On September 2015 the UN General Assembly has approved the new Sustainable Development Goals which should be achieved by 2030, sometime called Agenda 2030. The seventeen goals include 169 targets and 241 indicators, whose attainment could require hundreds of trillion dollars in the coming 13 years. Financial flows to developing which have greatly increased since 2000, in particular private flows, both Foreign Direct Investments and remittances but also Portfolio flows; in a sense a lot of the savings are out there.

A fist contribution of the paper regards the analysis of the conditions which should help to make the best possible use of these foreign financial means. The paper shows that an effective financing for development requires for the full application of the principles of universality and differentiation which are part of Agenda 2030. The first principle implies that the Goals are for each country, the second one recognizes that there are different responsibilities according to the different levels of income per capita. Sustainable Development Goal number 17, the last one, asks for global partnership for development and indicates several areas where this partnership should unfold, including finance. The paper tries to work out some suggestions for the actual working of this partnership and for achievement of the goals, or at least of some targets inside them.

The paper shows that international finance is in a situation of Financial Mercantilism, which is defined in the paper by referring both the writers of the Mercantilist period and to the present working of financial systems. There are many similarities between the operation of old days merchants and today financial intermediaries. This is not the best setting for long-term development finance and this fact creates serious problems both for the channeling of the funds towards development goals but also and more worryingly for many developing countries themselves. Unfortunately some features of the debt crisis of the eighties could be back. The paper discusses how to limit and to mitigate the possible negative impacts of Financial mercantilism on development finance. Policy recommendations are hinted in the conclusive part of the paper.
Prologue

On July 2014 a ‘vulture’ fund Themis Capital and Des Moines won a case against the Democratic Republic of Congo which should now repay 18 million dollars of an original debt plus 70 million as interest (The Financial Times, 27th November, 2014). The debt had been contracted in the early 1980s by Mobutu, but Themis Capital was not among the original creditors, it bought Congo’s debt years later at huge discount on face value, but now should be repaid at full nominal value. Congo has an income per capita of 430 dollars, 71.3 per cent of the population below the national poverty line and most of its people were not born when the debt was contracted.

Section 1 deals with the financing needs of the new Sustainable Development Goals. Section 2 discusses some feature of international financial markets and the problem of developing countries’ debt of the eighties. Section 3 presents the problem of the ‘secular stagnation’ while in section 4 we find a description of toady financial Mercantilism. Sections 5 and 6 discuss the general problem of how to finance developing countries, while in section 7 we find three specific proposal to make development finance more sustainable and more equitable.

1. Financing the Sustainable Development Goals

On September 25th 2015 the United Nations General Assembly passed a resolution including the new Sustainable Development Goals, SDGs, sometime called Agenda 2030 (see UN-GA 2015). The seventeen goals include 169 targets and 241 indicators were added on March 2016 (see UN ECOSOC 2016), the goals should achieved by 2030.

With so many goals and sub-goals the quantity of financial means to implement all of them are of course extremely important. The 2015 European Report on Development suggests tens of trillion of dollars needed on infrastructures and energy only, two of the six enablers which should help to achieve the SDGs (see European Report on Development 2015 pp. 73-ff.). Lomborg in the so called Copenhagen post 2015 Consensus criticizes the fact that there are too many SDGs, but suggests that 2.5 trillion should be come only from international development assistance till 2030. Not all these flows might be needed by developing countries; many goals should be of primary concern for high income and emerging economies in particular. Many goals are related to environmental issues and they should see the rich and large emerging countries at the forefront: these goals have been re-established in December 2015 in the Cop21 conference on climate change in Paris. At least nine of the seventeen goals focus on climate actions designed to save energy and to change the current use of natural resources, from rainforest to the oceans to production and consumption systems.

However low income countries too should pursuit the goals in which environmental sustainability has a leading role; think of the challenges represented by infrastructures, clean water, sanitation and big cities in a low income country. On top of these developing countries still face some traditional goals such as poverty, hunger, health and education, which were already part of the 2000 Millenium Development Goals. To address all these challenges developing countries will probably need
trillion of dollars in the coming decade and the question is where to find these funds and how to channel them where they are most needed. This problem dates back many decades, but it has been directly tackled by the UN system since the Monterrey conference of 2002 on Financing for Development, which has been followed by a similar conference in 2008 in Doha. More recently and in preparation of the SDGs in 2014 the UN has produced a Report of the Intergovernmental Committee of Experts on Sustainable Development Financing (see UN-ICESDF (2014) and in July 2015 in Addis Ababa there was the Third International Conference on Financing for Development (see UN-AAAA 2015).

Even if the overall quantity available might be short of what would be needed there will probably be a lot of funds potentially flowing towards developing countries, thanks in particular to the huge increase in private funds to developing countries, in particular since the year 2000. Figure 1 describes the major flows to developing countries.

**Figure 1. Total net resource flows to developing countries, by type of flow.**

(1990-2017 forecasts Billion of Dollars)

It is easy to see that the situation has completely change with respect to the nineties. Official Development Assistance, ODA, which is international aid, mainly public used to be the most relevant item, now is lagging behind private flows. Of course the figure flows include flows towards upper middle income countries, the so called emerging markets including Asian and Latin American ones where FDI in particular play a major role.

We can also notice that following the financial crisis of 2008 FDIs and Portfolio flows in particular have become very volatile, while remittances are much more stable and still growing, as matter of

Sources: World Bank Staff calculations, World Development Indicators, OECD. Private debt includes international bonds and borrowing through commercial banks.
fact they some to play and anti-cyclical role: they tend to increase after crises and natural disasters.\footnote{Notice that here we consider only officially recorded remittances; informal remittances could be extremely high.}

For low income countries the picture is slightly different, but if we take the same types of flow for Africa between 1990 and 2010 we see that up to the year 2000 Official Aid was the largest type flows. In 2010 ODA was in the third place behind Foreign Direct Investments and just behind remittances. In the case of African countries net portfolio flows were very small and highly fluctuating and they became negative following the 2008 financial crisis.

The good thing is that money flows towards developing countries, including private funds, but in order to asses how far these different types of funds could be used to achieve the SDGs some provisos are necessary.

*First*, FDI are the largest type of private flow but they move mainly towards Middle Income Countries and much less towards Low Income ones, moreover they are motivated by the search for profit. These decisions could coincide with the pursue of an appropriate goal in a country but not necessarily. One main issue in FfD has to do with the so called Public Private Partnership, PPP; which means how to provide the appropriate mix between incentives for private funds and coherence with respect to the SDGs and to the developing country priority. Energy and infrastructure are two obvious areas in which it is interesting to try to channel private investments of a long run nature, but in the end FDIs depend on strategic decisions by transnational companies.

*Second*, remittances are the second largest type of flow and indeed move also towards low income countries and they are characterized being typically form people to people; as a matter of fact remittances are the other side of the coin of worker’s migrations and of lack of appropriate jobs in many low and middle income countries.\footnote{Recorded remittances can be as high as 45 per cent of GDP in some small countries, but even in some large countries such as Bangladesh, Pakistan and the Philippines they are around 10 per cent fo GDP(see Capelli and Vaggi 2916).} Remittances can certainly contribute a lot to goals such as education, housing, sanitation but that will largely depend on decisions taken by local households. Moreover we tend to think of remittances as money flowing form rich to poor countries, but less than 40 per cent of overall remittances go from ‘North’ to ‘South’, around 35 per cent of them are move among developing countries, which is good but does not really add to the overall funds required but all developing countries.\footnote{The overall number of migrants is in the range of 250 million people, of which around 200 million from developing countries. Unfortunately the SDGs dedicate very little space to the issue of migrations, they are: point 29 of UN-GA 2015 Resolution, target 8.3 on how protect labour rights including migrant workers; target 10.7 on responsible migrations and target 10.c. on the reduction of the cost of remittances.}

Besides FDIs, remittances and international aid in international markets there are many more different types of financial flows, which take the form of myriads of funds of type of financial instruments and of portfolio investments. The SDGs have put forward a lot of very ambitious objectives and needs to be attained but the good news is that there is a lot of money in the markets.

