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Regional solutions for inclusive and sustainable development*

Note by the UNCTAD secretariat

Summary

The increasing economic, health-related and environmental crises faced by developing countries, along with a more inward turn among leading economies and increased attention being paid to the geopolitical dimensions of trade, technology and financial flows, raises the threat of a more fragmented global economy and challenges the integrity of the multilateral system. As a result, regional arrangements and their historically embedded identities, norms and values may play a more prominent role and shape distinct regional responses to crisis management and development pathways. Managing economic interdependence in such a polycentric world requires a more synergistic relationship between global institutions and regional arrangements. Supported by institutional structures such as the developmental State, this note details how open developmental regionalism may be the best approach to facilitating the management of the diverging interests and sensitivities of developing countries and developed countries, for a more inclusive and developmental governance.

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I. Introduction

1. Developing countries face several daunting and interconnected challenges in the pursuit of an ambitious sustainable development agenda. The period of rapid and broad-based growth that marked the opening decade of the current millennium took place under favourable global conditions, fuelled by rapid private credit growth in developed economies, particularly in the United States of America, and continuing transformation in China, with positive spillovers on developing economies through increased exports, low-cost capital and rising commodity prices. These favourable conditions were, however, undermined by the global financial crisis of 2008/09 and had largely disappeared by 2019, even before the pandemic, leading to a great deal of uncertainty and concern about the prospects for continued catch-up growth and sustainable development through the remainder of the present decade.¹

2. In the face of a more challenging economic climate after the global financial crisis, many developing countries responded by borrowing in international markets; in the last decade, the external debt stocks of developing countries have grown, on average, by 7.1 per cent annually.² At the same time, the combination of new information and communications technology linked to the digital revolution, together with a tightening of intellectual property rights, has shifted the balance of power towards larger firms with dominant market positions and has raised concerns that many developing countries are being left further behind in terms of technology.³ The pandemic has served to reinforce these constraints and generate additional hurdles, along with diminished fiscal space, for many economies.⁴

3. The recognition of these difficulties has led many developing economies to seek opportunities that differ from previously chosen paths. A greater emphasis is being placed, in particular, on regional and South–South arrangements that could help create employment and economies of scale and foster diversification and production upgrading. Economies in Africa have launched the African Continental Free Trade Area, completing a negotiation process that began in 2015; economies in East Asia have long recognized the importance of the regional dimension; and the largest economies in Latin America are aiming to revitalize regional ties. Regional options, however, come in different shapes and sizes, and might not, in themselves, offer the desired development pathways countries are seeking.

II. Regional trade integration and development

4. Trade has always received significant attention in regional economic integration processes, because more intensive regional trade has the potential to back national development strategies and formal trade integration can lead to greater economic cooperation and support the inclusiveness of the multilateral trading system. In the 2000s, the strengthening of commercial ties in the global South was underpinned by a transformation in the composition of exports, from primary commodities to manufactures; this was reflected in increased regional trade liberalization: of 350 regional trade agreements in force as at September 2021, 266 were signed after the year 2000.

¹ UNCTAD, 2019, *Trade and Development Report 2019: Financing a Global Green New Deal* (United Nations publication, Sales No. E.19.II.D.15, Geneva); see <https://unctad.org/webflyer/south-south-cooperation-time-covid-19-building-solidarity-among-developing-countries>.

Note: All websites referred to in footnotes were accessed in August 2022.

² See <https://sdgpulse.unctad.org/debt-sustainability/>.

³ UNCTAD, 2017, *Trade and Development Report 2017: Beyond Austerity – Towards a Global New Deal* (United Nations publication, Sales No. E.17.II.D.5, New York and Geneva).

⁴ UNCTAD, 2021, *Trade and Development Report 2021: From Recovery to Resilience – The Development Dimension* (United Nations publication, Sales No. E.22.II.D.1, Geneva).

5. There are several explanations for why intraregional trade relationships can be more conducive to development compared with other trade relationships.⁵ From a structuralist perspective, the likelihood that trade will have a positive impact is greater when it takes place among countries in the same region because of the advantages arising from proximity and also from the fact that these countries are often closer in terms of development level and this is more likely to provide a level playing field. In addition, when the economic structures of trading partners are similar, gains from trade arise primarily from economies of scale rather than from comparative advantages that reflect differences in either technology or relative endowments. In such a context, more trade is likely to provide greater potential for promoting export diversification and accelerating industrial development, because it is arguably more difficult to transform comparative advantages in the short term than to boost economies of scale, particularly when the former aims to move exports away from a reliance on raw materials or the abundance of low-skill labour.

6. Another benefit of intraregional trade is that regions can support greater knowledge flows (among countries with shared normative traditions and similar learning capacities) and encourage the provision of public goods. A regional approach facilitates learning and the sharing of information related to trade development and trade policy or other areas of functional cooperation such as agriculture, food security and the governance of environmental and health issues. Further, regions can overcome market and coordination failures and coordinate activities with strong regional externalities. Many competition-related challenges are regional in nature; for example, landlocked countries depend on appropriate infrastructure in other countries for trade in goods. Some externalities are not geographically limited to a region, but others relate only to neighbouring States.

7. From a political economy perspective, regional trade rules within developing regions are often less stringent than those under bilateral or plurilateral trade agreements characterized by a large degree of power asymmetry among the participants. The risk that power asymmetries could lead to the narrowing of national policy space in developing countries signing trade agreements is likely to be lower when such agreements take place intraregionally. Finally, during the pandemic, the crucial role of regional integration in reducing regional dependence on international trade and increasing resilience to external shocks was recognized.

