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Seven years after the outbreak of the global financial and economic crisis, growth of world output remains mediocre, around 2.5 per cent for 2015.[1] This rate has remained largely unchanged since 2011, and significantly below the pre-crisis growth of 4 per cent. A slight acceleration of growth in developed countries (mostly in Japan and the Eurozone) from 1.6 to 1.9 per cent along has been offset by a slight deceleration in developing countries from 4.5 to around 4 per cent and an economic contraction in the transition economies, of almost 3 per cent this year. The relative resiliency in developing countries growth results mainly from the performance in East, South and South-East Asia, while other developing regions are suffering more severe slowdowns.

Due to slow growth in global demand, international trade remains subdued. Between 2012 and 2014, the rate of growth of world merchandise trade (by volume) oscillated between 2 and 2.6 per cent. These growth rates are significantly below the average annual rate of 7.2 per cent recorded during the 2003–2007 pre-crisis period. Preliminary estimates for 2015 indicate that merchandise trade volume continues growing at about 2-2.5 per cent, a rate close or even below that of global output. This remains largely insufficient to provide, by itself, a significant stimulus to economic growth.

Additionally, the downside risks to global recovery have been growing; every week we see new signs of weakening GDP growth in several countries and regions, stagnating international trade and financial fragility. This panorama suggests that the world economy has not yet overcome its crisis, which may have entered a new and dangerous phase.

[1] Output is measured in 2005 US$ at market prices.

The world economy has entered a new third phase of crisis

During the first phase, virtually all countries applied supportive economic policies to avoid the implosion of the financial system and mitigate economic downturn. Simultaneous expansionary fiscal and monetary policies in developed and developing countries alike were successful in that respect.

The second phase witnessed diverging economic policy paths in developed and developing countries. As early as in 2010, developed economies shifted towards fiscal austerity as a way to restore market confidence, relying on monetary policies to support economic activity. At the same time, developing countries maintained their counter-cyclical policies. As UNCTAD first warned, this policy mix has been inapproriate; it has proven ineffective for bringing about recovery in developed countries, and has encouraged large capital flows to emerging economies, increasing these economies' vulnerability.

Expansionary monetary policy in developed countries has, by and large, failed to spur private spending in the midst of a recession, as firms, households and banks were de-leveraging while future investment prospects remained subdued; asset price appreciations did encourage demand through resulting wealth effects, but with the risk of re-creating financial bubbles. By contrast, fiscal expansion has largely remained unused, in spite of its proven record in recessionary conditions, given high public spending multipliers. Fiscal austerity was therefore costly, and to some extent self-defeating because with slower GDP growth, fiscal revenues fell short of expectations. Since this policy mix did not translate significantly into higher credit to the private sector and stronger demand within developed economies, expansionary monetary policy translated in to capital outflows towards emerging economies that seemed to have de-linked from the global recession.

These trends at first encouraged economic rebound in developing countries, which became the main growth driver in the world economy. However, excessive and volatile capital movements were of little help for investment; instead, they generated macroeconomic instability and vulnerability in developing countries. In fact, they greatly expanded domestic credit, increased foreign debt (particularly in the private sector) and appreciated domestic currencies, therefore creating vulnerabilities to a reversal of capital flows. This reversal has been taking place in the last few months. On top of that, maturing investments in primary commodities did not find markets expanding as strongly as in previous years, putting downside pressure on commodity prices. Together these factors pointed to a dramatically deteriorating international economic

environment for most developing countries, which have found it increasingly difficult to maintain their countercyclical policies.

This has led to a third stage in the international crisis, in which weakening commodity prices, deteriorating external and fiscal balances in many developing and transition economies and the reversal of capital movements has led to currency depreciation, asset price declines and policy tightening. External debt may become a serious problem again. Developed countries have benefited from gains in the terms of trade by improving domestic purchasing power. However, they will not be insulated from a significant economic slowdown in developing and transition economies.