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\(1\) Notice that here we consider only officially recorded remittances; informal remittances could be extremely high.

\(2\) Recorded remittances can be as high as 45 per cent of GDP in some small countries, but even in some large countries such as Bangladesh, Pakistan and the Philippines they are around 10 per cent fo GDP(see Capelli and Vaggi 2916).

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2. International finance

2.1 International financial markets

In 1985 the overall value of financial derivatives was slightly more than 1 trillion dollar, in 2007 overtook 600 trillion and after 10 years it is still an amount eight times higher than the world GDP. The causes of the enormous increase in International Financial Markets date back to the end of the Bretton Woods system based on the dollar exchange standard and to the increasing financial liberalization which has taken place since the early eighties. On 15th August 1971 Richard Nixon “closed the gold window” and the world of international finance was changed forever. The dollar floated and the foreign exchange risk was privatized. The ratio of currency trading to international trade in goods and services plus long term investment rose from 2 to 1 in the mid seventies to 80 to 1 in the late nineties. The bond issuances which had been largely limited to domestic markets under the Bretton Woods system entered more and more the international markets. Overseas sales of US bonds rose from 3% of US GDP in 1970 to 150% in the mid-1990s. Overseas sales of UK bonds rose from nil in 1970 to 1000% of UK GDP in the mid-1990s!! Figure 2 describes the enormous change in international finance which took place during the eighties as a result of financial account liberalizations. The derivative markets had been there for many years but now it changed completely and it took a growing and more and more dominant role, at least until the 2007-2008 financial crisis.

Figure 2. The exponential growth of finance (Source: The Economist and BIS)

The world of finance is characterized by systemic risk; the best description is in the work of Hyman Minsky, the author who probably foresaw the potential damages of uncontrolled finance in the
clearest way. His contributions date back to the mid-seventies when the overall market for derivatives was still puny and the consequences of the abandonment of some of the Bretton Woods pillars were not yet evident (see Minsky 1974 and 1975).

2.2 Developing countries’ foreign debt crisis

Since the eighties developing countries have experienced repeated major financial crises, we recall just the major ones:
- the debt crisis opening up in August 1982 with Mexico default,
- Mexico’s second default in December 1994,
- the Asian Crisis of 1997-1998,
- Russia, Turkey, South Africa, Brazil in 1998-99,
- Argentina in December 2001, with problems again for Turkey, South Africa.

In most cases currency depreciation has led to improvements in the external account and to economic growth even if with different speed in different countries. The most successful case has probably been South Korea in 1997-98. A 45 per cent depreciation of the won between November 1997 and April 1998 and a minus 8 per cent of the GDP in 1998, were followed by a growth rate in the range of 5 per cent in 1999 only slightly lower than before 1997. By the end of 1999 Korea was already paying back the funds received by the IMF. It was a typical V crisis, a deep but a short one.

An opposite case was that of many Middle Income and in particular Low Income countries after the debt crises of the eighties; Mexico’s default in 1982 was followed by almost 30 countries, including some European countries, such as Portugal, Poland and Hungary and some Asian countries which have then become very successful high income economies such as South Korea. Following the eruption of the debt crisis many countries in Sub-Saharan Africa, Middle East and North Africa and in Latina America and the Caribbean, income per capita did not improve for ten years. It was the period of the so called ‘lost decade’, but in fact the impact on the real economies went on until the late nineties.

A sensible solution to the crisis emerged only with the Heavily Indebted Poor Countries Initiative, HIPC, which was first proposed in 1996. For the first time this plan implied some type of debt cancellation, taking into account, at last, of the fact that most of the foreign debt of these countries and in particular of the weakest African ones, was due to arrears on previous payments. Thanks to a large advocacy activity under the umbrella of the Jubilee 2000 campaign the HIPC initiative was

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4 However following the 1997-98 crisis in South Korea investments went down 10 per cent point of the GDP, from 35 to 25 per cent. Malaysia, Thailand and the Philippines followed similar patterns, but the crisis was much deeper and longer in Indonesia (see Vaggi 2002).

5 The countries hit by the debt crisis of the eighties were: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, Venezuela, Costa Rica, Jamaica, Cote d’Ivoire, Nigeria, Sudan, Yugoslavia, Poland, Hungary, Turkey, Algeria, Egypt, Morocco, Bangladesh, India, Pakistan, The Philippines, South Korea, Indonesia, Malaysia, Thailand, Portugal (see Vaggi 1993).

strengthened at the Koln G7 of 1999 started to be implemented in the early 2000s even if the procedures to obtain the partial cancellation of foreign debts could take as long as six years. In 2005 and the World Bank and the IMF added the Multilateral Debt Relief Initiative, MDRI, which also implied debt cancellation. Figure 3 shows that this cancellation has been very effective in improving the debt sustainability conditions of these countries. However the improvements in the various debt ratios are largely concentrated in the early 2000s and they are the direct outcome of the cancellations of foreign debts. Following the initial reductions the debt to GNI ratios and the Debts service ratios have largely stabilized and they have not shown any further improvement.

Figure 3. Debt ratios, External debt/GNI(%) All HIPC, since 2000 (source: World Bank)

After some quite years in 2015 Puerto Rico started to have major sustainability problems and has defaulted and in 2016 Mozambique is getting again into serious repayment troubles. Another debt crisis cannot be ruled out, in particular for the Least Developed Countries(see Eurodad 2014 p. 16).7 Most of these crises were related either to defaults on commercial loans and on sovereign bonds or to the so called financial bubbles. All crises were characterized by previous large capital inflows

7 Griffith Jones and Tyson 2012 find many similarities between some African countries today and with Latin America and Asia in the eighties and nineties respectively.
either because of the higher interest rates offered by developing countries’ bonds or by the supposedly higher returns on equity investments. We are again in a situation in which on one side a lot of funds are available on international financial markets and on the other side very large financial means are needed to try to accomplish the goals of Agenda 2030, particularly in developing countries. The risk is that the money should flow towards low income and lower middle income countries repeating the negative experiences of the eighties and nineties. Those crises have taught some lessons which should be adopted in development finance, FfD, an issue discussed in Sections 5 to 7, where some innovative policies are highlighted. But before that we need to try to understand better the type of economic and financial environment in which FfD tools should be implemented; the next section deals with sluggish economic growth, section 4 discusses the mechanisms which regulate international finance.

3. Secular stagnation and the ‘savings glut’

As we have seen developing countries suffered many crises since 1982, but the new dimensions acquired by international financial markets during the eighties had also a major impact on some high income European countries. In September 1992 international speculation forced Italy, Spain and the UK to devalue their currencies versus the German. Foreign exchange reserves at the three central banks were not sufficient to defend the value of the Italian lira, of the British pound and of the Spanish peseta. Reserves are a typical tool devised to defend the currency from speculative attacks particularly in a system of fixed exchange rate as the Bretton Woods dollar exchange standard was. In 1977 the value of global official reserves to daily transactions on foreign exchange markets was around 15 but by 1989 this ratio was already down to less than 2; the three central banks had less ammunitions than international speculators. 1993 was a year of negative growth but the current account balances improved rather quickly, again a bad but short crisis.