8. Recent research shows that in the aggregate, participation in regional trade agreements is associated with greater economic growth and less inequality. The impact is strongest in developing Asia but is also evident in Africa and Latin America.⁶ There is broad agreement that regional integration is both desirable and necessary, yet despite its growing importance in the last decades, there is still room to improve both its scope and impact. The key question, therefore, is how to structure integration in different regions of the global South in a way that is sustainable and maximizes contributions to structural transformation and economic development.

9. The greatest barriers to interregional trade are often due not to tariffs and regulatory barriers so much as inadequate infrastructure and underdeveloped production strategies in developing economies. For example, under the Southern African Development Community, 97 per cent of duties on imports from outside the Community have already been removed, yet the volume and balance of trade has changed little.⁷ Integration arrangements, if they are to be effective, should be complemented by advances in cooperative arrangements that address infrastructure barriers and trade capacity-building. Moreover, addressing regional economy constraints to make integration viable requires political will from an early stage of the integration process.

⁵ UNCTAD, 2007, *Trade and Development Report, 2007: Regional Cooperation for Development* (United Nations publication, Sales No. E.07.II.D.11, New York and Geneva).

⁶ A DiCaprio, AU Santos-Paulino and MV Sokolova, 2017, *Regional trade agreements, integration and development*, Research Paper No. 1, UNCTAD.

⁷ R Davies, 2009, *Promoting regional integration in Southern Africa: An analysis of prospects and problems from a South African perspective*, *African Security Review*, 5(5):27–38.

A. Regional trade agreements and megaregional agreements

10. International trade governance in the 1990s was marked by the conclusion of the Uruguay round of multilateral trade negotiations and the establishment of the World Trade Organization in 1995. The multilateral trade regime comprises a set of negotiated, binding and enforceable rules and commitments built on the core principles of reciprocity and non-discrimination. Together, the rules and commitments provide for certainty and predictability in international trade and limit adverse international spillovers that might result from beggar-thy-neighbour policies (i.e. discriminatory or mercantilist trade policies, whereby economically or politically powerful countries seek to obtain benefits at the expense of other countries). The multilateral trade regime has granted developing countries some important exceptions, namely, special and differential treatment provisions, which add flexibility to the trade governance framework under the World Trade Organization by permitting developing countries to offset structural disadvantages through particular benefits, such as longer time periods for implementing agreements and binding commitments; and measures adopted to increase trading opportunities for developing countries.

11. The 1990s also saw the beginning of a proliferation of bilateral and regional free trade agreements. Regional economic integration has traditionally sought increased market size and regional trade that can provide efficiency gains through an increased regional division of labour and the economies of scale required to achieve structural transformation. The resulting employment and income gains would allow for a more equitable sharing of the economic benefits of trade integration and help reduce vulnerability to shocks. However, the bilateral and regional free trade agreements that have spread across the global economy since the 1990s are characterized by commitments that exceed those in multilateral trade agreements by giving little room for special and differential treatment provisions and including both more specific commitments within certain policy areas and an expanded number of policy areas, such as intellectual property rights protection, government procurement, investment, competition policy, environmental and labour-related standards, regulatory harmonization, enforcement and dispute settlement provisions. Such extended commitments reduce policy space for developing countries and incentives for multilateral trade cooperation. Moreover, they tend to empower special interests and politically well-connected firms and to increase the extent of trade through international supply chains and the size of the foreign value added component of exports. They therefore have a causal impact on the depth of free trade agreements that, as a result, have stronger redistributive outcomes that often favour larger firms.⁸

12. Such forms of trade integration have thus led to concern about the power of large multinational corporations and a popular backlash against trade integration in both developed and developing countries.⁹ The latter has been combined with expressions of dissatisfaction with the World Trade Organization, with some observers pointing to an alleged governance gap between existing rules that arguably address “twentieth-century trade” and what may be required to govern “twenty-first-century trade”, that is, the multilateralization of free trade agreements covering intellectual property rights protection, investment, competition, environmental and labour-related standards, innovation and electronic commerce; and moving commitments with regard to trade in services to the same level as those with regard to trade in goods.¹⁰ One reflection of this widespread concern has been the flattening in the number of newly concluded bilateral and regional free trade agreements, following the peak at the time of the global financial crisis, and a related emphasis on megaregional trade agreements.

⁸ See UNCTAD, 2022, *Trade and Development Report 2022: Development Prospects in a Fractured World – Global Disorder and Regional Responses* (United Nations publication, Sales No. E.22.II.D.44, Geneva).

⁹ UNCTAD, 2018, *Trade and Development Report 2018: Power, Platforms and the Free Trade Delusion* (United Nations publication, sales No. E.18.II.D.7, New York and Geneva).

¹⁰ See <https://voxeu.org/article/multilateralising-21st-century-regionalism>.

