2. INTERDEPENDENCE

> *The present situation appears to require a new development paradigm, and this paradigm will need to take explicit account of the fact that issues concerning the management of the world economy, on the one hand, and long-term development objectives on the other, are intermingled.*
>
> Trade and Development Report, 1981: 2.

The distinct perspective of the TDR on development issues has been, from the very outset, that of interdependence in two areas: interdependence of economic conditions and policies among countries, and interdependence among different areas of economic activity and spheres of economic policy. The Report to the First United Nations Conference on Trade and Development in 1964 had already formulated a strategy designed to promote economic development in the poorer countries through strong capital formation and expansion of exports, both traditional and non-traditional. Central to that agenda was the idea that developing countries could base economic development on their own efforts only if they had sufficient scope to accelerate capital formation and diversify their economic structure. This agenda also emphasized the *interdependence between trade and finance, given that, particularly in the early stages of industrialization, imports would almost certainly grow faster than exports, and financing the gap would be key to accelerating growth* (04:VII).

At the time, the World Bank, the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT), in line with their respective mandates, took only partial approaches to international economic cooperation and development. The World Bank dealt with structural and long-term development issues, the IMF focused on monetary, balance-of-payments and short-term stabilization issues, and GATT was exclusively concerned with trade. This pattern was modified over time: through the conditionalities and cross-conditionalities attached to its lending, the IMF also entered the development arena and, together with the World Bank, increasingly shaped the trade policies of its developing-country clients, while the WTO also entered the field of finance through its work on financial services.

These international economic governance arrangements, the subject of profound TDR criticism in recent years, were already considered inappropriate in the early 1980s, since they *separate from one another the ever more closely connected problems of development, employment, debt, trade and payments balances.* The TDR suggested an *alternative approach on the basis of the interdependence of the problems in these fields and of the mutual dependence of employment and development* (84:11). UNCTAD's approach to economic development, and especially that of the TDR – its flagship report – has thus been based on a "holistic" view that addresses explicitly the linkages between these different areas of policy and their interaction in determining development outcomes.

2.1 Defining interdependence

In 1986, the TDR summarized its view of *interdependence of countries and markets,* which would remain largely relevant over the subsequent 25 years, and which shaped both its analyses and policy recommendations, as follows:

> *In most countries, a substantial share of home output is being absorbed by foreign demand, and a substantial share of home demand is being satisfied by imports... Most countries are also more tightly linked through monetary and financial relations. As the main money and capital markets have become more closely integrated, capital has become highly mobile across frontiers and this has made it more difficult for countries with open capital markets to both control their exchange rates and pursue autonomous monetary policies.*
>
> *External indebtedness provides another important form of linkage. For one thing, the debt servicing capacity of developing countries is affected by their exports and imports. For another, those developing countries that have borrowed heavily from capital markets have become directly exposed to swings in world interest rates.*
>
> *Differences in the way prices of different types of internationally traded goods are formed are also important. Since prices of most primary products fluctuate in response to market conditions more widely than those of manufactures, the real incomes of primary producers are particularly vulnerable to changes in the pressure of world demand.*
>
> *In any country, a gap [between the propensity to save and the willingness to invest] must be filled either domestically, via public sector borrowing and spending, or internationally, via external deficits and debt accumulation by other countries... For a large economy, choosing between the trade-surplus and domestic options has major international repercussions* (86: VI, VII).

Global interdependence thus has two aspects. First, it results from the trade and financial relations of countries and the impact of the <u>performance</u> of the developed countries on the potential for growth and development in the developing countries. Second, it results from the impact of macroeconomic, trade and financial <u>policies</u> in the major economies on economic performance and policy requirements in other countries. *Interdependence among countries implies that the economy of each is both sufficiently open for it to come under considerable influence from abroad, and sufficiently large for its own policies to make a significant impact on others* (90:134).

The interdependence of different spheres of economic activity and policy results from the effects of trade flows and trade policies on financial stability and external indebtedness, on the one hand, and on the impacts of the availability of external finance and exchange-rate developments on trade flows, trade policies and the pace and pattern of structural change, on the other. Consequently, the TDR emphasized the crucial importance of the interaction between the economic performance of different countries and regions, which determine the external environment for national development processes. In addition to the behaviour of markets, this external environment is shaped to a large extent by different areas of public policy. The concept of interdependence is therefore closely related to that of coherence between macroeconomic, financial, trade and development policies and related institution building. In this sense, the TDR, by analysing the implications of economic performance and policy decisions in the major developed countries for the economically much weaker developing countries – and later also the transition economies – to some extent anticipated later policy debates in the context of "globalization", a term that became popular in the 1990s.

> *An appropriate management of interdependence implies that no country with a sufficiently open economy (even if it is too small to have*

itself an impact on others) should be expected to be able to put its house in order regardless of what other countries are doing. ... Nor should any country set its policies without paying attention to their possible international consequences. A considerable amount of flexibility and discretion may be introduced, based on extensive consultations among the parties concerned. However, it should also be recognized that it necessarily implies a certain degree of constraint on national policy making (90: 134, 135).

2.2 Applying the concept of interdependence

In the early years of the TDR, the main issue with regard to interdependence was the unfavourable external environment for development, which saw a continuing deterioration in the terms of trade and a major recession in the industrialized countries. The interdependence between developing-country export earnings, which should become more complex after a majority of developing countries shift to outward-oriented development strategies, and macroeconomic developments in the developed world was emphasized in the first issue of the Report: *The level of economic activity in the developed market-economy countries remains the single most important factor in determining the export earnings of developing countries* (81: 3).