Fifteen years later, in 2007, there has been another major crisis which originated in the US sub-prime mortgages market and then spread to Europe. The crisis is not yet completely over and its impact on long term growth is still not clear. Since 2008 economic growth is quite weak in many High Income Economies even if interest rates are very low. This has led to a debate on the so called secular stagnation hypothesis, following Larry Summers’ reappraisal of this term. Many explanations of this phenomenon focus on the relationship between savings and investment and the fact that due to an excess of savings the real interest rate needed to equate investments and savings at full employment level may be negative. This means that monetary policy becomes ineffective because due to low inflation and low nominal rates there is a floor, the so called Zero Bound Level, ZBL, for nominal rates (see Baldwin and Teulings, 2014, p. 2.) which makes it impossible to reach negative rates. To put it in Keynesian terms it is as if the liquidity trap had become a permanent feature of the economy (see Krugman in Baldwin and Teulings, 2014, p.15). Major explanations for the increase in savings are related to demographic reasons (ibid. pp. 11-12, 14), and to an increase in life expectancy combined with lower population growth rate, the so called “ageing society”.

Here we have two paradoxes.

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9 These phenomena lead to an increase in the dependency ratio because of the raising share of pensioners; an older population requires more savings.
Paradox 1, in the 1939 Harrod’s growth model a higher saving ratio, s = S/Y, leads to a higher warranted growth rate. In the neoclassical version of the model as presented by Solow in 1956 a higher s implies a higher income per capita in the steady state, provided S=I. Now it seems that savings is the problem and might cause a growth slowdown; of course S > I because of the lack of investments, not of course in East Asia where investment ratios are still high.

Paradox 2, the three countries/areas which are saving more are China, continental Europe and Japan, the one which saves less is the US. (see Blanchard O.J., Furceri D. And Pescatori A. 2014 p.104), however the economy is now growing faster in the US than in both Europe and Japan.

This suggests that the saving glut plus demography are not sufficient elements to explain secular stagnation; one has to look for a combination of both supply and demand side causes of the slowdown of growth rates in high income economies. There is a the need for huge investments in particular in infrastructures in both high income economies(see Caballero R.J. and Farhi E. 2014, pp. 118-119) and in developing countries where population is still growing.

4. Financial Mercantilism

4.1. Neo-Mercantilism and its features, the revenge of Thomas Mun?

Thomas Mun was one of the directors of the East India Company and the father of the mature phase of Mercantilism, characterized by the so called balance of trade system, according to which a surplus in foreign trade is the main cause of national wealth. It is thanks to this surplus that precious metals flew into the country coffers. Of course not all countries can run a trade surplus at the same time; Mercantilism is a zero-sum game which leads to ‘beggar thy neighbour’ type of policies.

Both stagnating economies and structural ‘imbalances’ are stimulating neo-mercantilistic and protectionist policies; nations fiercely compete on international markets(see also UNCTAD 2014, pp. 17-19). The East Asian countries and China in particular are often regarded as the obvious culprits, mainly because of the keeping low and undervalued exchange rates, which have helped to sustain growth and to build current account surpluses and huge reserves(see for instance Subramanian 2015, p. 25).

The management of the exchange rate is only one among the possible policies which can generate a current account surplus. Export subsidies and import duties are the traditional tools, but we also have selective credit systems, tax exemption on reinvested profits, domestic wages/incomes compression, subsidies to Research and Development, product standards etc. With a strong simplification let us point out two main feature of modern Mercantilism.

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10 According to Solow’s model capital should flow to low and middle income economies, because of their higher profitability, as measured by the marginal productivity of physical capital.

11 “….we must observe this rule; to sell more to strangers yearly than we consume of theirs in value.” (Mun 1623?, p. 5). Mun goes on defending the role of trade with the East-indies (ibid. p. 7).

12 Subramanian points out that the huge savings which are at the core of the major explanations of the ‘secular stagnation’ are the result of high growth rates in emerging markets and that low growth is really a problem of OECD countries.

13 Opposition to the free movement of people quite often complements neo-protectionist policies.
**A first feature of Mercantilism;** in today’s world, where all economies are so much interconnected we consider as neo-mercantilist all those policies which rely mainly on exports for the sale of the goods and services and which restrain domestic demand.\(^{14}\)

In order to better understand what Mercantilism is today we must not confuse it with the lack of competition on international markets. During the last thirty years there have been very strong newcomers in international markets, the so called emerging economies, in particular in East Asia, and we can say that many sectors are now more competitive than they used to be in the fifties sixties of the last century.

This has very little to do with the idea of competition characterized by a multitude of independent producers and by the possibility of new producers to enter the market; this is a *competition among giants*. In many sectors: from automotive, to finance, to capital equipment, to infrastructure procurement, to international finance there is a strong concentration of productive capacity, also through mergers and acquisition. At the world level these sectors are characterized by *oligopolistic competition*\(^{15}\).

**A second feature of Mercantilism** is the alliance between big corporations and the state and not only in East Asia. Big international companies may even turn the functions and powers of the states to their advantage\(^{16}\).

This type of alliance characterizes the Mercantilist era and this is what worries Smith because it could lead to lower growth but also modify the nature of society. It is precisely against this type of association that Smith wrote *The Wealth of Nations* (see Smith 1776, book IV in particular). This alliance could perpetuate and even enlarge the differences between the different market players, thus increasing imbalances instead of reducing them.

On one point recent economic events seem to contradict *Mun’s rule* according to which the direction of the movements of capital flows depends on the sign of the current account. We must also notice that the exchange rates movements are not regulated by the imbalances in the current account and by the ‘flow-specie’ mechanism which had already been devised by David Hume (see Vaggi G. and Groenewegen P. 2003 pp. 78-80). The evolution of the Euro-dollar exchange rate during the last seven years does not seem to support this rule. Of course a negative current account does generate opposite movements in the financial account, however, these movements are only part in the overall financial account. Most capital flows in the financial account are linked to Foreign

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\(^{14}\) This does not necessarily equate with ‘export-led growth’. For instance the case of Smith’s ‘vent for surplus’ argument does not imply the compression of domestic demand.

\(^{15}\) Mercantilist policies do not necessarily imply state intervention. In many cases mercantilist authors asked the sovereign to refrain from regulating trade, for instance in the case of an old law prohibiting the export of money (see Mun 1623?, pp. 34-36). These does not make them free traders; the real issue is that they were able to influence the state to adopt or not to adopt those policies and strategies which were more favourable to national merchants. The overall mercantilist period is more complicated than its traditional representations.

\(^{16}\) The term ‘state’ indicates also the international bodies and organizations where individual nation states have different powers and can thus influence their decisions.
Direct and to portfolio investments and financial flows play a major role in foreign exchange markets, FOREX, even in a system of largely flexible exchange rates.

**Paradox 3.** This leads us to the role of international finance and somehow paradoxically brings us back to an earlier phase of Mercantilism the so called *monetary balance system* (see Rubin 1929, pp. 26 and 43-46), prevailing in sixteenth century Europe. According to this view financial flows were not just related to trade, but depended also on the reputation of the national currency: a strong currency resulting in net inflows. This is somehow similar to modern phenomena such as ‘flight to quality’ and the readiness to accept zero/negative interest rates on assets denominated in a currency which is regarded as a very good store of value.

4.2. Financial mercantilism

In the old days the merchant’s gain derived from his ability to *buy cheap and selling dear* and the difference was his *profit upon alienation*. In order to achieve this gain the merchant had to move the goods in space and time, even if he did not physically produce a new product; in eighteenth century France corn had been transported from the countryside to the cities; in seventeen century England spices had to leave the Indies and to reach the metropolitan area.

With their value chains transnational corporations do something similar and they also do generate new types of goods. It is not just transnational corporations who behave like the old merchant companies. In international markets financial investors too act like modern mercantilists, who basically gain on the difference between their buying and selling price; however in modern international finance where there is no need either to go through production processes or to move goods across time and space.

