Chapter IV

Reforming the International Financial Architecture: The View from UNCTAD

A. INTRODUCTION

The international financial architecture (IFA) is a framework of institutions, policies, rules and practices that govern the global financial system. Its aim is to promote international cooperation with a view to ensuring global monetary and financial stability, enabling international trade and investment, supporting the mobilization of the stable and long-term financing required for economic development, combatting the climate crisis, and achieving the Sustainable Development Goals.

Recurring financial and debt crises, as well as the shortfall in required development and climate finance, reiterate that the existing framework of IFA is ill-equipped for today's world. Many of its shortcomings are of a systemic nature. Two specific issues have been apparent from an early stage. First, the structure of IFA and its institutions are not designed to deliver the kind of financial support that developing countries need to realize their growth and development ambitions (Kregel, 2018). Second, developing countries often have sizable and lasting current account deficits. As a result, they operate under a governance hierarchy that demands they make more stringent adjustments in the face of macroeconomic imbalances compared to advanced economies (Martin, 2023). This contributes to the accumulation of unsustainable external debt burdens.

The search for a new change of direction requires these systemic challenges to be comprehensively addressed. So far, the necessary global agreement and the political will to take reforms forward have been lacking. Instead, a wide range of piecemeal and ad hoc reforms have been pursued. A series of reform proposals (new institutions, new alliances between existing institutions, new policy instruments and new systemic thinking), often initiated by developing countries, are being proposed as an alternative to the current IFA.

"New proposals are widening the scope of institutional experimentation and may give rise to more participatory global financial governance."

These proposed revisions are often contested because they may appear incoherent both between themselves and with the current IFA. Yet, they are widening the scope for institutional experimentation and may eventually give rise to more participatory and sustainable global monetary and financial governance (Grabel, 2018).

For UNCTAD, the IFA should enable developing countries to integrate into the global economy in a process facilitated by successful structural transformation. Within this, the role of mechanisms and institutions within international finance is two-fold: on the one hand, to help alleviate trade deficits and unstable debt burdens; on the other hand, to enable financing for long-term, sustainable and transformative growth. The contribution of international trade and financial flows to growth and development is closely connected to a country's balance of payments position. It is also impacted by structural asymmetries in the international division of labour and international markets.

Importantly, the position of UNCTAD regarding IFA is informed by its broader vision of development and transformation. The UNCTAD approach to trade and development policy is multifaceted. First, it recognizes structural obstacles and constraints. In this context, UNCTAD also advocates for a more balanced and sensitive framework for international cooperation. This would address existing biases and help mobilize the requisite resources to raise investment levels in developing countries. Developing countries would be able to shift away from commodity dependence towards more diversified economies; initially, this could centre on a strong push for industrialization and be underpinned by a sustained acceleration in growth (Prebisch, 1964). This approach would inevitably involve a significant rise in the imports of capital goods, with developing countries needing to generate sufficient foreign exchange to cover the associated costs.

While chapters V and VI address in detail two other crucial areas – debt and climate finance – this chapter provides a survey of key recent proposals for IFA reform, examined through the lens of longstanding contributions by UNCTAD in this field. The ability to respond to today's challenges has been complicated by recent changes in the political and economic landscape, which is why this survey focuses on two key areas.

The first challenge relates to the promotion of economic and financial stability in a world that is becoming increasingly financially fragile and vulnerable to cross-border spillovers. The second challenge is the need to secure vast financial resources to support economic, social, and human development; to make progress towards the Sustainable Development Goals; and to develop frameworks for the type of cooperation that can address complex problems in the global commons (such as global pandemics, climate change, forced displacement, tax avoidance, and cyberrelated risks).

B. TOWARDS A DEVELOPMENT-CONSCIOUS INTERNATIONAL FINANCIAL ARCHITECTURE

A systemic approach

Access to foreign currencies is essential for two purposes. First, it enables financing of international trade transactions. In the absence of sufficient foreign exchange, economies are forced to cut down on imports during periods of sluggish export earnings growth or in response to external shocks. Developing countries in particular, are vulnerable to these circumstances. Second, foreign exchange is paramount for financing the imports of capital goods that are required for industrialization and economic advancement.

One source of foreign exchange is export revenues. It has long been recognized that export-oriented strategies not only increase allocative efficiency and larger market size, but also help overcome the balance of payments constraint (Thirlwall, 1979). The current global financial architecture evolved following the rejection at Bretton Woods of Keynes' plan for a symmetrical treatment of all trade imbalances. Keynes' plan for an International Clearing Union proposed preventing structural trade imbalances by penalizing trade surpluses, as well as deficits. Its rejection created structural impediments for developing countries and their ability to rely on export earnings for sustainable growth. It also led to two sets of structural problems.

