all the more poignant with the calls for additional assistance to the poorest countries in addressing their food security problems and climate change. More generally speaking, reconciling national development priorities with the taxpayer-approved objectives of donor countries has been difficult. What would be needed is a much stronger commitment by donors to accepting the principle of needs-based allocations and alignment of aid flows behind national development strategies. Under this approach, sustainable development strategies would provide the framework for policy coherence at the national level and also determine the nature of the financing gaps to be filled by aid flows and the timing required. Alignment with other sources of development financing could occur as part of the same process, while additional targets may need to be set to ensure sufficient resource mobilization for supporting climate change mitigation and adaptation efforts in developing countries, aid for trade and the delivery of global public goods.

Meanwhile, in many countries, aid flows have been overtaken by other resource flows, including foreign direct investment and worker remittances. Remittance flows nowadays triple the annual amount of official development assistance provided by traditional donors that are members of the OECD's Development Assistance Committee (DAC). Remittances may increase substantially as a source of development finance in the future (see chapter 10). At present, however, even if important to many low-income countries in macroeconomic terms, transaction costs for migrant workers and families to wire money to relatives back home remain high and incentives and mechanisms to channel resources to developmental investments tend to be weak in most countries. There are effective ways to

overcome this problem as studies have shown (see chapter 10 and Sharma and others, 2011, for instance). A more complex issue (because of its political ramifications) is arriving at a proper international framework to guide the international mobility of labour. The lack of a coherent regulatory multilateral framework for international migration has been labelled as “the big hole in the traditional development agenda” (Clemens, 2011). The key to achieving development of international framework regarding migration is to find incentives that attract both home and host countries to take part in cooperative action. Since it is often difficult to find sufficient mutual rewards in the field of migration alone, it may be necessary to make changes in other areas of international relations, including trade, technology and finance.

A number of options are available for creating a more stable financial system and a better environment for sustainable growth. Four areas of reform would need to be considered. First, further improvements to international financial regulatory framework are needed to stem excessive risk-taking and capital flow volatility, including through appropriate capital controls and macro-prudential regulatory reforms imposing counter-cyclical biases in rules for reserve requirements and loan-loss provisioning. Second, as new systems of regulation are being elaborated, there is a need for a fundamental revision of existing mechanisms of compensatory financing designed to cope with external shocks. Such revisions should ensure more adequate availability of and easier access to international liquidity, especially for developing countries. Third, a new global reserve system could be created, one that no longer relies on the United States dollar as the single major reserve currency (see chapter 9 of this volume). The dollar has proved not to be a stable store of value, which is a requisite for a stable reserve currency. Nonetheless, motivated in part by needs for self-insurance against volatility in commodity markets and capital flows, many developing countries accumulated vast amounts of such reserves during the 2000s. Hence, a new system needs to be developed that facilitates better pooling of reserves at the regional and international levels and permit the emission of international liquidity (such as SDRs) to create a more stable global financial system. Such emissions of international liquidity could also underpin the financing of investment in long-term sustainable development, as suggested above. And fourth, none of these reforms will work effectively, however, if the democratic deficit undermining the credibility of the Bretton Woods institutions is not repaired. The governance structure of the IMF and the World Bank must be reformed so as to more adequately reflect changes in the weights of actors in the world economy, and to be more responsive to current and future

challenges, thereby strengthening the legitimacy and effectiveness of these institutions. A new multilateral agency would need to be created to enforce the rules to be established for better and more comprehensive international financial regulation and supervision. The new multilateral financial authority would also need to ensure coherence between the global financial regulatory framework and multilateral trade rules.

Repairing deficiencies of the present multilateral trading regime (with or without the conclusion of the Doha Round) is another major challenge. Since the establishment of the WTO, the main emphasis has shifted towards setting common trade rules, as reflected in the trade liberalization that has taken place worldwide over the past two decades. This has progressively restricted the space available to developing countries for utilizing trade policies to foster economic development. There has been progress in providing developing countries, especially the least developed countries (LDCs), with greater duty- and quota-free access to developed-country markets for their products through the application of the most-favoured-nation treatment. Yet, important barriers to market access persist for developing countries. Also, agricultural subsidies in advanced countries remain high and continue to limit production and income opportunities for farmers in developing countries. While further progress needs to be made in enhancing world market access for developing countries and reducing agricultural support measures in developed countries, multilateral rules will need to be recalibrated in order to increase the space available to developing countries for building production and trading capacity.