*Space* has become relevant only in so far as different financial markets have specialized in different types of products. For instance the City of London is home to the largest foreign exchange market, moreover there are different regulations and laws applied to similar products: to issue a bond in London goes under a different legislation than issuing it in Frankfurt.

*Time* is much more relevant because one must be quick to enter and exit the market. In the old mercantilists’ way the profit upon alienation depended on the quality of the product and its locations, now profit depends upon the *time* of buying and of selling any type of financial product. In financial markets operations are typically quite fast and they are characterized by *short-termism*.

Even the bond markets can no longer be regarded as a place of long-term commitments. The fact that the contracts/obligations refer for instance to 10 years bonds and are long-term does not imply that they are not sold and bought in a continuous way. The search for high yields in emerging markets does not at all imply that these capital inflows will stay there for the maturity of the bond. The capital gain motive is always there and it supersedes the interest rate component. Returns play an important role in the decision of portfolio differentiation and in the ‘parking’ of part of the funds under management, but expectations on possible gains/losses is the decisive element in the considerations about buying and selling. Again a very Mercantilist attitude.

In financial markets ‘products’ are basically *forward contracts*, sort of *bets*, that is to say commitments to buy and to sell at some future time and at certain conditions. These are immaterial products, but of course do move wealth and income and can make people richer and poorer. As in
the case of Mun’s balance of trade doctrine financial markets are a characterized by a ‘zero sum game’. The changes in the distribution of income and wealth take place without going through the production system and not even through trade, transportation and storing as in the old Mercantilist practices\(^\text{17}\).

Using a Marxian terminology we could say that in financial markets the *appropriation of surplus value* no longer needs to go through the commodity production phase, but moves directly from money to more money \(M - M'\), with \(M' > M\). There is no need of any intermediary stage. This of course works at the level of individual business, let us say at the micro level. It is much less clear what is the impact of modern finance at the macro, that is to say on the growth rate and on the ability of a country to increase its physical output of goods and services; for this let us move to the next sub-section.

4.3. Asian growth and finance

International financial markets should favour a better *allocation of resources* at the world level. The easier to move capitals across border the better because a larger set of financial investment opportunities should help to allocate capital in the most efficient way. Financial markets should bring savings where they are lacking and hence most needed and were they can also generate higher returns. All this follows the so called market efficiency hypothesis.

At the *micro* level this means that each of us has a much wider range of possibilities to distribute her consumption over his lifetime through the inter-temporal allocation of savings. I recall when in the fifties and sixties my father was buying long-term Italian bonds in order to secure an income during retirement. It was a privately managed *de facto* pension scheme with a long-term contract between an individual saver/consumer and the state. Today pension funds have the same scope; the aim of the contract is indeed long-term: savings now against consumption capacity in the future. However, in order to guarantee the future income the pension funds *must* earn a return on a periodical basis which means funds must continuously shift the savings across different types of investments.

At the *macro* level international financial markets should help to increase the average world growth rate and to speed up the closing of the gap between low and high income economies; however there are serious doubts that more finance implies more growth(see for instance Arcand *et al* 2012).

**Paradox 4.** East-Asian economic growth is largely explained by a combination of export-led growth, industrial policies and huge accumulation of physical capital. Capital accumulation has largely relied on domestic savings with investment ratios in the order of 25-30 per cent since the sixties; China has reached 45 per cent in 2009-2010. Not only these investments are obviously long-term, but they are largely based on self-financing by firms through reinvested profits. In the Japanese and Korean experience one could speak of a fundamental profit-investment nexus(see UNCTAD 1996) which has by passed International Financial Markets\(^\text{18}\).

\(^{17}\) Of course the insurance and credit sectors provide specific services to households and to firms, but many types of investment banking activities on the derivative markets have to do with the hedging the risk of one financial product against another.

\(^{18}\) According to Solow it is “time to rethink the way the credit mechanism mediates between savers and investors and puts credit to productive use” IMF *Finance and Development* of June 2011, p. 51.
In an interview to the IMF journal *Finance and Development* Hélène Rey, says that “it is hard to ascertain or measure the real gains from financial openness and freely moving capital….trillions of dollars have crossed borders, and yet despite our best efforts and hundreds of studies, it has been extraordinarily difficult for economists to identify any benefits from these flows” (Rey 2015, p. 6).

Let us recall the so called ‘quantitative easing’ policies of the Federal Reserve System and of the European Central Bank. How much of these money has ended up into the real economy, either into productive investments or into households’ consumption? How much money has gone into financial markets, or it stagnates into the bank’s coffers? With interest rates close to zero the monetary policy cannot stimulate the real economy. Nothing new under the sun, at least since Keynes’ ‘liquidity trap’, but the possibility of using these additional liquidity into the financial sector further reduces the stimulus to channel it into the real economy and it increases the volatility of financial markets.\(^{19}\) A higher volatility amplifies the opportunities of speculating on the difference between the buying and the selling price of any financial product, which is at the core of financial mercantilism.\(^{20}\) The lack of investments and the high savings could also be linked to the growing role of finance the role of finance in High and Middle income economies.

As a matter of fact short-termism is not just a feature of financial operators, but it seems to become a rather pervasive behavior by corporate people and some people speak of short-term capitalism (see Mallaby 2015). This is a very important issue, but there is not time to deal with it here.

### 4.4. The concentration of power.

A final point: what is wrong with Mercantilism? Mercantilism should not be easily dismissed as a wrong and outdated theory. Mercantilism has been a fundamental aspect of the modern history of Europe and from the seventeenth to the nineteenth century mercantilist policies have been very effective in determining the economic successes of countries such as England and the Netherlands. Mercantilist thought has been part of the establishment of the nation states in Europe. Moreover Mercantilism has been a fundamental phase in the building of economics as a science.

Adam Smith identifies two major problems. A first problem concerns the focus of finance on capital gains rather than directly addressing the issues of productive capacity and of productivity increases. In chapter V of Book II of the *Wealth of Nations* Smith discusses the natural order of investments which should first secure an agricultural surplus and then should move on to the manufacturing sector which thanks to the division of labour could generate productivity increases. Investments should then move towards domestic trade and finally to foreign trade (see Smith 1776, II.v). The Mercantilist writers were underlying the importance of focusing on foreign trade, but to Smith this was like starting from the tail rather than from the head and it would have damaged the country. That part of capital which is employed in the

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19 The capital requirements imposed on banks contribute to keep the money away from consumption and investments. However these requirements are necessary because the volatility of international financial markets affects the prices of public bonds, a fact which weakens the structure of banks’ accounts and requires higher capital ratios.

20 Gavin Jackson underlines the relationship between quantitative easing and in the intensity of volatility, “investors...must sell when prices fall and buy when prices rise, which adds to any market movement” (*Financial Times*, 15, October 2015).
carrying trade, is altogether withdrawn from supporting the productive labour of that particular country (Smith 1776, II.v.30).

Here ‘carrying trade’ refers to the physical transfer of goods across borders and not to financial carry trade, but there are striking similarities between the two cases, because both activities dislodge funds from the most productive types of investment. In Book IV Smith directly tackles mercantilist policies, he writes that an invisible hand leads the individuals to employ their capital in domestic industry rather than in the foreign one (see Smith 1776, IV.ii.9). This is the only passage in the Wealth of Nations in which the invisible hand metaphor appears.

The second problem is much more worrying to Smith because it has to do with the second feature of Mercantilism (see above 4.1.): the concentration of market power into the hands of few big players, the British East India Company being a typical case. In our days it could be the overwhelming power of big international investment banks. As in the case of transnational corporations this situation violates free competition, because it generates large imbalances in negotiating power among the different market players. It is thanks to this superior power that the ‘merchants’ can twist the markets to their own interests.