"There is a contrast between the growing trade and financial imbalances impacting heavily developing countries, and the efforts of advanced economies that seek to safeguard their own financing needs."

First, with no moderating incentives introduced to surplus industrial exporters, the Bretton Woods arrangement placed the full burden of adjustments on deficit countries (except the one issuing the international reserve currency). Second, the pressure to preventively accumulate costly but idle international reserves further embedded a macroeconomic deflationary bias, hampering economic development more generally.

When UNCTAD was created in 1964, it coordinated the appeals of developing countries for a supplementary financing mechanism adapted to their liquidity needs and development aspirations. A central point of contestation has been the contrast between growing trade and related financial imbalances impacting heavily developing countries, and the efforts of advanced economies that seek to safeguard their own financing needs.

Earning foreign exchange through exports requires access to developed country markets and policy space at the national level to support the creation of competitive industries. As chapter II shows, both these conditions are increasingly difficult to meet in the current framework of international trade and finance.

Unequal gains from trade, market concentration and growing debt servicing burdens endanger many developing countries' social and financial sustainability. A balanced policy response at the multilateral level should include reforms to the governance ecosystem (chapter V), and revisions to existing trade agreements to create more ample policy space for countries to redesign their production, consumption and trading profiles to meet contemporary global challenges.

As the following two chapters show, many existing multilateral approaches to financial governance – including the principles of managing sovereign debt, financing the green transition and costs of the climate crisis, as well as crisis resolution mechanisms – urgently need to be recalibrated to address the new realities of the global political economy. A multitude of complex shocks have arisen since 2020 and have only been addressed in an ad hoc manner. As more stress is bound to arise and as crises become more complex, policy tools and coordination mechanisms must be adapted to address these shifts at a systemic level.

UNCTAD advocates for an integrated approach built on pragmatic sets of policy proposals to make economic governance more inclusive, international finance more stable and international markets more accessible and less volatile. In parallel, efforts have been directed to improving the response of the international community to economic shocks, with particular attention to the problem of growing debt.

UNCTAD understands the interdependence of finance, trade and development; the institution's insistence on structural transformation has put it ahead of the curve (table IV.1). Nevertheless, it is increasingly clear that a truly systemic approach means considering the relationship between trade and finance and incorporating the urgent challenges stemming from environmental shocks and sustainability, notably climate and biodiversity challenges, as well as geopolitical risks (IPCC, 2022; IPBES, 2019).

The work of the United Nations Global Crisis Response Group, set up in the aftermath of the start of the war in Ukraine, as well as the Black Sea Initiative, are recent examples of practical implementation of systemic thinking by UNCTAD. As this Report goes to press, it is becoming apparent that the scope of economic, social, environmental and humanitarian crises has expanded dramatically. To ensure that international governance can address these interrelated challenges and keep the demands of developing countries at its centre, the existing elements of the international financial architecture must be reformed. This must also be complemented by new institutional mechanisms and policies, as recently stressed by the United Nations Secretary-General (United Nations, 2023).

Enabling policy space for green industrial transformation

Successful structural transformations have generally relied on proactive government policies. At the same time, the instruments and strategies that brought about developmental successes in the 1970s and 1990s need to be adjusted to navigate today's priorities. These include the global green transformation and biotech revolution, the geonomics of global value chains, as well as the impact of the geopolitical-related economic restrictions by the major economies (Vidigal and Schill, 2021; Hrynkiv, 2022).

In its long-standing calls for strategies of a developmental State and more recently, a green developmental State (*Trade and Development Report 2021*), UNCTAD has stressed that structural transformation requires significant productive investment. It also requires imports of capital goods and equipment embedded with foreign technologies which will allow efficiency gains and promote productivity. This means that, in an economy where investment is growing both in absolute terms and as a share of GDP, such imports will also need to grow faster than GDP. The financing of these imports will seriously constrain structural transformation unless additional export revenue can be obtained.

The developmental State has been a strategic political choice of countries aiming to compete in the global economy, but this has largely been in the form of export targets and attracting FDI. In today's context of growing economic and non-economic uncertainties, policymakers need to be able to use a range of capital account management measures to insulate the domestic financial system from fluctuations in the global financial cycle and financial instability (Mayer, 2021). In particular, controls on short-term capital flows (bonds, equity, money market and derivatives) can help stabilize exchange rate developments while fending off speculative attacks on the domestic currency. These instruments can also have macroprudential functions in limiting capital surges and sudden stops, while more longer-term flows (FDI, real estate and credit) may remain less regulated, to benefit economic growth (Rademacher, 2023).