These interactions and spillovers (both positive and negative) among different groups of countries highlight the interdependence of the global economy. In this context, although individual countries or group of countries may need to implement appropriate policies at the national and regional levels, these policies should be consistent with international economic recovery. For instance, the strategy of restraining domestic demand and trying to grow through net exports will be self defeating if followed by many trading partners: it will only aggravate the weakness of global demand, which is in UNCTAD's view the main factor hindering economic recovery. International trade cannot be an autonomous source of growth for the global economy: external demand for one country is the domestic demand of another one, and vice-versa. Domestic demand and international trade will recover or stagnate together.

Weak commodity prices due to both excess supply and weakening demand

Commodity markets witnessed particularly turbulent times in 2014 and 2015. Most commodity prices fell significantly in the course of 2014, continuing the declining trend that started after the peaks of 2011−2012, with a particularly notable slump in crude oil prices. The pace of the price decline accelerated particularly in the commodity groups for which demand is more closely linked to global economic activity, such as minerals, ores and metals, agricultural raw materials and oil. Market fundamentals appeared to be the major driver of commodity price movements, although financialization of commodity markets continued to play a role, as sharp reversals in financial investors' net commodity positions accelerate and exacerbate price movements. Furthermore, the strong appreciation of the dollar over the past year has been an important factor in the declining prices of commodities.

The plunge in oil prices resulted mainly from greater global production, especially shale oil in the United States, and OPEC's abandonment of its price-targeting policy, presumably to defend its market share by attempting to undercut higher cost producers in order to drive them out of the market. The resulting lower oil prices have had an impact on other commodity prices through different channels. Lower oil prices provide incentives to increase commodity production as a result of reductions in some production costs. They may also discourage demand for agricultural products used in biofuels and reduce the prices of synthetic substitutes for agricultural raw materials (e.g. cotton and natural rubber). However, most of the price evolution in agricultural markets was determined by their own supply, which was affected, in particular, by meteorological conditions. The declining prices of most minerals, ores and metals were also due mainly to larger supplies, as investments of the last decade came on stream, just as markets were losing steam.

Prospects for commodity prices are uncertain. Lower commodity prices caused by oversupply are already leading to some downward adjustments in investment and production capacities, while future demand would appear to hinge on the pace and pattern of recovery in the developed economies and on growth prospects in the larger emerging economies. Still, recent trends are a reminder of the challenges that many commodity-dependent developing countries still face and how crucial it is for them to properly use their resource rents to implement diversification and industrial policies for achieving structural change and sustained growth.

Incomplete systemic reforms mean the causes of the crisis have yet to be addressed

The length of the global financial crisis and its evolution into a third phase involving emerging economies, is evidence that the causes of the crisis have not been adequately addressed. Among these causes, the shortcomings of the international monetary and financial system have a prominent place.

A well-functioning international monetary and financial system should be able to properly regulate international liquidity, avoid large and lasting imbalances and allow for counter-cyclical policies; instead, the current system is characterized by financial instability, pro-cyclical capital movements, recurrent sovereign debt crises and the lack of appropriate mechanisms and policies to deal with them. This results to a large extent from the explosive growth of private sources of liquidity since the breakdown of the Bretton Woods system in the early-1970s, far exceeding official sources. Yet, while private international liquidity tends to be abundant in boom periods, it rapidly evaporates in crises. Furthermore, these capital flows

follow economic conditions and policy decisions in developed countries rather than financing needs in developing and transition economies.

In response to this procyclical pattern, many developing countries have accumulated large amounts of official liquidity in the form of foreign-exchange reserves, but this has provided only a limited insurance. UNCTAD's *Trade and Development Report 2015* analyses different alternatives aimed at reforming the international monetary and financial system. It concludes that strong multilateral rules and arrangements, such as for exchange-rate management or liquidity provisioning through special drawing rights, are still the best options. Their adoption, though, requires institutional changes that appear out of reach in the immediate future. Foreign currency swap arrangements can offer a way forward, but these have mainly catered to the needs of developed countries. Such swaps involving developing countries are still relatively limited. The International Monetary Fund's expanded loan facilities could also help but, so far, new arrangements have largely remained unused. Meeting the needs of developing countries will require prior reform of the International Monetary Fund's governance, policy orientation and surveillance mechanism.