In the case of finance we can indicate at least three ways in which the largest banks can influence the markets:

- asymmetric access to information,
- lack of transparency in many financial products and contracts, the fact that some investment opportunities, usually the more remunerative ones, are
- available only to investors with large amount of funds.

5. Financing for Development

5.1. Different resources for different countries

The 2015 European Report on Development repeatedly states the way in which finance will be mobilized and directed to the different SDGs is more important than the overall availability of funds (see European Report on Development 2015, pp. 27, 323). The real issue will be the composition of different financial means with respect to both the type of needs, the goals, and above all the type of countries. Let us briefly summarize the state of the issue.

Everyone agrees that developing countries should try to rely more and more on domestic resources (see also Touray 2014), on private ones and above all on public resources, namely taxes. But here there is the problem that the tax base and the tax revenue of developing countries can only increases in a slow way, while ODA and Other Official Flows may decrease more rapidly. There is a possible time mismatch between the ability to raise enough domestic resources and the way in which donors disengage from providing these countries with concessional flows. This creates the problem of the so called missing middle (see Kharas et al. 2014, pp. 26-7).

There are at least three major ways to describe the financial needs and the characteristics of different developing countries.

First, different types of financial instruments are needed for different goals/targets; Kharas et al. provide a classification of the different types of finance for the different development goals (see
Kharas et al. 2014, p. 7.) and elaborate on the report of the experts on sustainable development financing (see UN-ICESDF 2014, pp. 8, 18). European Report on Development 2015 suggests different types of financing according to the different enablers of sustainable development (see European Report on Development 2015 chapter 6 and pp. 298-299).\(^\text{21}\)

Second, different financial opportunities depend also on different income levels of various countries (see European Report on Development 2015, pp. 299-300, 315 and Kharas et al. 2014, p. 27). Private flows are more important for MICs, while international public flows are still extremely relevant in LICs and LDCs. European Report on Development 2015 proposes a fourfold classification of the different types of possible financial resources (see European Report on Development 2015 pp. 31-2):

- domestic public resources
- domestic private resources
- international public resources
- international private resources

Third, another obvious way to classify the different types of FfD is the degree of concessionality. This criterion is clearly extremely important when referred to countries with different income levels; a combination of types of need, income levels and degree of concessionality is also in UN-ICESDF 2014, p. 31. ODA and grants in particular are the preferred type of resources for LDCs and LICs, and for human and social type of needs, such health and WASH, Water Sanitation and Hygiene. Moreover, resource poor countries have very little FDIs, but many LDCs and LICs receive a lot of remittances in proportion to GDP and this helps to compensate for the negative current accounts (see Capelli and Vaggi 2014).\(^\text{22}\) This is also the case in some LMICs.

There is a large consensus that Least Developed and Low Income countries should proceed through a process of graduation from benefiting only from concessional flows to the access of International Financial Markets. This could imply moving from grants to fully concessional loans, to blended finance etc. These countries should make maximum use of not-fully market instruments for development finance and the whole process should be gradual and carefully monitored. Moreover this implies a careful use of countries classification based on income thresholds (see Kharas et al. 2014, p. 25), for example for access the to the World Bank IDA financial window. In practice it might be very difficult to strictly follow this route and it requires a continuous dialogue between countries and International Financial Institutions.

In this process of graduation an important role can be played by Multilateral Development Banks, such as the regional banks AfDB, ADB. The new so called BRICS Development Bank (see Griffith

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21 European Report on Development 2015 gives a lot of attention to new possible types of international financing for development (see European Report on Development 2015, pp. 123-125).

22 In many MICs and resource rich countries FDI generate the problem of profit repatriation which of course has a negative impact on the current account (see Capelli and Vaggi 2014). Portfolio flows too might have negative effect of on growth, also because of possible shocks (see European Report on Development 2015 p. 154).
Jones) and the Asian Infrastructure Investment Bank (AIIB) could also play a role in this process of graduation, in particular taking care of infrastructural projects in LDCs and LICs.

Public Private Partnership, PPP, is also seen as a very powerful new tool to increase foreign financing, in particular when public funds, ODA, is used to ‘leverage’ more private funds. This can be a very important tool in particular in the case of funds dedicated to special goals and purposes. The typical case is the Global Fund to combat HIV, malaria and other diseases. Of course the use of public funds to raise private funds could also expose the receiving country to the risk of more volatility.

The issue of a slower graduation of LDCs and LMICs countries out of concessional finance and into international markets is quite reasonable, even if it may have difficulties in its implementation; the main aim being that of trying to avoid problems in the future. A financial crisis could have terrible impacts on countries. To this purpose it is useful to add two more points on the issue of the appropriate type of development finance for different types of countries.

**Fourth**, it would be useful to classify the different financial resources also according to two other features:

- whether the resources are **short/long term** and
- whether or not developing countries can **lock-in** these flows.

The latter feature refers to the possibility of the receiving country to have some control on the destination of the financial flows and above all on the fact that the funds will stay enough time to achieve the desired goals. Of course both criteria are coherent with a view of development as a long term process and are particularly important for the different types of private flows. A joint venture in a factory is more localized than a portfolio investment.

**Fifth**, a new criterion should supplement the traditional classification of countries according to income per capita and human development indicators: the **productive structure** and the export capacity of a country. Tezanos Vázquez and Sumner group developing countries according to four dimensions of development which lead to five clusters (see Tezanos Vazquez and Sumner 2013, pp. 1733, 1737-8), and there are significant differences with respect to income based classifications. The first development dimension they identify is: “development as structural transformation” which includes GDP and export composition. The two above criteria underpin the capacity of a country to adjust to international markets.

Of course there are overlapping with the classification in terms of income levels; in general Middle Income economies have stronger productive capacity than LDCs. However in the past many MICs had serious problems with foreign debts and even recently some emerging economies, and even BRICS, experience serious problems in international markets; Argentina, South Africa, Brazil, Turkey, Russia are typical cases of countries which may easily slip into current account problems. Many LMICs and also UMICs have not yet fully recovered from the debt crisis of the eighties (see UN-ICESDF 2014, p. 7), and interest payments, though not as heavy as in the late nineties, do contribute to worsen the current account.

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23 Innovative ways to mobilize resources could also help countries in this phase of transition towards international financial markets, such as dedicated funds which focus on specific issue such as climate change, health. The OECD 2014 Development Cooperation Report puts forward the idea of ‘peace bonds’ to finance peace initiatives which appear in SDG 16.

24 Nielsen classifies countries in a different way (see Nielsen 2013, pp. 1093-96).
The lesson from the various financial crises of the eighties and nineties is that the ability of a country to react to a crisis rests mainly with its productive and trade structure. Capital outflows are difficult to resist and can easily lead to exchange rate depreciation. But depreciation can work, in the sense of restoring international competitiveness improve the trade and current account and hopefully restart a process of economic growth, only if the country has the ability to produce and then sell products which are in high demand on international markets and possibly include value added. Depreciation worked in South Korea because its export composition was apt to take advantage of price competitiveness in the production of commodities which were, and still are, in high demand on international markets. Most countries in Sub Saharan Africa have structurally negative trade and current accounts and they are still building foreign debt. During the period 2000-2015 45 out of 48 countries in Sub Saharan Africa had on average a deficit in the Current Account and for 14 countries the deficit was larger than 10 per cent of the GDP. Before a vast transformation in their productive structure even commodity exporters are exposed to huge risk of insolvency.