Table IV.1 The UNCTAD vision for reforming the international financial architecture

UNCTAD lens for financial governance challenges (and landmark policy proposals)	United Nations Secretary-General actions as formulated in the Common Agenda Policy Brief on Reforms to the International Financial Architecture
General	A1: Transform the governance of international financial institutions.
	A2: Create a representative apex body to systematically enhance coherence of the international system.
Liquidity 1965: Universal SDR allocations with aid link; 1971: Creation of the Group of 24.	A10: Strengthen liquidity provision and widen the financial safety net.
	A11: Address capital market volatility.
Investment 1964: Multilateral interest equalization fund (Horowitz Proposal); 1965: Universal SDR allocation with aid link; 1970: Official development assistance target of 0.7 per cent of gross domestic product; 1971: Definition of least developed countries; 2014: Support for Southern-led multilateral development banks (MDBs).	A5: Massively increase development lending and improve terms of lending.
	A6: Change the business models of multilateral development banks and other public development banks to focus on the impact of Sustainable Development Goals; more effectively leverage private finance for Sustainable Development Goal impact.
	A7: Massively increase climate finance, while ensuring additionality.
	A8: More effectively use the system of development banks to increase lending and Sustainable Development Goal impact.
	A9: Ensure that the poorest can continue to benefit from the multilateral development bank system.
Debt 1983: Creation of Debt Management and Financial Analysis System (DMFAS); 2014–2015: United Nations General Assembly resolutions creating the Ad Hoc Committee on Sovereign Debt Restructuring, definition of basic principles.	A3: Reduce debt risks and enhance sovereign debt markets to support Sustainable Development Goals.
	A4: Enhance debt crisis resolution through a two-step process: A debt workout mechanism to support the common framework and, in the medium term, a sovereign debt authority.
Finance–corporate nexus 1967: United Nations General Assembly resolution creating the Ad Hoc Group of Experts on International Cooperation in Tax Matters; 2004: Upgrade into a Committee; 1975–1993: Creation of the Centre for Transnational Corporations.	A12: Strengthen regulation and supervision of bank and non-bank financial institutions to better manage risks and reign-in excessive leverage.
	A13: Make businesses more sustainable and reduce greenwashing.
	A14: Strengthen global financial integrity standards.
	A15: Strengthen global tax norms to address digitalization and globalization through an inclusive process in ways that meet the needs and capacities of developing countries and other stakeholders.
	A16: Improve pillar two of the proposal by the OECD/Group of 20 inclusive framework on base erosion and profit shifting to reduce wasteful tax incentives, while better incentivizing taxation in source countries.
	A17: Create global tax transparency and information-sharing frameworks that benefit all countries.

Source: UNCTAD based on United Nations (2023), which contains more detailed lists of subactions.
Note: Blue shading indicates the action and/or subactions that deal with the transversal challenge of climate and environmental sustainability.

Ultimately, the goals of today's developmentalism derive from the global agenda of decarbonizing economic activity and international efforts to tackle climate change. Therefore, linking nationally devised and implemented strategies is part of a much larger international climate action project. National strategies will need to reference their contribution to wider international endeavours on low-carbon development, such as the Paris Agreement (chapter VI).

"The goals of developmentalism derive from the global agenda of decarbonizing economic activity and international efforts to tackle climate change. Linking nationally devised strategies is part of a much larger international climate action project."

In this context, conventional approaches to financial de-risking by the State need to be recalibrated for the age of climate crises (box IV.1). For instance, de-risking often implies a constraint on the very policy instruments that a green developmental State would apply. Regulatory de-risking can make it more difficult to maintain vertically integrated, State-owned energy utilities, to redirect subsidies from fossil fuel to renewable energy providers, such as via feed-in tariffs, or ensure guaranteed grid access for renewable energy sources. At the same time, financial de-risking tends to target green-oriented grants, tax relief, or debt-based instruments, thus creating a bias towards portfolio flows that can hamper macroeconomic and financial stability (Gabor, 2021). Chapter VI offers a detailed look at pathways for a sustainable transition away from fossil fuel dependence and public policy tools to accompany the divestment effort.