13. Most megaregional trade agreements, referred to as such due to their large economic and geographic sizes, have aimed to consolidate the large number of bilateral and regional free trade agreements and to do so with a view to including deeper commitments in order to deal with twenty-first-century issues, for example, the Transatlantic Trade and Investment Partnership between the United States and the European Union. However, negotiations on the Partnership have been dormant since 2017. Some megaregional trade agreements, such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (which replaced the Trans-Pacific Partnership following the withdrawal of the United States from the latter), pay significant attention to a wide range of issues such as gender, climate change, human rights and labour standards but also emphasize the digital economy and data governance. However, whether such agreements are an appropriate means of data governance is an open question. Data-related issues affect many economic areas, including trade, finance, production, market structure and taxation, yet such issues also affect many non-economic areas, including health, the environment, national security and human rights, such as privacy. Moreover, a large proportion of data are not linked to any trade flows.

14. Megaregional trade agreements have led to different responses, particularly among developing countries, partly with a view to dealing with potential trade-diverting effects, including under the Transatlantic Trade and Investment Partnership, for example, through the Regional Comprehensive Economic Partnership; and partly to benefit from supply-chain relocation and to boost intraregional trade and maximize its developmental impact, for example, through the African Continental Free Trade Area.

B. Development-oriented trade integration

15. Boosting structural transformation and intensifying cross-border production and market linkages cannot rely simply on increased trade flows. Instead, regional trade integration must be part of a broader development strategy that also promotes regional integration and cooperation in a range of non-trade areas. Such an approach, which may be called “open developmental regionalism”, aims to ensure a stable macroeconomic and financial framework that supports fixed investment and the creation of productive capacity and employment, including by avoiding real exchange rate instability and overvaluation and by fostering the provision of long-term investment finance. Moreover, it aims at policy coordination across policy areas both within an economy and among countries in a region. Critical in achieving these objectives are institutional structures such as a developmental State, as well as joint, regional industry and infrastructure policies, particularly with regard to physical infrastructure, customs, transport, energy and communications networks.

16. In addition to the external economic environment, the commitments that countries make in trade agreements shape the extent and nature of trade integration and economic development in developing countries. It is therefore vital for such commitments to respond to development priorities rather than the business interests of a few large multinational corporations. However, commitments in regional free trade agreements and some megaregional trade agreements have increasingly fostered incentives skewed to increasing cost competitiveness through wage repression or buying up competitors, rather than to increasing profitability through investment and increased productivity.

17. Multilateralism is beneficial for developing countries because, individually, they have weak bargaining power compared with developed countries. Moreover, multilateralism, as a central pillar of global trade governance, provides for transparency, security and predictability in global trade relations. Yet recognizing the virtues of the multilateral system does not mean defending the status quo. If progress is not made on the goal of making the multilateral system more inclusive, multilateralism may be eclipsed by megaregional trade agreements, driven by the most powerful States. This implies that developing countries need to be engaged in multilateral trade governance while recognizing the advantages that open developmental regionalism may provide in areas that do not lend themselves to trade rules and/or where they do not yet have the capacity to engage in binding multilateral commitments.

18. Contrary to the deep free trade agreements of the 1990s and early 2000s or the recent megaregional trade agreements, which include several chapters similar to those of the Trans-Pacific Partnership that did not enter into force, open developmental regionalism could be an important element in ensuring that the voices of developing countries are heard and in reinforcing South–South cooperation towards achieving a more development-oriented international trade governance. Open developmental regionalism would limit binding commitments to border measures, while relying on cooperation and, over time, flexible policies aimed at the regional harmonization of behind-the-border trade measures.¹¹ Supported by institutional structures such as the developmental State, open developmental regionalism could thus also facilitate the management of the diverging interests and sensitivities of developing countries and developed countries, for a more inclusive and developmental international trade governance.

III. The production dimension of regionalization

19. In recent decades, the combination of the presence of large international firms with dominant market positions and advances in information and communications technology has made it easier and cheaper to organize geographically dispersed production networks, contributing to the spread of global value chains that account for an increasing share of international trade, global gross domestic product and employment. Products are no longer made in one country and shipped to another for sale; instead, they often go through many stages, traversing several geographical and organizational borders and adding components and value before reaching final markets. This has significantly increased trade in intermediaries and vertical specialization (that is, the import content of exports). Policymakers are therefore increasingly turning to integration and upgrading in global value chains as a means of driving economic development, generating employment and raising incomes.

20. However, despite the increased participation of developing countries in global production networks in many different sectors, building and upgrading manufacturing capacity remains a goal in most developing countries. Developing economies with limited productive capacities can remain trapped in, and competing for, the lowest value adding activities at the bottom of a global value chain, which can result in slow economic growth and limited employment generation.¹² Participation in global value chains also involves the additional risk of leading to specialization in a narrow strand of production with a concomitantly narrow technological base and overdependence on multinational enterprises for access to global value chains. Such integration can lead to asymmetric power relations between lead firms and suppliers and can result, in particular in developing countries, in a weak bargaining position in attracting foreign direct investment and maximizing the potential advantages from hosting such flows.

21. An alternative approach in developing economies is to focus more on regional markets in the global South. Economies in East Asia, particularly China (despite its global reach in terms of imports and exports) and Taiwan Province of China, the Republic of Korea and Singapore, have long recognized the importance of the regional production network in East Asia. In addition, in response to the collapse of trade following the global financial crisis, several suppliers in other developing regions shifted end markets from the

¹¹ Border measures related to imports involve tariffs and quantitative restrictions; behind-the-border measures are those with effects beyond customs, including non-tariff measures (non-customs tariff policy measures that yet have some economic effects on international trade), technical barriers to trade, rules of origin and domestic regulations related to intellectual property rights, government procurement, investment, competition and environmental and labour-related standards. Particularly binding commitments on behind-the-border measures that concern domestic regulation tend to complicate development strategies aimed at structural transformation and based on industrial, technological, trade-related and regulatory policies.