Greece is an a similar situation, even if it should leave the Eurozone and devalue with respect to the Euro it is doubtful that there could be any major improvement in her current account, because the productive structure and her import and export composition is very weal in terms of tradable goods and services.

The ability of an economy to graduate from concessional funds and finance its goals on private international markets is directly linked to its capability to avoid major current account crises. We could consider this a criterion of resilience to possible external macroeconomic and financial shocks.

FfD needs a country specific approach(see Kharas et al. 2014, p. 17). This is the only realistic possibility because of the large number of goals and sub-goals, but above all because of the different conditions of each country with respect to income and human development levels, economic structure and so on.26

6. The case of Sovereign Bonds

Since a few years ago interest rates are very low, if not negative, in High Income economies, this is also the outcome of abundant savings(see OECD 2015) and of the various ‘quantitative easing’ measures by the FED, by the Central Bank of Japan and by the ECB. This has led to the well known carry trade phenomenon and the search for higher yields with the usual attention to corporate bonds and also to emissions by emerging and developing countries, something we have already seen in the past. In Low Income Countries this type of financing is still quite small vis à vis other types of

25 The situation has not improved much since the eighties and nineties. Between 1980 and 1998 the 28 HIPC countries which will later benefited from debt cancellation have had a current account deficit for all the years but one.

26 The UN group of experts on development finance mentions the need of securing country ownership in the design and implementation of policies and in the financing strategies(see UN-ICESDF 2014, pp. 8, 18).

27 The bond market is by far the largest component of derivatives, with more than 500 trillion dollars and bond markets can be highly volatile and generate a lot of economic instability.
resources, but for it has perhaps the largest potentiality to increase because of the abundant liquidity on international financial markets, but it could lead to very dangerous situations.

The growing interest in bonds of LICs and LMICs includes many countries in Sub Saharan Africa, where sovereign bond issuing has grown to more than 6 billion in 2014 bringing the overall total to more than 18 billion. 14 countries, both commodity exporters and not, have issued bonds most of them denominated in US dollars(see Tyson 2015 I, pp.3-5 and p. 19 for the countries involved)\textsuperscript{28}. All these type of bonds are below investment grade. Most of these issues are managed by a lead underwriter which usually is a global investment bank and it could not be in any other way(see Tyson 2015 I , p. 6). The debt to GDP ratios of these countries are relatively small in the range of 40%(see Tyson 2015 II, p. 6) much lower than those of the eighties and nineties before debt restructuring and debt conversion initiatives HIPC and MDRI.

In Sub Saharan Africa there is also a growing domestic bond market in local currencies which has reached 400 billion USD in 2014, of course interest rates on local currency bonds are higher with respect to those on international bonds; (see Tyson 2015 I, p. 12). These interests rates are still relatively low vis à vis those experienced in the eighties and nineties, a 7 per cent real growth rate could help to bring the nominal(in dollars) growth rate as high as the interests rates, thus satisfying a financial sustainability condition according to which the debt to GDP ratio does not increase if the nominal growth rate is at least as high as the nominal interest rate(see Vaggi and Prizzon 2014).

However all these countries have negative primary fiscal balances and this contributes to the increase in the public debt to GDP ratio(see Tyson 2015 II, p. 6-7); moreover by and large they have also negative current accounts, which contribute to increase foreign indebtedness. In the case of countries which are commodities exporters the value of exports fluctuate with commodities prices. These countries are exposed to all three types of risk in the case of foreign debt: interest rate risk, exchange rate risk, liquidity risk. We could also add country instability and price volatility of commodities in international markets, which it is of fundamental importance for countries which are commodity exporters.

Financing development goals and investments in poor countries with bonds is apparently safer than other types of portfolio flows and of course than commercial loans.

\begin{quote}
In principle bonds are long term, but in the times of Financial Mercantilism the separation between short term and long term flows is blurred; in the case of a perceived crisis long term flows can always leave the country.
\end{quote}

International markets are dominated by the search for capital gains and not only by the pursuit of the higher yields associated with longer maturities and with riskier products(see Moore in Financial Times 19, march 2015, p. 22).\textsuperscript{29} In case of tensions on international financial markets thee will be a run out of riskier bonds and a the search of safe assets, the so called ‘flight to quality’.

Ghana, Kenya Tanzania and Ethiopia already had to delay or cancel issuances because of expected interest rates increase when in early 2014 the Federal Reserve announced to so called “tapering”.

\textsuperscript{28} Tyson 2015 I and II provide an exhaustive analysis of the different types of issuances and of the related problems.

\textsuperscript{29} A simulations in the European Report on Development 2015 suggests a negative impact of “tapering” on GDP growth in Sub Saharan Africa of 0.8% (see European Report on Development 2015, p. 139).
Sub-Saharan African countries do also experience capital flights following the opening of the capital account (see Tyson 2015 II, p. 8). The Congo case in the prologue is not a unique one, there is for example the much more well known the well known opposition between the Argentinian government and Elliot Management following a sentence by Judge Griesa in a New York court.\(^{30}\)

The problem with developing countries bonds is that many of the lessons from the debt crises of the eighties about the sustainability of development finance have not led to major changes in international financial regulations. A UN document issued on the 21\(^{st}\) of January 2015 in preparation of the Addis Conference on FfD of July 2015 and indicates that “debtors and creditors must share the responsibility for preventing and resolving unsustainable debt situations” (see UNDESA-FfD 2015 p. 9). Target 17.4 of the SDGs implies that the international community should ‘Assist developing countries in attaining long-term debt sustainability, through coordinated policies aimed at at fostering debt financing, debt relief and debt restructuring’ (see UN GA 2015).

Unfortunately nothing of that sort is really available now. Debt sustainability analyses have progressed a lot since the debt crisis of the eighties\(^{31}\), however the tools and policies to deal with debt distressed countries are very much the same today as they were thirty years ago. Let us indicate five problems.

1. There is no orderly work out mechanism for debt restructuring, the project of a **Sovereign Debt Restructuring Mechanism SDRM** proposed by Anne Krueger then Deputy Managing Director of IMF in 2003 has not progressed (see UN-ICESDF 2014, pp. 44-45). In 2014 the UN General Assembly passed a resolution asking for a framework for sovereign debt restructuring (see UN Resolution 68/304, 2014).

2. There is no scheme such as that included in **chapter 11** of the US banking regulations, which allows for a temporary freeze on unpaid interests, the mechanism of building debt just because of growing arrears solution.

3. **Flexible exchange rates** are no shield against sudden deterioration of the country risk perception by financial markets. Rey has showed that in the global financial cycle flexible exchange rates cannot insulate emerging economies from financial crises (see Rey 2013). Direct control on capital flows is needed in order to avoid major crises.

4. Following the Asian crisis of the nineties there has been a large accumulation of **reserves** for precautionary reasons\(^{32}\), but Low and Lower Middle Income countries have very limited reserves. Given the dimension of today international financial markets and their volatility the size of reserves should be much higher than just a six months import coverage and it greatly depends upon the mount of foreign inflows.

5. At the time of the Asian crisis of the nineties and of the Latin American debt crisis of 1982 the focus was on the overall amount of the so called ‘**hot money**’, short term foreign debts, plus the size of current account position, generally a deficit. Reserves were regarded as too small to face short

\(^{30}\) See IMF 2014 Box 1 pp. 8-9 for the description of the various phases of the litigation between Argentina and NLM Capital.

\(^{31}\) See for instance the models of the IMF, the World Bank and of UNCTAD.

\(^{32}\) Systemic risks and financial volatility are mentioned as the major reason for the accumulation of reserves by developing countries also in the UN Preparatory document for Financing for Development conference in Addis next July (see UNDESA-FfD 2015, p. 10).
term outflows. Today reserves should be evaluated with respect to the stocks of all types of private, and non-concessional public foreign inflows, irrespective of the maturities, perhaps with the exclusion of remittances. According to this criterion long-term bonds must be included among the type of liabilities which could create a situation of financial fragility.