Transitioning to renewable energies and embracing the circular economy could boost industrialization in many developing economies. By decoupling economic activities and natural resources, activities related to the circular economy, or to producing renewable energy could generate business opportunities for small firms and rural areas. This would not only diversify economic production. It would also lessen the reliance on a narrow range of primary commodities, contributing to developing countries enjoying broader tax bases. Furthermore, decoupling could stimulate domestic resource mobilization as a source of development finance. These activities could help alleviate countries' balance of payments constraints. Relying on domestically produced energy and food could reduce the need to import virgin raw materials. This could free up limited foreign exchange to instead import capital goods that contribute to industrialization and economic advancement.

Box IV.1 The Horowitz Proposal for a multilateral interest equalization fund: Fit for the green transition?

Consideration of multilateral development finance within UNCTAD has centred on two themes. First, consistently strong support for the role of multilateral development finance in the overall provision of development finance. Second, proposals to reform institutional lending programmes and policies, in particular proposals that use the skill and prestige of those institutions to facilitate other flows, through the use of guarantees or by acting as intermediaries by borrowing and on-lending.

At UNCTAD I in 1964, discussions revolved around setting up mechanisms with the involvement of multilateral financial institutions. This would expand the use of private capital market finance. Among these ideas, Horowitz's proposal to create a multilateral interest equalization fund caught attention and was further explored by the members of the Committee on Invisibles and Financing related to Trade (CIFT) at UNCTAD II in 1968. This plan, generally known as the Horowitz Proposal[a] would have allowed an international institution to borrow funds in financial markets on commercial terms and relend these funds to developing countries at lower rates of interest and with longer maturities. The interest subsidies were to be covered by contributions from developed countries and from the World Bank.

While there was no concrete follow up to this proposal, in 1975 the World Bank did establish a scheme for interest subsidization through its "Third Window" Interest Subsidy Fund. The Conference, at its fifth session in 1979, recommended that early consideration be given to a proposal for establishing a long-term facility in the World Bank to finance purchases of capital goods by developing countries. In the early 1980s, due to the stagnation and subsequent collapse of developing country access to capital markets, attention turned once again to intermediation as a means of improving access and greater use of private direct investment.

To some extent, Horowitz's approach to private finance mobilization appears as a forerunner of contemporary de-risking, which dominates policy discussions on climate finance. Yet, even though the Horowitz Proposal would represent a significant improvement over the current situation, the logic of de-risking itself (and hence any mechanism inspired by it) increasingly appears as much too weak to address a challenge such as timely and adequate climate finance (Braun and Gabor, 2023).

Source: Based on UNCTAD (1984).

[a] The basic proposal was made to the first session of the Conference in 1964 by David Horowitz, at the time, Governor of the Bank of Israel and Head of Delegation of Israel to the Conference (E/CONF.46/C.3/2).

These aspirational international aspects of climate adaptation policies call for a new multilateralism. Such a paradigm would provide the global public good needed to deliver shared prosperity and a healthy planet. It would also ensure that no nation could pursue economic and environmental goals that were to the detriment of other nations. However, if these two conditions are absent, developing countries will need to rely on external financial inflows – private or public — for their foreign exchange and liquidity needs.

Developments in short-term liquidity provision

As soon as it was created, UNCTAD coordinated the appeals of developing countries for a supplementary financing mechanism adapted to their liquidity needs and development aspirations. While growing trade and related financial imbalances mostly impacted developing countries, efforts of the most advanced economies only addressed their own financing needs. This is reflected in efforts by the Group of 10 in 1962 to establish a General Arrangement to Borrow, which marginally increased the contributions of richer countries in their own currencies to IMF capital without changing the quotas or drawing rights of poorer countries (Toye, 2014). Later, the Group of 10 introduced a new source of liquidity, through the creation of SDRs, to supplement the role of the dollar.

Building on the expertise of the Bellagio Group[1] which had already convened in preparation of the first UNCTAD conference in Geneva, UNCTAD drafted a plan (UNCTAD, 1965) for augmenting the lending capacity of Bretton Woods institutions by extending the allocation of SDR on a universal basis. UNCTAD envisioned an "aid link" (Toye and Toye, 2004), i.e. a link between a universal SDR allocation by IMF and an automatic provision to the World Bank for development lending and investment (Orange-Leroy, 2023).

With the creation of special drawing rights in 1969 and with an initial general allocation of SDR $9 billion, IMF acknowledged the validity of the UNCTAD argument to support universal allocation, but the amount remained modest. It was further allocated in proportion with IMF quotas favouring developed countries. As IMF rejected the UNCTAD aid link concept, the development potential of special drawing rights was weakened.