¹² G Gereffi, 2014, Global value chains in a post-Washington Consensus world, *Review of International Political Economy*, 21(1):9–37; UNCTAD, 2014, *Trade and Development Report, 2014: Global Governance and Policy Space for Development* (United Nations publication, Sales No. E.14.II.D.4, New York and Geneva).

global North to the global South in an effort to regionalize supply chains.¹³ The impacts of the pandemic can further reinforce this trend, as more industrialized economies may now be willing to prioritize resilience and the dependability of production over cost savings linked to global outsourcing in international markets.

22. Regional value chains can be instrumental in increasing value added in developing countries. Given the size of and productive capacities in many developing countries, a local industrial strategy might quickly reach its limits. This can be overcome through a regional perspective, as different complementary advantages in a region may be leveraged and economies of scale, vertical integration and horizontal specialization may be promoted. This is particularly important in smaller countries, among which regional connections are crucial in complementing capacities, considering supply-side constraints.

23. Regional value chains are characterized by end products that are exported by a country within a region, more often to a regional partner, and by many high value adding activities undertaken within the region. They can therefore significantly contribute to the creation of value at the local level and offer more opportunities to participate, gain experience and build the local capacities needed to compete globally, thereby serving as a stepping-stone to global value chains.¹⁴ In addition, regional markets might also provide better potential for upgrading, particularly in terms of functional upgrading, including in design, marketing, branding and distribution.

24. Recent evidence, however, suggests that despite the advantages, regional value chains are much less developed than global value chains.¹⁵ In the last two decades, the gap between the two types of chains has been widening rather than shrinking and in all of the regions covered in the trade in value added database (excluding Europe), the extraregional component of foreign value addition is significantly higher than the intraregional component. Understanding new markets and the investment and sourcing policies of leading firms and buyers selling in these markets will be key in fostering the expansion of regional value chains in future.

25. From a policy perspective, South–South cooperation can bolster regional integration initiatives by helping to overcome the obstacles that have hindered their development to date. Such cooperation can also help set up new financing mechanisms for trade and infrastructure development and, in particular, support a more ambitious development agenda that focuses on productive capacity-building and structural transformation at the regional level. In addition, leveraging the strategic links between production for global and regional value chains is critical. Trade policy can play a strategic role in this context. In line with international agreements, regional markets in final goods can still be partially protected and reserved for local firms (thereby restricting foreign direct investment firms to supplying local markets, for example through special economic zones or industrial parks), to play a role along the lines of that under the infant industry paradigm in order to build capacity and allow for learning by doing. Moreover, government procurement can still be a powerful tool for supporting such a strategy and should be preserved. This should, however, be combined with capacity-building measures and a clear goal to begin exporting within a reasonable time frame, as this will lead firms to increase productivity and competitiveness and obtain access to modern production processes, technologies and standards.

IV. Financialization and corporate arbitrage: Challenges for regionalism and development

26. The reorganization of production in recent decades through increased flows of foreign direct investment, at both the global and regional levels, has coincided with significant changes in the way that firms and markets operate in the economies from which

¹³ Gereffi, 2014.

¹⁴ See <https://www.sdgfund.org/global-value-chains-and-south-south-trade>.

¹⁵ B Los, MP Timmer and GJ de Vries, 2015, How global are global value chains? A new approach to measure international fragmentation, *Journal of Regional Science*, 55(1):66–92.

most of these flows originate. The two main underlying and interconnected shifts can be broadly described as liberalization and financialization. The former refers to a catch-all description of policy shifts that have produced a shrinking (and in some areas a withdrawal) of public oversight and the management of many parts of the economy, including with regard to integration into the global economy, and a greater reliance on price incentives (and the profit motive) in delivering public goods. The deregulation of financial markets and opening up of capital accounts were particularly important aspects of this shift and contributed to the growing weight of the financial sector in the economy (financialization), along with volatile movements in asset values (including prolonged boom periods) and the growth of non-bank financial institutions, such as the wealth management industry. These features can be seen in both developing countries and developed countries, albeit to varying degrees. Some of these efforts have coincided with faster growth rates in regional groups, yet UNCTAD research has shown that under these conditions, achieving the developmental impact of regional integration (as measured with regard to human development, structural transformation, export concentration, energy and the productive capacities index) has become more challenging, requiring greater strategic policy efforts to establish and sustain a desired development path.¹⁶ The role of liberalization in shaping development prospects in general, and trade and capital flows in particular has been studied in the literature; less attention has been paid to the impact of financialization, including at the regional level, and this area is addressed in this chapter.