A preferred option for developing countries may be to proactively build on a series of regional and interregional initiatives with the aims of fostering regional macroeconomic and financial stability, reducing the need for foreign exchange accumulation, and strengthening resilience and capabilities to deal with balance-of-payment crises. To address the limited size of existing regional arrangements, interregional swap arrangements would be particularly useful. Another possibility might be the creation of a common fund with a periodic increase of paid-in capital, which could be used by a regional clearing union or reserve pool to increase its liquidity provision capabilities.

Bolder banking regulation can make finance work better for development

The international financial system continues to suffer from a deficit of regulation. Much of the current regime is still driven by large international banks and financial intermediaries whose activities increased much more rapidly than the capacity of any public institution (either national or multilateral) to effectively regulate them as well as by shadow financial institutions designed explicitly to be outside the purview of regulators.

The 2008 financial crisis triggered several initiatives aimed at strengthening regulation and supervision; however, many reforms remain both too timid and narrow, and insufficient

account has been taken of the specific needs of developing countries, such as taming speculative cross-border capital flows.

Higher capital adequacy ratios and new provisions for systemically important banks are a positive step. However, Basel III maintained the risk-weighted system, thus failing to prevent high leverage and procyclicality, while discouraging lending to small and medium-sized enterprises. In addition, a focus on traditional banking has meant inadequate attention to shadow banking whose importance has continued to grow, including in several developing countries. Innovative forms of credit provision and a new breed of asset managers (such as hedge funds) and broker-dealers (often in financial conglomerates) have kept leveraging at high levels, impairing financial stability. Despite the poor record of credit-rating agencies, their assessments still rule asset allocation and borrowing interest rates, as well as risk weights for capital requirements.

A bolder agenda is needed, beginning with a strict separation of retail and investment banking, as well as monitoring and regulating shadow banking. Dealing with conflicts of interest around credit rating should be addressed, although this will not end with the bias that make CRAs follow ideological prejudices rather than macroeconomic fundamentals when assessing sovereign debt sustainability. Banks could assess for themselves the creditworthiness of borrowers and/or pay fees to a public entity that assigns raters to grade securities. Finally, developing countries should not be required to apply prudential rules conceived for countries hosting large and internationally active financial institutions, some of which are difficult to implement and result in credit rationing to sectors and economic agents that need support from a development perspective (e.g. SMEs, peasants, start-ups, long-term projects, innovation, etc.).

External debt may become a serious problem again

Continued international financial instability and insufficient prudential regulation naturally lead to recurrent external debt crises. Although imprudent lending and borrowing are usually made by private agents, bad debts are frequently transferred to the public sector when economic conditions deteriorate and servicing is impaired. This is why a fairer and more efficient system for handling sovereign debt problems is urgently needed.

UNCTAD's concerns on this issue go back all the way to the 1970s. As early as in 1977, it called for explicit principles for sovereign debt rescheduling and this has remained a persistent

area of work for UNCTAD ever since. The ambition to establish ground rules for sovereign debt restructurings has also been shared and promoted by a series of institutions and by renowned academics with a voice at the international level, including the IMF.

A few weeks ago, on 10 September, the United Nations General Assembly finally adopted a resolution on nine Basic Principles on Sovereign Debt Restructuring Processes, building to a considerable extent, on extensive work carried out at UNCTAD. The adoption of this resolution marks a decisive and very timely step forward in the search for practicable, efficient and fair solutions to sovereign debt problems. The global economy continues to exhibit an unhealthy dependence on debt. During the years of the "great moderation" (1985–2005), global debt levels rose from around $21 trillion in 1984 to $87 trillion by 2000, and to a staggering $142 trillion by the end of 2007. Since the financial crisis in 2007/08, another $57 trillion has been piled on top.