Following the decision of the United States to suspend dollar gold-convertibility in 1971, pre-existing challenges of deteriorating terms of trade and volatile commodity prices were compounded by increased exchange rate

[1] The Bellagio Group was first convened in the 1960s by Professor Fritz Machlup to brainstorm the structure of the Bretton Woods System and what might follow. The group of about 30 economists (which included Charles Kindleberger, Robert Mundell and Robert Triffin) met over several months to construct a proposal for exchange rates and adjustment mechanisms for the international monetary system (see: https://bellagio.mit.edu/).

volatility, which required larger and more regular SDR allocations. However, such moves were resisted by the United States Treasury, strengthened in part by the rise of monetarist economics and like-minded officials in the Bretton Woods institutions. The result was a strengthening of stricter conditionalities for lending to developing countries, and active promotion of the role of private financial actors as the main providers of domestic and cross-border liquidity.

During the 1970s, the World Bank progressively moved from specific project lending to programme lending. Throughout the 1980s debt crises and until after the 1997 Asian financial crisis, IMF routinely only extended liquidity to deficit developing countries in exchange for domestic implementation of structural adjustment programmes. Such programmes embedded core measures supporting trade and finance liberalization and deregulation, thus penalizing developing countries that implemented industrial policies or capital controls recommended by UNCTAD.

However, as the narrative of the Washington Consensus crumbled with the 2008 financial crisis, many developed countries rediscovered the policy recommendations promoted by UNCTAD to avoid deflation. In addition to coordinated (though short-lived) countercyclical fiscal policies, two IMF allocations totalling $183 billion of special drawing rights soon followed, in 2009.

Similarly, special drawing rights played a positive role during the COVID-19 pandemic, as the largest ever allocation approved on 2 August 2021 tripled the total amount of SDR to $660 billion, sparing the world a full-blown cascade of liquidity crises and unnecessary economic deflation across vulnerable deficit countries. In parallel, IMF also backtracked from its earlier positions on external financial liberalization, supporting the persistent calls of UNCTAD for rehabilitating capital account management techniques, including capital controls, as a legitimate means for addressing exchange rate and financial volatility (IMF, 2013; 2022).

These policy reversals highlight the underleveraged potential of capital account management and SDR allocations for enabling deficit countries to manage and overcome short-term liquidity constraints. Since 2008, strengthened international calls for a GFSN have stressed how SDR allocation and unconditional multilateral lending more generally, along with regional financial arrangements and bilateral swap arrangements, can help vulnerable deficit countries to minimize the need for the costly and deflationary build-up of idle international reserves.

As called for by the United Nations Secretary-General (United Nations, 2023) there is an urgent need to update IMF quota formulas to reflect the changing global landscape and boost the representation of developing countries (see also the subactions A1, A2, A10 and A11 listed in table IV.1). There is also a need to de-link access to resources from quotas and conditionalities and determine their allocation based on need and vulnerabilities. Developing countries should be able to rely on the full capital account management toolbox and proactive intervention to reduce exposure to capital flows volatility. Crucially, SDR allocations should be automated and countercyclical. Although still contentious, allocating SDRs, coupled with the aid link envisioned by UNCTAD (1965) as a means to finance longer-term development and sustainability challenges, remains technically possible.

C. HOW TO DELIVER DEVELOPMENT FINANCE? HISTORICAL APPROACHES AND CONTEMPORARY TRENDS

In the area of development finance, the UNCTAD approach has historically focused on the need to recognize and respond to the special financing needs of developing countries and the policies that can enable growth, financial sustainability and long-term, climate-resilient development goals.

UNCTAD efforts to advocate for the special financing needs of developing countries resulted in the United Nations General Assembly adopting a resolution setting the ODA target for donor nations at 0.7 per cent of gross national income (United Nations General Assembly, 1970). Developed countries have acknowledged this target but, with a small number of exceptions, consistently failed to meet it over the past 50 years.

Much of the policy debate on the optimal balance of public and private funding has focused on overcoming the primary role assigned to private investors to invest in infrastructure and other development finance. This has opened up discussions of “de-risking” investment, a term that applies to securitized infrastructure bundles and to the investment environment. De-risking involves a greater scope for a variety of public guarantees, insurance programmes and other mechanisms that shift risk from the private to the public sector, often in ways that are non-transparent and compromise public accountability (Alexander and Rowden, 2018).

One widespread assumption about development finance is that leverage and crowding-in can deliver new and heretofore untapped pools of private investment, especially when it comes to financing social and economic infrastructure. However, as chapter VI shows, there is little empirical evidence to support arguments around the vast developmental potential of private financial flows and the use of public resources to leverage and crowd-in private investment. Empirical evidence suggests that domestic public finance has long played a central role in financing infrastructure. This is because infrastructure has a long maturity profile and is not a commercially attractive investment for private investors; it offers high risks and relatively low economic returns, especially in relation to opportunities in other areas (Griffiths and Romero, 2018).