A. Financialization in developing countries and among multinational corporations

27. The procyclical and short-term nature of market-driven finance is an important explanatory factor, yet, at a deeper level, the financialization of corporations, along with changes in corporate behaviour, are also a factor. The surge in the profitability of leading transnational corporations, predominantly from advanced economies, together with their growing concentration, has acted as a major force in pushing down the global labour income share and channelling the resulting increase in profits away from reinvestment in productive capital formation towards higher dividend payments and share buybacks, often through the use of tax havens and other opaque accounting procedures to hide such flows.¹⁷

28. Over the past two decades, the geographical fragmentation of supply chains has been paralleled by the inner transformation of firm structures, with finance, accounting, legal, business administration, consultation and, crucially, corporate treasury operations, given a more central role in corporate organizations. Many of these functions tend to be separated from other headquarters functions and performed by a subsidiary or set of subsidiaries. In addition, the subsidiaries that perform treasury functions tend to be in particular jurisdictions that provide optimal institutional environments for the performance of each function. Similarly, strategic management might also be offshored to jurisdictions that provide large pools of managerial talent and that are located near major markets. As a result, when multinational corporations invest abroad, they tend to set up a subsidiary or a joint venture company in a host country. The subsidiary is controlled directly by a parent company or indirectly by one or more subsidiaries that are ultimately held by the parent company but considered, for all intents and purposes, as an independent legal person.¹⁸

¹⁶ UNCTAD, 2022.

¹⁷ UNCTAD, 2018.

¹⁸ R Palan, H Petersen and R Phillips, 2021, Arbitrage spaces in the offshore world: Layering, “fuses” and partitioning of the legal structure of modern firms, *Environment and Planning A: Economy and Space*, available at <https://journals.sagepub.com/doi/full/10.1177/0308518X211053645>; JP Robé, 2011, The legal structure of the firm, *Accounting, Economics and Law: A Convivium*, 1(1):1–88; UNCTAD, 2015a, *World Investment Report 2015: Reforming International Investment Governance* (United Nations publication, Sales No. E.15.II.D.5, New York and Geneva); UNCTAD, 2016, *World Investment Report 2016: Investor Nationality – Policy Challenges* (United Nations publication, Sales No. E.16.II.D.4, New York and Geneva).

29. Among the largest 100 non-financial multinational corporations worldwide, the direct ownership of subsidiaries in developing countries is rare.¹⁹ For example, there is practically no direct relationship between the United States and developing countries in which corporations invest. UNCTAD research has shown that nearly all interactions between a parent company in the United States and subsidiaries in developing countries are mediated through subsidiaries in the United Kingdom of Great Britain and Northern Ireland.²⁰ Until recently, the central assumption of economic theory and policymaking had been that such corporate layers were merely functional elements of efficiency, establishing an allocation of ownership stakes across countries that need not affect or reflect the productive operations of a firm. However, research has increasingly recognized that indirect forms of investment can create a distinction between the ultimate and immediate owners of assets and thereby pose a major challenge for Governments in reasserting control over the investment regime.²¹

30. The use of intermediary subsidiaries contributes to statistical anomalies in foreign direct investment accounts, because flows through intermediary subsidiaries located in third countries inevitably create data anomalies and double counting in related statistics.²² Data on aggregate foreign direct investment positions are typically based on immediate asset ownership and therefore provide a potentially biased measure of international financial ties, distributions of asset ownership and risks associated with investment, for both home and host countries.²³

31. Such insights serve to highlight challenges related to the macro-level financial regime governing global corporate behaviour, the efforts of national Governments to attract foreign capital and ensuring the effectiveness of regional integration efforts, which are negatively affected by the global regulatory environment of competition States and global corporate structures. Due to corporate arbitrage and the role of financial innovation in the legal frameworks of multinational corporations, host countries do not receive the benefits theoretically associated with foreign direct investment, such as greater employment and productivity, technology transfer, increased manufacturing capacity and, crucially, tax revenue.

B. Multinational corporations and the macroeconomy

32. At the level of global corporate activity, the inner financialization of the corporate structure can serve as a tool for value extraction and earnings stripping.²⁴ In addition to corporate groups themselves, the beneficiaries of this phenomenon tend to be advanced economies, in particular, global financial and corporate hubs that tend to be located in Europe and offshore financial centres.

33. Success in attracting foreign direct investment is not, in and of itself, conducive to making incoming foreign capital work for the host economy and increasing productive capacities and levels of employment and welfare. Large corporate groups can be structured in such a way that local subsidiaries exploit local economic advantages in the form of inexpensive labour and natural resources, among other forms, while other subsidiaries located in other jurisdictions benefit from value extraction through localized profits, low taxes and other regulatory advantages.

¹⁹ UNCTAD, 2022.

²⁰ Ibid.

²¹ T Bertz, A Pond and W Yin, 2021, Investment agreements and the fragmentation of firms across countries, *The Review of International Organizations*, 16(4):755–791; Robé, 2011.

²² G Zucman, 2013, The missing wealth of nations: Are Europe and the U[nited] S[tates] net debtors or net creditors? *The Quarterly Journal of Economics*, 128(3):1321–1364.

²³ For example, in 2014–2015, Bermuda replaced Cyprus as a leading foreign direct investment investor in the Russian Federation, and the leading three foreign direct investment investors in China are Hong Kong, China; the Cayman Islands; and the British Virgin Islands (data from the Ministry of Commerce, China, and the Central Bank of the Russian Federation).

²⁴ UNCTAD, 2022.

34. Earnings stripping through the use of corporate subsidiaries affects the fiscal space of a host economy. Developed countries can potentially offset a significant part of lost direct corporate tax revenue by collecting increased investor-level tax revenue on dividends, interest and capital gains, which tend to be boosted by higher rates of global corporate tax avoidance. Developing countries, by contrast, are generally unlikely to recover significant revenue in this way. They also face an additional disadvantage in the long term, namely, that the cost of borrowing is higher, usually by several times, than the cost for advanced economies. Developed countries can issue debt to offset tax losses at extremely low or even negative interest rates, yet developing countries typically pay higher interest rates. This causes the costs of incurred tax losses to compound over time. For example, Germany loses around \$24 billion in taxes due to profit shifting (3 per cent of total tax revenue)²⁵ yet can issue 20-year bonds with a yield of -0.03 per cent to pay for public services. By contrast, Mexico loses around \$8 billion due to profit shifting (6 per cent) yet can only issue bonds with a yield of 7.1 per cent. Ultimately, such uneven costs of government borrowing determine whether or not a country can grow out of increases in debt issued to offset tax revenue shortfalls.