7.1. Sustainable Financing for Development

Long term financing of the sustainable goals is a very complicated matter because of the economic and financial fragility of many developing countries in particular the most needy ones. We conclude this paper with three proposals which can help to improve the sustainability of foreign finance for development.

7.1. Entering international financial markets in a gradual way

At some point Low and Lower Middle Income countries will be part of international financial markets, but the problem is when and how. Opening up to international finance will contribute to financial development of these countries, but there is a problem of finding an appropriate sequencing of steps in order to reduce the possibility of severe crises. te Velde 2014 asks for a prudent opening to international capital market. Countries should make use of all available tools and policies to slowly and smoothly bridge the domestic and the international financial markets.

We have already seen that there are some conditions in terms of productive and export structure which should be achieved before entering international finance. Of course this type of structural transformations need time and in between other policies and tools could be of help. First, LDCs and LMICs should try to follow an ideal sequencing with respect to finance: first they should try to develop a domestic credit and financial system, based on domestic savings and on lending to local enterprise. In many countries in Sub Saharan Africa credit is very difficult to achieve particularly for Small and Medium Size Enterprises, SMSEs, and interest rates can be very high, in the range of 30%. International public resources, regional development banks and also philanthropy funds could play a big role. The domestic banking sector could then be at the core of the development of local financial market, but in some cases there could be also regional financial markets, Dakar, Johannesburg, Nairobi and Lagos are obvious candidates.

Issuing bonds on international financial markets is quite risky for LICs and LMICs also because they have very small domestic financial markets which are not liquid and offer few financial

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33 Today no one would think of reserves as a measure of national wealth as at the times of Mercantilism, but it is curious to observe that in the age of growing international finance reserves have in fact grown to very high ratio to GDP.

34 FDI and remittances do not generate foreign liabilities; however FDI can generate flows of profit repatriation in the following years and this has a negative impact on the Current Account Balance.

35 te Velde also notices that there is a considerable body of literature which shows that the impact on growth of FDI and portfolio flows is dubious (se te Velde 2014, p. 4).
products to “hedge” against different types of risk.\textsuperscript{36} This limitation represents also an opportunity because it allows domestic credit and financial markets time to grow and become more robust before having to deal with the more complicated products of international finance.

Second, a prudent management of capital inflows and of the capital account in particular, with policies designed to favour the really long term inflows and to penalize short term inflows could help(see IMF 2011b)\textsuperscript{37}. Chile Malaysia are examples of rather successful adoption of these types of policies in the past.

These policies are nothing more than good common sense but they require Special and Differential Treatment for the developing countries which will adopt them. Provisions for special and differential treatment are included in the Agenda 2030, but to put them into operation requires a lot of negotiations; exceptions are not easy to be granted in a period of neo-Mercantilism, not even to low income countries. Special privileges and policy space for developing countries is part of the general view of the re-balancing of economic powers which characterizes this paper and which in this case applies do the different skills in handling credit and finance. A slower inclusion into international financial markets, which implies some preconditions goes into the direction of trying to reduce the distance between well advanced financial operators, who have a myriad of opportunities and possibilities and the new comers. I am not terribly optimistic on the possibility of these gradual inclusion of the weakest countries into international finance, but at least we should recognize the risks of a hasty approach to bond issuing, just because the money is there and investors are in search for higher yields; at some points African sovereign bonds have been even oversubscribe. Warnings about the risk of excessive borrowing by African countries come also by Rashid and Stiglitz 2013\textsuperscript{38}.

7.2. Indexed bonds

A second proposal concern a financial tool which would make life much easier for the developing countries trying to enter the international bond markets: index linked bonds. For low income countries the best situation would be that of being able to issue a bond with three types of characteristics:

- it is long-term;
- it is directed to generate capacity and productivity increases;
- it has an element of risk sharing.

The first two features are self-explaining. The third one has to do with the fact that in the transition towards stronger economic and financial structures crises are inevitable, and it is necessary to limit the risks that a crisis could derail the economy from its long term-growth path.

\textsuperscript{36} In the Financial Times of April 25, 2015 Alberto Gallo reminds us that “the general rule in markets, however, is that you can never hedge everything”(p. 20).

\textsuperscript{37} Eurodad 2014, p.10 too asks for provisions for capital account regulations; see also Tyson 2015 II p. 11.

\textsuperscript{38} In an interview to Finance and Development Stiglitz notices that “cross-borders flows can be very destabilizing” and that lacking a global regulatory system countries should protect themselves(IMF 2011, p. 51).
Bonds rates could be linked to *macro* magnitudes: typically GDP growth, but also export performances and prices of primary commodities in the case of resource rich countries. Instead of indexing the interest rate one could think of indexing the redemption value of the bonds, as in the case of inflation linked bonds. However for a developing economy it would be much better to index to GDP growth interests payments rather than the capital value. In case of either an external shocks or of the slowing down of the growth rate of the economy the immediate impact will be on the money needed to avoid arrears. Liquidity comes to the fore.

In a well known paper Borenzstein and Mauro maintain that indexed bonds could help to stabilize the debt ratio. There are several advantages with this type of bonds: first, they transfer part of the risk to the creditors and in general interests payments become pro cyclical: interest are higher when the country performs better and *vice versa*, therefore indexed bonds prove particularly useful in case of an economic slowdown.

Second, this mechanism puts less stress on government finances and allows for more fiscal space, because less precautionary finance is needed, and they help to stabilize fiscal policy. A recent study by the Bank of England which deal with advanced economies only shows that they can also produce significantly positive welfare effects, mainly by reducing default risks.

On the other side of the coin indexed bonds usually have higher borrowing costs than equivalent conventional bonds, so called ‘plain vanilla’ type, with no special rules attached. Therefore when interests rates are relatively low and funds abundant the borrowing countries show little interest in using this type of financing and prefer traditional bonds. Long term economic growth is an essential component of development and indexed bonds fit very well into this scenario, because they contribute to smooth the business cycle, moreover they could create a stronger commonality of interest between borrowers and lenders.

In the past index-linked bonds have been adopted in the debt restructuring processes of Mexico and Argentina. GDP bonds have come back in fashion in connection with the Greek crisis of 2015 and they have been indicated as a possible tool to restructure the Greek debt (see Goodhart 2015). On August 8, 2015 the Italian financial newspaper *Il Sole 24 Ore* has launched a proposal for a generalized utilization of GDP bonds; in the following days several comments have been added (see http://www.ilsole24ore.com/art/commenti-e-idee/2015-08-08/btp-legati-pil-puntare-crescita-100011.shtml?uuid=ACYyYxe).

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39 There is little role for indexed bonds in ERD 2015; while more attention is dedicated to Diaspora bonds (see ERD 2015, see p. 123).

40 We must remember that in the case of the debt crisis of the eighties and nineties most of the increase in the debt stock originated because of the inability of countries to service debts and in particular to pay interests.

41 For a brief literature review of these bonds since the debt crisis of the eighties see Barr et al. pp.4-5. Recently GDP indexed bonds have been suggested in the case of Greece.

42 See Barr et al 2014, who also find that GDP-linked bonds can facilitate more borrowing because they increase the threshold limits of the debt GDP ratio.