Drawing on the seminal work of Albert Hirschman, UNCTAD has argued that if private finance has a role to play in supporting the development strategy, it is to be crowded-in as part of an integrated and thoughtful development pathway that involves significant public investment in infrastructure and that generates the backward and forward linkages necessary for structural transformation.

When the Group of 20 was created in the wake of the 2008 global financial crisis, promises were made about the reform of the international financial architecture, starting with IMF quotas. However, results were disappointing. In 2014, Brazil, China, India, the Russian Federation and South Africa established the BRICS New Development Bank and, in the same year, China gave the regional impulse for the Asian Infrastructure Development Bank. Both initiatives signalled that Bretton Woods institutions were failing to respond to the needs of developing countries and to adapt to evolving economic and geopolitical realities, not to mention the daunting environmental challenges.

In principle, sources of long-term financing include the use of hybrid capital, which allow MDBs to lend more without impacting their triple-A credit ratings, as these securities are treated as “equity” by credit rating agencies. However, being subordinated in the capital structure, MDBs pay significantly more for hybrid bonds than for conventional funding (Khadbai, 2023). Critics claim that financial conditions imposed by lenders can keep debt burdens heavy and cut into spending on development. According to recent reports, potential investors in hybrid bonds from the African Development Bank asked for a spread of 150–200 basis points over the Bank’s usual cost of funding, aligning with the rates commercial banks and corporates usually pay for hybrid securities (ibid).

It is against this record that the rise of Chinese development banks and the participation of China in international lending has reshaped the topography of development finance. Newly created institutions offered financing to countries that needed to mobilize capital for infrastructure projects and provided innovative financing models for developing countries to invest in their ports, roads and power grids. And while Chinese financial support tended to be relatively limited in the early stages, it has increased over the years.

Chinese development finance takes the forms of grants, interest-free loans and concessional loans. Data gathered in documents from the State Council Information Office of the People's Republic of China (2011, 2014 and 2021) suggests that the proportion of interest-free loans has diminished in favour of grants and concessional loans, with each type representing almost half of the total foreign aid by China. In terms of geography, two recipient regions stand out, with developing countries in Africa (44 per cent) and Asia (36 per cent) receiving the bulk of Chinese support in the 2013–2018 period. Data also suggests that Chinese development lending expanded in the first 15 years of the twenty-first century, peaking around 2016.

The impact of these capital injections and competition among lenders at the international, regional, subregional, and national institutions in the Global South and East on the trajectory of the green transition remains unclear. As infrastructure finance increasingly becomes a tool in global diplomacy, it may mean that environmental, social and transparency standards are lowered, while urgent financing needs of sustainable development and climate crises are overlooked (Alexander and Rowden, 2018). Chapter VI discusses the current state, challenges and opportunities for a climate-aligned system of financial governance in detail.

D. SOLVENCY, SOVEREIGN DEBT RELIEF AND RESTRUCTURING: EVOLVING CHALLENGES AND ONGOING ADVOCACY

As with the liquidity and investment challenges, UNCTAD has always recognized that there is an intimate connection between debt management, debt sustainability and the evolution of the external environment (*Trade and Development Report 1985*). In the three decades after 1945, although developing countries experienced recurrent liquidity and investment challenges, these rarely triggered sovereign debt crises. This meant that sovereign solvency was a less pressing issue when UNCTAD was created in 1964. Yet even in the early years, debt servicing was a pressing concern for developing economies.

Following the collapse of the fixed exchange rate regime in 1971–1973 and repeated oil shocks of the 1970s, developing countries were confronted with rising exchange rate and commodity price volatility, exacerbating their economic vulnerability and liquidity needs. Since 1978, UNCTAD proposals to address these issues informed the institution's position in the Paris Club (box IV.2).

In the early 1980s, the Federal Reserve of the United States embarked on aggressive interest rate hikes to stem domestic inflation. However, there was no consideration for international spillover effects, namely that numerous indebted developing countries were unable to refinance their debt at affordable rates. This transformed liquidity challenges into fully fledged and deeply damaging sovereign debt crises.