35. Given this global context and structure of power, the developmental impact of regionalization efforts appears marginal at best. The global corporate and financial regulatory architecture favours private corporate and financial interests and is guarded by policies in advanced economies.²⁶ In the absence of a set of regulatory standards and a systemic framework of regulation, developing countries need to build relevant finance, accounting, legal and data-related expertise with a view to enhancing the visibility of corporate behaviour at the global level.

36. With better public scrutiny of the realities of foreign direct investment, regulatory institutions could be led to take action. In the light of this analysis, such measures are essential if developing economies are to address the mechanisms of rent extraction by the global corporate sector and facilitate the role of foreign capital in the structural transformation of their economies. An attempt to consolidate available resources at the regional regulatory level could be a useful first step towards the harmonization of regulatory policies and curbing, at least at the regional level, opportunities for corporate arbitrage.

37. The availability of reliable data on corporate financial behaviour, professional expertise and dedicated regulatory mandates at the national level can play a key role. Yet regional monitoring and regulatory response are also critical. In this regard, it is encouraging that the European Union is considering making it mandatory for large companies to detail their groups of subsidiaries in corporate registers. This is an important step towards improved oversight of corporate behaviour.

38. If left unresolved at the global level, however, the problem will magnify in future, leading to greater inequality within and between countries. The success of the base erosion and profit shifting project led by the Organisation for Economic Co-operation and Development and the Group of 20, as well as tax justice campaigns, show that multilateral dialogue and efforts with regard to complex issues are viable. The phenomenon of corporate financial and rent extraction is by definition multifaceted, yet United Nations entities, in particular UNCTAD, are in a unique position to lead a programme of reform, capitalizing on the relevant expertise of UNCTAD, as well as the International Labour Organization and the World Trade Organization. The goal would be to formulate a multilateral and multilayer strategy to represent the interests of developing countries and aimed at addressing the negative consequences of corporate rent-seeking and financial arbitrage.

²⁵ J Garcia-Bernardo and P Jansky, 2021, Profit shifting of multinational corporations worldwide, Working Paper No. 14, Institute of Economic Studies, Faculty of Social Sciences, Charles University Prague.

²⁶ UNCTAD, 2022.

V. South–South opportunities: Why South–South and regional development finance and why now?²⁷

39. South–South cooperation is set to increase in the coming years, as developing economies experience economic growth, along with awareness of the importance of regional cooperation initiatives. The ongoing impacts of the pandemic underscore the need for the adaptation of international development cooperation practices. With regard to South–South cooperation agreements for trade and investment, regional integration must go beyond market integration and aim to develop regional productive capacities and regional value chains. Major industrial policy efforts and coordination, in turn, could enable economies in the global South to “build back better” following the pandemic, increase resilience and foster structural transformation.

40. Regional and South–South solutions for financing inclusive and sustainable development are being called upon as never before, as countries worldwide deal with the new demands of food and commodity price inflation, coming on top of ongoing pandemic-related relief and recovery and the significant investment push needed to achieve the Sustainable Development Goals and climate-related goals. Private finance will be critical in filling financing gaps but cannot lead or provide the momentum needed to address related demands and the scaling up of public finance is therefore required to accomplish most of the task.

41. National development finance institutions in many countries are, however, undercapitalized for the tasks they face. In addition, many of the challenges are either regional at the source or require regional solutions because they involve cross-border spillovers that countries cannot address alone. In this context, the role of public banks, both regional and national, is being reappraised. New banks are being established and existing ones expanded, national banks are lending beyond their borders and regional banks and other instruments are taking on an expanded role, to deal with regional public goods and bads and to help support national lending to members. Many of these are new banks are owned and led by the global South, to the extent that the landscape now offers more diverse institutions and choices for harnessing development finance than before. At the same time, however, the implications of past decades of undermining such public institutions can be seen. Although their lending has increased significantly in recent years, it remains dwarfed by other sources of finance, in particular bilateral aid and swaps that do not offer the same principles of universality or neutrality nor the advantages of transparency.

42. Regional development finance institutions and instruments to provide foreign exchange liquidity in times of balance of payments distress had emerged many decades previously but gathered momentum after the financial crisis in Asia in the late 1990s and the global financial crisis. In 2007, there was about \$360 billion available to countries in distress, with the majority (\$321.6 billion) coming from the International Monetary Fund and the remainder (\$40.5 billion) potentially available to members of the three major regional financing arrangements, namely, the Arab Monetary Fund, the Chiang Mai initiative in Asia and the Latin American Reserve Fund. Over a decade later, the landscape of emergency liquidity had changed significantly in terms of both the magnitude of the total and the sources; there was about \$3.5 trillion available, of which, in 2018, the International Monetary Fund provided \$1 trillion, 11 regional financing arrangements provided \$1 trillion and a new source of finance provided \$1.5 trillion, namely, bilateral swaps negotiated between central banks now accounted.²⁸ New regional financing arrangements now included examples from Europe (European Stability Mechanism, 2012; Eurasian Fund for Stabilization and Development, 2009) and developing regions (BRICS[Brazil, Russian Federation, India, China and South Africa] Contingency Reserve Arrangement, 2015).