For the moment, public sector borrowing in advanced economies leads the way, as is to be expected in the wake of such a serious economic crisis. In many developing countries, external sovereign debt indicators actually improved during the 2000s due to booming exports, higher fiscal revenues and strong gross domestic product growth. However, there is no space for complacency.

External debt levels are rising again in most developing countries. With the exception of Africa, which remained a less attractive market for private investors and greatly benefited from debt reduction programmes, all other regions exhibited a significantly higher debt stock, in nominal terms, by mid-2015 than in the 1990s. Albeit from relatively low levels, debt-to-GDP ratios are also on the rise again. But perhaps the most important development to watch is corporate debt in emerging markets. This has more than quadrupled from $4 trillion in 2004 to $18 trillion in 2014. Most of this debt is still held in bank loans rather than bonds, and while the bulk (90%) of this debt is domestic rather than external, the trend in external corporate debt in emerging markets is an upward one and is further complicated by the growing presence of foreign banks in many emerging economies.

In an economic environment characterized by falling commodity prices, prospective interest rate rises, currency depreciations and an overall slowdown in output growth, such debts will become more difficult to service.

There is therefore a real danger of repeating the pattern seen prior to the Latin American crisis of the 1980s and the Asian crisis of the 1990s when bad private liabilities undermined public sector balance sheets. Since then, financial liberalization has accelerated and foreign asset managers can, even more quickly, unload entire positions in a country's debt, whatever their currency denomination, and exit the market for reasons which have little to do with fundamentals. This, in turn, can trigger steep currency depreciations and banking difficulties, followed by corporate bankruptcies and job losses. Public authorities have little choice but to intervene to contain a financial meltdown through emergency financing, the bailing out of large number of unviable private entities and through countercyclical measures.

Towards better multilateral rules and norms for sovereign debt restructuring

There is growing consensus that the current system to deal with sovereign debt problems and crises, once these occur, is not fit for purpose. Under this ad hoc and highly fragmented system, such problems tend to be addressed too late and with too little. As, for example the Greek debt crisis has shown very clearly, debtor governments have been reluctant to acknowledge solvency problems for fear of triggering capital outflows, financial distress and economic crisis, while private creditors have an obvious interest in avoiding haircuts. Moreover most of the burden of adjustment is placed on the debtor economies through lending conditionalities that favour austerity and structural reforms with regressive effects on income distribution. Finally, with the strengthening of creditor rights and the growth of bond financing, sovereign debt restructuring has become enormously complex and open to abuse by highly speculative hold-out funds run by non-cooperative bondholders, including so-called vulture funds.

There is, of course, a range of options to address these weaknesses. Following the IMF's unsuccessful proposal for a Sovereign Debt Restructuring Mechanism, most efforts have been expended on strengthening the existing market-based approach to debt restructuring by clarifying and reinforcing its legal underpinnings, including improvements to so-called collective action clauses (CACs) in bond contracts and clarification of the *pari passu* (equal treatment of bondholders) provision, as well as encouraging the use of GDP-indexed or contingent-convertible bonds. The main advantage of this approach is that it remains voluntary and consensual. However, it does not address potential problems with outstanding debt contracts, concerns particular types of debt instruments (such as bond debt in the case of CACs), and provides little in the way of crisis resolution aimed at fast recovery and a return to sustainable growth.

The previously mentioned UN Resolution on Basic Principles on Sovereign Debt Restructuring goes one step further by promoting soft-law principles contained in international public law. As stated, this presents a very welcome and important development in this area. However, a statutory – multilateral treaty-based – approach that defines a set of binding rules and norms, agreed in advance as a part of an international debt workout mechanism, remains the most effective means to reduce uncertainties and promote higher stability in international financial markets, and to provide fair outcomes efficiently.

In UNCTAD's view, all three approaches to improving sovereign debt workout mechanisms are complementary and can and should be pursued alongside one another.