Lacking a systemic analytical framework for promoting a constructive multilateral vision, the Bretton Woods institutions treated emerging debt problems as a distinct problem specific to each debtor country. Accordingly, the remedies prescribed focused on debt rescheduling and domestic adjustment, irrespective of the costs in terms of forgone output, and thus, debt servicing capacity itself (UNCTAD, 2012a). Forced to accept the conditionalities of IMF structural adjustment programmes, developing countries agreed to adopt more flexible exchange rate regimes, to accept austerity measures, privatize public services and sell off public assets to domestic and foreign investors.

Box IV.2 UNCTAD and the Paris Club: 40 years of cooperation

Since 1978, representatives of the UNCTAD Secretary-General have participated in more than 260 Paris Club debt reorganizations for more than 60 countries. This is in accordance with resolutions 165 (S-IX) and 222 (XXI) of the UNCTAD Trade and Development Board. At these meetings, UNCTAD presents its view on the debtor country's economic prospects and expresses its perspective regarding terms of debt restructuring conducive to long-term sustainable development.

The participation of UNCTAD in Paris Club meetings has given the institution a unique opportunity to closely follow the evolving practices of Paris Club creditors – mostly from OECD member countries. The observer status of UNCTAD in Paris Club meetings and its work with debtor countries led the institution to realize that, for some developing countries, debt data recording issues can be a serious concern when devising their debt renegotiation strategy. This led to the creation of the DMFAS Programme which is currently in use in more than 80 institutions in 60 countries.

DMFAS advocated for a statutory process of sovereign debt restructuring modelled, in part, on chapter 11 of the United States bankruptcy code (*Trade and Development Report 1986*). Observing that the process of action and reaction by individual creditors and debtors is likely to be disorderly, UNCTAD proposed that a measure of debt or debt-service forgiveness must be part of the normal menu of financial techniques (*Trade and Development Report 1987*).

UNCTAD further advocated to establish an international debt facility (*Trade and Development Report 1988*), stressing that the failure to assign to any international financial agency the role of "honest broker" left the level of debt reduction to be shaped by the balance of negotiating strength rather than by objective needs (*Trade and Development Report 1990*).

The repeated nature of countries facing Paris Club debt rescheduling during the 1980s and 1990s highlighted the inadequacies of the then prevailing approach to restructuring developing country debt, and to LDCs in particular.

UNCTAD was one of the early proponents of the need for a new framework for dealing with the debt of the poorest countries. The institution supported the proposal for the HIPC Initiative launched in 1996 at the Group of Seven summit in Lyon, France. In the late 1990s, UNCTAD observed that the process for countries to benefit from the Initiative was lengthy and characterized by a complexity that burdened countries' already weak institutions. UNCTAD pushed for further enhancements to the Initiative, which led to the 1999 and 2001 reforms to eligibility thresholds and topping-up procedures.

The Paris Forum, which is jointly organized by the Paris Club and the Group of 20, held its first meeting in 2013. This is a very different gathering to a Paris Club debt rescheduling. Its main aim is to provide a discussion platform among creditors, debtors and international organizations regarding the main issues in the international financial environment and their impact on developing countries. UNCTAD began participating in these meetings in 2015 and has made regular contributions to discussions.

Source: UNCTAD.

What ensued was a “lost decade” of deflation and disrupted development across many countries in the global South. Similar policy prescriptions led to comparable results in the 1990s and early 2000s in the wake of the emerging market financial crises of 1997–1998. In response, and to provide assistance to indebted developing countries, UNCTAD established DMFAS.

In the wake of the 1989 Brady Plan implemented by United States authorities, Bretton Woods institutions finally made a more concerted move to restructure unsustainable debts, along the lines proposed earlier by UNCTAD. This took the form of the HIPC Initiative adopted in 1996. Despite being plagued by slowness and a familiar set of policy conditionalities, the Initiative did allow a number of countries to re-enter international capital markets just as economic growth across the global South began to accelerate.

Following the Asian financial crisis, in 2002, IMF proposed a Sovereign Debt Restructuring Mechanism to compel all commercial creditors to agree on debt restructuring, although this was resisted by key members of the IMF Board. Instead, Group of Eight countries supported the Multilateral Debt Relief Initiative in 2005, a slight improvement on the HIPC Initiative.

With interest rates in advanced economies close to zero or negative during the decade following the 2008 global financial crisis, public as well as private debt soon soared in developing countries. This was especially acute in those that had opened up externally, i.e. to emerging and frontier markets, making them vulnerable to changes in the external environment.