²⁷ This chapter draws upon chapter 4 of UNCTAD, 2022.

²⁸ L Mühlich and B Fritz, 2021, Borrowing patterns in the global financial safety net: Does governance play a role? *Global Policy*, 12(S4):47–68.

43. Given the plethora of new and expanded regional arrangements, they might have been at the forefront of pandemic-related economic shocks. Instead, there has been a significant use of bilateral swaps. The emerging trend of a significant reliance on bilateral swaps had been observed before the pandemic and reliance increased sizeably during the pandemic.²⁹

44. Such swaps are offered by a wide range of central banks, predominantly the People's Bank of China and the Federal Reserve in the United States, and, to a lesser degree, by the central banks of other advanced economies such as Australia, Japan, Sweden, Switzerland and the United Kingdom. However, while such voluminous sources of finance may seem to be a positive development for countries in distress, in practice, bilateral swaps lack many of the advantages of multilateral or regional lending, including with regard to predictability and transparency.³⁰

45. This aspect of the global financial safety net is discretionary and not driven by standard practices or protocols. Therefore, it does not provide a level playing field for all countries. Not all countries have the ability to negotiate such bilateral agreements and the relationship between lender and borrower is not necessarily equal if it focuses on the interests of the economically stronger country, particularly with regard to trade and financial ties but also political and geostrategic issues. This form of liquidity provision during the pandemic was strongly skewed towards higher income countries and certain regions, namely East and Central Asia and Europe, mainly represented by the central banks of China, Japan, Sweden, Switzerland and the United States. There have also been a few instances of bilateral swaps among emerging economies, such as between Qatar and Türkiye and between Indonesia and the Republic of Korea).

46. The implications of these new trends deserve greater attention. The evolving reliance on bilateral solutions rather than multilateral solutions raises at least five major concerns, as follows:

(a) If demand for liquidity resources grows (which could be likely given the continued post-pandemic environment and rising interest rates and food prices), poorer countries and regions will face greater difficulties in sourcing the required crisis financing; as yet, none have negotiated swaps.

(b) Regional financing arrangements and the International Monetary Fund are multilateral institutions, yet the extent to which bilateral swaps have outpaced multilateral liquidity provision throughout the crisis raises questions about the confidence of countries in the crisis resolution capacity of these institutions.

(c) Insufficient choice and competition in the system could discourage better services delivery and weaken the bargaining power of Governments with regard to programmes to return countries to stability and sustainability.

(d) The threat of the potential marginalization of regional financing arrangements was evident before the pandemic, to the extent that some studies showed that such arrangements should ensure that member countries, rather than outside institutions, had ownership of regional surveillance and enforcement systems.³¹ The reluctance to use the Chiang Mai initiative multilateralization has apparently been linked to the fact that member countries can draw only part of their entitled shares without having to secure an International Monetary Fund programme.³² However, the long-standing inequalities in

²⁹ D Barrowclough, R Kozul-Wright, WN Kring and KP Gallagher, eds., 2022, *South–South Regional Financial Arrangements: Collaboration Towards Resilience*, Springer Nature, Cham, Switzerland; L Mühlich, B Fritz and WN Kring, 2021, Towards the marginalization of multilateral crisis finance? The global financial safety net and COVID-19[coronavirus disease 2019], Policy Brief No. 15, Global Development Policy Centre, Boston University, United States.

³⁰ See <https://www.mobilizingdevfinance.org/research-material/global-financial-safety-nets-sdrs-and-sustainable-development-finance-can-options>.

³¹ WW Grimes, 2011, The future of regional liquidity arrangements in East Asia: Lessons from the global financial crisis, *Pacific Review*, 24(3): 291–310.

³² Mühlich et al., 2021.

access to and the availability of short-term financing show the uncoordinated status quo of the global financial safety net.

(e) A reduction in the use of regional multilateral institutions raises concerns with regard to national interests that increasingly influence the crisis finance regime.

47. A similar picture is seen with regard to long-term finance, namely, just as multilateral and regional banks have been increasing the amount of long-term finance available, they too have been dwarfed by other sources of finance available bilaterally. Most development banks are national, but the 10 per cent that are multilateral or regional³³ have a particularly important role to play in an integrated world, particularly with regard to solving problems that transcend national borders. In addition, as with regional financing arrangements, there are many benefits to pooling resources among different countries; doing so not only increases the amount of available financing but can also create larger markets, increase synergies with infrastructure or other services and enhance “voice” in the global economy. For these reasons, there has been a wave of new regional development finance institutions alongside the scaling up of existing ones, as well as a trend of larger national banks lending outside their borders to other countries in the region. Many of these changes have been particularly marked in the global South, with the rise of new banks owned and led by the global South, as well as the strengthening of long-standing ones.³⁴

48. Aggregate lending by regional banks has increased steadily over recent decades and, in some instances, has increased at a rate faster than among the Bretton Woods institutions, in some cases also exceeding the latter in terms of amount.³⁵ Regional banks provided at least \$180 billion in 2018, of which slightly more than half was provided on concessional terms³⁶ and was therefore critical for borrowers. Moreover, lending by the Asian Infrastructure Investment Bank, the European Investment Bank or the New Development Bank, which are not considered regional banks in official databases, has significantly changed the landscape of lending. The European Investment Bank, for example, lent more than the World Bank in 2021.