43 Griffith Jones and Sharma point out to a number of reasons why investors might not like to buy indexed bonds (see Griffith Jones and Sharma 2006).
An essential component of this proposal is that of having very long maturities, up to forty years; this fact will reduce the pressure of foreign debt service on indebted countries. Long maturities are instrumental to try to give the indebted country enough time to improve both its trade composition and its budget. In order to service her foreign debt a country must generate a surplus in the non-interest current account, NICA, (see Vaggi and Prizzon 2014) and quite often also in the primary budget. The improvement of the NICA entails an increase of exports, not quite an easy task for a LIC, and a decrease of imports; a primary surplus usually requires a contraction of public expenditure and an increase in taxes. Both strategies can be quite painful for economic growth.

There are also some technical issues to face, for instance one has to decide if interest rates are linked to the variations of either the nominal or the real GDP. In the case of domestic debt linking the rate of interest to the changes in nominal GDP covers the investors from inflation; there are already bonds whose capital value is linked to inflation. In the case of foreign debt the GDP and the stock value of debt are denominated in different currencies; it could be useful to link the interest rate to a combination of two elements: the inflation rate on the foreign currency in which debts are denominated and the real growth rate of the domestic economy.

Another important issue concerns the authority which should certify the growth rate, the risk being that the national government could underestimates growth in order to pay lower interests on foreign debt. The collaboration of international institutions and statistical organizations, such as Eurostat for Europe, could help to overcome this difficulty.

These type of bonds could also be used at the meso level and be linked to specific sectors, such as the productivity increases in agriculture, or to the performances of some manufacturing sectors. The precise sectors to support would depend on the existing productive structures. Of course this type of financing implies the existence of a development strategy of the country and a sort of industrial policy. It could be based on moving out from labour and resource intensive manufacture into low technology products, or from low to medium technology sectors. Interest rates could be linked to the performances of specific investments in agriculture and in manufacturing programs/projects.

The returns on these bonds could also be linked to the performances of firms, for instance inside an industrial zone, which in fact would mean to use them to finance the micro level. These bonds would still be issued by the a government agency and will have the backing of the country itself. The economic performances of sectors and areas can provide the index for the returns on capital, and in the micro level one could even think of possible convertibility into equities.

The fact the sectors which will receive the funds are part of a general and long term strategy of the country should help to limit the interests rates because the bond subscribers know that they invest into a sector which is part of a long term commitment by the country. The government itself has an interest in securing the success and the profitability of the specific sectors and areas which benefit from this type of funds.

Indexed bonds could also be used to finance major infrastructures in order to remove major constraints to economic growth: it could be energy, transportation, ports. In this cases it might be difficult to identify a program/project specific indicator to which link the bond returns and it would probably be better to use more macro type of indicator.

7.3. Separate markets for the sovereign bonds of low income countries
The tools and policies seen in the previous parts of this section can greatly help developing countries to manage their bond issuances. However these instruments cannot avoid a situation in which bonds issued by African countries become object of speculative activities. The Experts on Sustainable Development Financing ask for an enabling international environment that among others “remove the sources of international financial volatility” and strive “to reduce global financial fragility” (UN-ICESDF 2014, p. 40). The document also advocates financial markets regulations (see *ibid.*, pp. 27, 34). Also SDG 10.5 refers to the “regulation and monitoring of global financial markets and institutions” and debt sustainability is mentioned in SDG 17.4. This is more or less everything we find on the regulation of financial markets in the SDGs.

Regulations may be useful but what should the real content of these rules be? For many Low and Lower Middle Income countries it would be much easier if development finance could take place on a dedicated market; FfD should have its own track, separated from international financial markets. If Development Finance for LICs and LMICs could have ad hoc markets, procedures and regulations that would reduce instability and volatility and the risks of default. Basically these regulations should try to prevent or at least to penalize short-term speculative investments. In practice this special track for LICs and LMICs sovereign bonds aims at a separation of long term investments from speculative activities.

Very difficult to achieve, but also extremely necessary. Let us imagine that developing countries could issue bonds with three characteristics:

- at the time of the issuance special legal clauses clarify the long-run nature of the bonds and indentify the forum which should be used in case of disagreement;
- the issuance is supervised by an international body, either a UN agency with experience in debt sustainability such as UNCTAD or the World Bank;
- there is a strict control the type of investment funds which are allowed to operate on the secondary markets, in particular when these funds intervene as buyers.

All these rules will discourage the most speculative buyers but they might imply higher spreads on the interest rates paid by this these bonds with respect to similar bonds on financial markets. This effect could be mitigated by a fund which should be used when the regular servicing of the bonds is at risk due to specific conditions external to the country. These conditions could concern: interest rates increases on international markets; fall in commodity prices; slowing growth in high income and emerging economies.

The risk of moral hazard can be limited as long as only the bonds of LICs and of some of the poorest LMICs are included in this system the fund might not be very high. The fund could be located at some International Institutions which could also help on the supervision of the external conditions which determine the activation of the fund. On one hand the role of the fund is similar to the World Bank IDA financial window, in the sense that only some well identified countries could take advantage of it, but on the other hand the funds available are used only if there are specific events, in this way it is a kind of insurance for the buyers of the bonds. The fund would come into operation in cases which are similar to those requiring the IMF’s intervention, when there are liquidity and balance of payments crises. There are however two main differences:

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44 Target 8.D of the Millenium Goals was much more articulated on the issue of developing countries debt.
• first, the fund specifically supports long-term borrowing by developing countries;
• second, the indexation makes interests and re-payments contingent on the evolution of the balance of payments and on the external conditions which have determined its crisis, an aspect which resembles chapter 11 of the US banking law.

The idea of having separate markets for LDCs and LMICs issuing bonds resembles the separation between the operations of commercial banks and those of investment banks which was introduced in 1933 with the so called Glass-Steagall Act and has been repealed in 1999 by the American Congress with the approval of a new banking law. Following the financial crisis of 2007-2008 the Dodd–Frank Wall Street Reform and Consumer Protection Act of July 2010 has introduced many forms of controls and regulation to speculative finance, but it has not recreated that separation. The closer that we come to this separation is with the so called Volcker rule, which is trying to prevent United States banks from making speculative investments with the deposits of their customers. The rule has been finally approved on July the 21st of 2015 but its content has been diluted.\(^45\)

A final remark. Sovereign bonds management requires a good knowledge of the mechanisms of international finance and many developing countries have very limited financial expertise and debt management capabilities. Negotiations and consultation on international finance will contribute to capacity and institutional building (see Tyson 2015 II pp. 10-11). Developing countries need time and special rules in order to be able to take advantage of the abundance of funds in international markets. They need both special and differential treatment and policy space in order to rebalance the excessive power of rich countries and of private companies in international finance. I am not very optimistic that this special conditions could be achieved, but the risk of new and very damaging financial crisis is behind the corner.

A more limited financial sector could provide services more effectively directed to the real economy, that is to say a financial sector which is oriented to sustain the real needs of households and firms (see Kay 2015). All the more so in the case of long-term development finance.

Are these the priorities of countries with limited capabilities? Should we imagine a LDC or even a LMIC to dedicate efforts and human capacities to deal with issues and technicalities such as the RUFO clause (Rights Upon Future Offers)? What about the Pari passu clause which guarantees equal treatment between old and new creditors and which created so many problems to Argentina? This followed from a decision of the US Supreme Court in June 2014 not to hear the Argentina’s appeal against a decision by New Your Court in favour of the claim by NML Capital, Ltd., a hedge fund based in the Cayman Islands about being repaid 100 per cent of the original value.\(^46\) The IMF has suggested modifications of the pari passu clause in order to strengthen the Collective Action Clause, CAC, mechanism and to prevent the possibility for the so called ‘holdout creditors’ to block in practice the proper restructuring of sovereign debts (see IMF 2014, pp. 4-5).

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\(^45\) A similar problems arose in 2013 with restructuring of Greek debt, in this case most of the bond issuances were under English law.
References