Anticipating a repeat of the 1980s lost decade in the event of an unforeseen external shock, UNCTAD continued pushing for a more comprehensive approach to debt restructuring. In 2006 the institution embarked on an extensive consultative exercise with multiple stakeholders to design a set of principles for responsible lending and borrowing. The *Principles on Promoting Responsible Sovereign Lending and Borrowing* were launched in 2010 with a roadmap to push towards a sovereign debt workout mechanism (*Trade and Development Report 2015*). Based on resolution 69/247 approved in December 2014, the United Nations General Assembly established an Ad Hoc Committee on Sovereign Debt Restructuring Processes, which defined a set of basic principles on responsible sovereign lending and borrowing in 2015 (resolution 69/319). This built on the work of UNCTAD (2012b). The reluctance of creditor countries to engage with these discussions denied a consensus and institutional embodiment.

When the COVID-19 pandemic hit, sovereign debt challenges rapidly multiplied. In 2020, the Group of 20 and Paris Club countries acted quickly to implement the Debt Service Suspension Initiative (DSSI) and to develop a Common Framework for debt treatment. Once more, the preferred approach was to address the debt challenge based on a narrow initiative and to target countries on a case-by-case basis.

This piecemeal approach from the Common Framework continues to be dogged by slow procedures, offers too little relief too late and appears unfit to address forthcoming debt challenges. Indeed, a rising number of developing countries with high debt now also face growing climate vulnerabilities. This creates a vicious circle between rising investment requirements for a climate-resilient structural transformation and heavy reliance on increasingly costly debt-financing.

The collision of debt and climate challenges bears a very high risk of abrogating sustainability on both fronts. Breaking this vicious circle demands an ambitious multilateral policy agenda focused not only on scaling-up public-led and affordable development finance but also on reforming the approach of multilateral institutions to prevent and manage sovereign debt crises (UNCTAD, 2022). In this regard, the outcome of the 2023 Paris Summit for a New Global Financing Pact proved disappointing. Chapter V addresses the implications of some of these issues for the global ecosystem of debt governance.

E. CONCLUSION

The systemic challenges of the international financial architecture and balance of payments constraints tend to push developing countries towards accumulating external debt and/or financial liberalization, with the attendant exposure to the vagaries of the global financial cycle. Existing conditions of global financial governance reforms reinforce these problems. Holdings of borrowed reserves imply a negative resource transfer, while access to the global financial safety net is uneven and made more difficult for those most in need.

To address the systemic deficiencies of the international financial architecture, UNCTAD has advocated that:

(a) Capital controls should be seen as part of a regular toolkit of pragmatic financial policy;

(b) De-risking with a view to extensively using private capital for development finance is a misguided approach and has not delivered the anticipated results;

(c) The way forward is to strengthen public sources of development finance, including official development assistance, SDRs (through more frequent ordinary issues, recycling of unused SDRs, and perhaps an SDR-aid link; also to underline the potential fiscal use of SDRs);

(d) Multilateral Development Banks must be recapitalized, and their capital use reformed.

At the same time, reforms of monetary and financial policies and principles are not sufficient to deliver the structural support to mobilize the resources required in developing countries today. As chapters II and III of this Report show, market concentration, profiteering and increased asymmetries in the gains from trade are strongly linked to financialization of the global business and international corporate arbitrage.

In this light, redirecting the value-creating activities of multinational enterprises into the host economies of developing countries needs to be on policymakers' agendas. Taxing the activities of multinational enterprises is an important source of development finance. Until very recently, international initiatives around global taxation have been led by OECD, which blacklisted non-cooperative tax havens in 2009 and initiated the Base Erosion and Profit Shifting (BEPS) initiative in 2013. This programme developed a new global tax standard and minimum corporate tax rate of 15 per cent, starting in 2024.

While UNCTAD has supported efforts to curb illicit financial flows and tax avoidance, it has stressed the greater potential of unitary taxation to determine the geographical origin of value added, and its fair apportionment in an era of globalization and digitalization. Much like UNCTAD had recommended reviewing and amending existing trade and investment agreements that constrain the policy space of developing countries, the institution also called for a renegotiation of bilateral tax treaties to integrate rules reducing profit shifting, e.g. general and specific anti-avoidance rules, rules for controlled foreign corporations, for limiting interest deductions and for taxing capital gains arising from indirect transfers, etc. (*Trade and Development Reports 2014* and *2019*).

Such concerns should be addressed systematically within the international financial architecture, and it is notable that at present, no dedicated organization analyses the specific concerns of taxation/fiscal policy space in developing countries. In this respect, the United Nations Tax Cooperation Convention noted on by the United Nations General Assembly in November 2023 is a significant step towards systemic reform of the finance–corporate nexus led by developing countries. However, this is only the beginning of a long journey towards meaningful and effective change.

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