49. These trends notwithstanding, the major threat faced by regional development banks is the dominance of non-multilateral, ad hoc bilateral flows and earmarked donor funding.³⁷ For the most part, developed countries have not increased financing to the regional development banks in which they had a stake, yet they now express concerns about the rise of other sources of finance that are filling the void. Similarly, with regard to reserve funds, regional development banks provide only a fraction of lending compared with bilateral official development assistance, at less than half the value of flows in the latest year for which data are available, although this includes one of the years of greatest lending by regional development banks. This is a concern because it involves the same issues of lack of transparency and universality. Not all countries can benefit to the same extent from bilateral aid flows and the swing of the political pendulum may likely undermine the ability of borrowers to make long-term development plans. Similarly, the principle of solidarity may be eroded if lenders are not also borrowers. In addition, the capacity and potential role of development banks is undermined if their finances are precarious or irregular; they will be constrained in their potential ability to make catalytic investments or to take equity positions in which they could become profit sharers and owners of intellectual or other property, rather than simply on-lenders, for example. The potential of regional development banks in the global financial architecture is therefore not used to its full benefit. The cost of

³³ J Xu, X Ren and X Wu, 2019, Mapping development finance institutions worldwide: Definitions, rationales and varieties, Institute of New Structural Economics, available at <https://www.nse.pku.edu.cn/en/research/publicaper/490123.htm>.

³⁴ D Barrowclough, KP Gallagher and R Kozul-Wright, eds., 2021, *Southern-Led Development Finance: Solutions from the Global South*, Routledge, Milton Park, United Kingdom; UNCTAD, 2015b, *Trade and Development Report, 2015: Making the International Financial Architecture Work for Development* (United Nations publication, Sales No. E.15.II.D.4, New York and Geneva).

³⁵ UNCTAD, 2022.

³⁶ Organisation for Economic Co-operation and Development, 2020, Multilateral development finance, available at https://www.oecd-ilibrary.org/development/multilateral-development-finance-2020_e61fdf00-en.

³⁷ UNCTAD, 2022.

this is likely to be felt most strongly among the activities for which it is always difficult to raise finance, namely, regional public goods and bads or lending to uncertain and risky activities that could be highly beneficial in economic terms if not in narrowly financial terms.

50. One way to redress the stark and growing disparity of the significance of multilateral lending compared with ad hoc bilateral capital flows would be to direct more funds to regional development banks. The need for this was one of the most significant lessons to emerge from the experience of the pandemic among regional development banks, particularly in terms of the importance of having sufficient and reliable sources of capital. Banks that were well capitalized were better able to offer assistance when needed.³⁸ There are different ways this can be done, many of which have been discussed by UNCTAD in editions of *Trade and Development Report*, including taking on additional members, including from higher income countries, as this both increases the pool of available capital and makes it easier for banks to raise additional capital in international markets. Another way is to revisit the triple-A requirements imposed on most banks by government owners, to enable them to hold smaller cash reserves. In this regard, there is a need to clarify bank mandates and the way in which lending decisions are monitored and appraised; it is difficult for banks to lend through a truly public orientation when they are underfinanced or criticized for taking on risky or less popular investments. Finally, another way is to not take on new members but, rather, to increase capital contributions from existing government members.

51. These are all important measures. The possible solution currently debated concerns the potential transfer of special drawing rights, including that resulting from a potential redistribution of the \$650 billion already issued in 2021. Such a redistribution from advanced countries that do not require special drawing rights to poorer economies that do has been addressed, and in principle supported, by the Group of 20, and a tentative figure of \$100 billion has been approved for such a redistribution. This would be highly significant, as it is already more than the amount of all concessional lending by multilateral development banks in 2018.

VI. Issues for discussion

52. In addition to the issues presented in this note, delegates at the fifth session of the Multi-year Expert Meeting may wish to consider the following questions:

(a) The fact that finance can be found at times of urgency, such as during the pandemic, does not necessarily mean that it is directed to where it is most needed. How can Governments show more support for their national and regional public banks, including through finance and capitalization, guarantees or political willingness to support a more public and developmental mandate?

(b) What are the implications of the rising dominance of bilateral capital flows compared with financial support for regional institutions?

(c) How can regional banks and regional financing arrangements better contribute to the international financial architecture? Can they be a useful stepping-stone to a more equitable and effective multilateralism?

(d) The pandemic has exposed profound fault lines in the functioning of global value chains. How can this opportunity be taken to relaunch regional value chains? What infrastructural investment is needed?

(e) The scope and impact of many regional trade agreements between economies of the global South remain limited despite their diffusion since the turn of the millennium. What additional provisions and/or clauses or complementary measures are needed to make these trade agreements more relevant?

³⁸ See <https://unctad.org/webflyer/public-banks-and-covid-19-combatting-pandemic-public-finance>.

(f) How can the phenomenon of trade regionalism be understood and to what extent can it be a stepping-stone towards a more inclusive, constructive and cooperative approach to multilateralism?

(g) What institutional arrangements are best suited to managing the different interests and sensitivities of developing countries and developed countries, for a more inclusive and developmental international trade governance?

(h) How can recent international efforts be enhanced to improve global tax justice and corporate governance, to better address the investment needs of developing countries?