Achieving coherence between trade and climate policies is a recently recognized challenge. In the absence of corrective measures, trade that is more open will likely lead to increased greenhouse gas emissions (for example, those generated through transportation of goods). Furthermore, national policies designed to address climate change may affect world prices and production, trade and livelihoods in other parts of the world. Domestic price subsidies to stimulate biofuel production in Europe and the United States, for instance, have impacted on land use, contributed to world food prices' upward drift and caused increases in poverty in large parts of the developing world. More generally, at present there is no level playing field in terms of the capacity of countries to conduct national climate change policies, which will have implications for international competitiveness. For instance, countries lacking resources and affordable access to carbon-efficient technologies possess a competitive disadvantage compared with those that are able to support industries in meeting climate change mitigation targets,

inter alia, through duties levied on the basis of the carbon content of products imported from countries not undertaking comparable mitigation efforts. In this way, climate-trade links would be used as a basis for protectionism. In addition, existing multilateral trading rules constitute hurdles to technology transfers to developing countries. Such obstacles also make the development of industries using green technologies more expensive. The Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS) will need to be revisited to allow for the affordable transfer of technologies to developing countries so as to enable them to adapt low-carbon and energy-efficient production methods. To further ensure a level playing field in the area of policies supporting green production, compensatory schemes will have to be established to cover the incremental costs of introducing cleaner technologies in developing countries.

Towards a fairer and sustainable globalization?

The international community must face a key fact, namely, that the pattern of uneven development brought about by globalization so far has been sustainable neither economically nor environmentally, nor has it been feasible politically. Hence, business as usual is not an option. Retooling the rules of the game for a fair and sustainable global development is therefore necessary. That, however, will not be sufficient. It is also about the players. Players will need to agree on the common global sustainable development goals to be pursued and will need to be convinced that cooperation will provide net benefits for all—benefits serving present and future generations. However, within any scheme of international cooperation, net benefits may be perceived as not being equal for all; and any expected unevenness in outcomes may impede the reaching of effective global solutions. Because of differences in living standards, and therefore in capacity to pay, some countries will be expected to shoulder larger shares of the total costs of providing global public goods, which may reduce their incentive to cooperate in providing them. Hence, with respect to establishing multilateral agreements, the pattern of burden sharing will be as important as the extent of the benefits to be conferred by the public goods.

NOTES

- 1 This chapter has greatly benefited from research undertaken at the UN Department of Economic and Social Affairs, in particular that in the context of the World Economic Situation and Prospects (see United Nations, 2009a, 2010a, 2011a, 2012) and the World Economic and Social Surveys of 2006 (on diverging growth and development), 2008 (on economic insecurity), 2009 (on climate change and development), 2010 (on global economic governance), and 2011 (on technological transformation for a green economy) (see United Nations, 2006, 2008, 2009b, 2010b, and 2011b). I am grateful to my staff at the Development Policy and Analysis Division for their research and work going into those studies. They are not responsible for any remaining errors and the views expressed in this paper do not necessarily coincide with theirs neither with those of the United Nations.
- 2 Aggregate measures of global income inequality, which combine within- and between-country income inequality, show clearly increasing trends over the past decades. The trends are starkly unambiguous when China is not included (Bourguignon and Morrison, 2002; Milanovic, 2005 and World Bank, 2006).
- 3 Megacities are high-density metropolises with a population of 10 million inhabitants or more. The number of megacities increased from 10 in 1992 to 21 in 2010. In other words, over the past two decades a megacity has been added every two years. Fifteen of 21 megacities are located in developing countries.
- 4 Data based on World Health Organization (2011), Obesity and overweight, Fact Sheet No. 311 (<http://www.who.int/mediacentre/factsheets/fs311/en/>).
- 5 Since 1990, forest area has decreased by 300 million hectares, an area larger than Argentina. Most losses were in Latin America and Africa, while there was some recovery in North America, Europe and parts of Asia.
- 6 The Living Planet Index, which reflects changes in the health of the Earth's ecosystems, has declined by 30 per cent between 1990 and 2010. Biodiversity in the tropics is declining most dramatically, which is seen to be associated with high depletion rates of primary forests and transformation of forest into agriculture land and pasture (WWF 2010).
- 7 See United Nations (2009a).
- 8 United Nations Department of Economic and Social Affairs, Population Division, *Trends in international migration stocks: migrants by age and sex*, POP/DB/MIG/Stock/Rev.2010 (New York, 2011).

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