The entire first decade of the TDR series was marked by the sovereign debt crisis that affected many developing countries, and frustrations relating to their adjustment efforts. In 1981 the TDR observed: *There exists a paradoxical asymmetry in international relations which, on the one hand, requires countries to honour their debt obligations and, on the other, permits creditor nations to hinder their doing so by restricting imports* (81: 3). The result was *a process that enforces the containment of external imbalances through sharply reduced economic growth* (82:1).

These unfavourable developments were seen as being not only due to the national policies of the developed economies, but also to the institutional framework and practical operations of the international trade and payments systems which govern the interactions among countries. In 1984, the TDR thus concluded: *The debt question can only be satisfactorily resolved in the context of reform of the system of trade and payments* (84: 12).

But the perspective of interdependence also led the TDR to caution about possible repercussions of the deflationary adjustment in debtor countries for the creditor countries and the world economy as a whole. It suggested that helping debtor countries to restore growth and imports would make a large contribution to correcting imbalances. A reduction of commercial bank debt, combined with official debt relief and new financial flows, would result in substantial annual increases in net import demand from debtor countries (88: ch. IV).

The same spirit has been behind the TDRs' policy recommendations for a greater role for official financing when payments difficulties arise (e.g. 94:170; 95: ch. II; 98: ch. IV), for orderly debt workout mechanisms that ensure burden-sharing between debtors and creditors (e.g. 86: ch. VI; 98: 71; 01: ch. III), and for official debt relief for the poorest countries (e.g. 88: ch.IV; 93: Part III). These recommendations are grounded in an application of the concept of interdependence that is consistent with an emphasis on the role of aggregate demand for growth and macroeconomic stability in the Keynesian tradition. An easing of the debt burden and the provision of adequate external support from official sources to economies in financial difficulties were seen not only as prerequisites for crisis solution in the interests of both debtors and creditors, but, more generally, as important elements of countercyclical policies at the global level.

For example, when the TDR 2003 identified *a widening deflationary gap created by deficient global demand*, it recommended the adoption of *Keynesian policies to expand liquidity and effective demand,* *both at the national and global level, including policies to address the liquidity needs and the debt burden of developing countries facing stringent external financial conditions. For all countries, the prospects for prosperity hinge on international cooperation as well as on the intensity of their own efforts* (03: IV). And when the TDR discussed the global policy response to the financial crisis that started in 2008, it suggested including in the fiscal stimulus programmes of the more advanced economies a concerted increase in bilateral aid flows to low-income countries with balance-of-payments problems and limited fiscal space: *In addition, a temporary moratorium on official debt repayments would allow low-income countries to counter, to some extent, the impact of lower export earnings on their import capacity and government budgets*. Such measures, the Report underlined, *would not only constitute an important element in efforts to attenuate the impact of the global crisis on growth, poverty alleviation and investment in the debtor countries, but it would also contribute to stabilizing global demand* (09: VII).

The debt and development crisis of the early 1980s clearly revealed the extent of global interdependence. The perspective of the TDR was therefore very much focused on macroeconomic, financial and trade policies in the developed countries, which shaped the external conditions for growth and development in developing countries. By contrast, the design of national development strategies initially received less attention. Although the TDR recognized that in some countries that were experiencing crises *the initial conditions making for vulnerability were the product of policy errors,* it also understood that the structural features of developing countries were such that external shocks *may interact with the initial conditions in such a way as to unleash explosive forces* (89: V).

Another important aspect of interdependence repeatedly mentioned in the TDR has been that stable growth of global demand is essential for stemming protectionism (87: II; 96: 92; 02: 137; 09: 36), and that distribution of global demand also matters in this regard, as evidenced by the growing imbalances in the world economy since the beginning of the new millennium (00: 27; 04: ch. I). This raises the important issue of coherence between the design of the international trading system and governance of the international monetary and financial system (see section 4.5 below).

2.3 Evolution of issues related to interdependence

Over time, certain facets of interdependence became increasingly important and others changed. When export-oriented development strategies and trade liberalization had become the credo of the international financial organizations, the WTO and most developing-country governments in the 1980s and 1990s, interdependence between economic development in the South and macroeconomic and trade policies in the North assumed ever greater importance, as expressed in TDR 1999: *Liberalization as a successful growth strategy in an interdependent global economy relies crucially on exports, which in turn are highly dependent on growth in industrial countries and greater access of developing countries to their markets* (99: IX).

In 2002, the TDR found that greater competition among developing countries in world markets for labour-intensive products implied a fallacy of composition, similar to that observed in primary commodity markets. This was evidenced by a tendency for the prices of manufactured exports from developing countries to fall vis-à-vis those of the industrialized countries since the late 1990s (02: ch. IV). Similarly, increased competition among developing countries to attract foreign direct investment in the labour-intensive segments of international production networks led them to offer ever greater fiscal incentives and other concessions to transnational corporations (TNCs) (05: IX; 02: ch. IV). As a result, interdependence between countries is no longer just a North-South matter. It has become increasingly relevant also for South-South economic relations.

TDR 2005 examined the implications of the new economic dynamism of a number of emerging market economies, especially China, for other developing countries (05: chs. II-IV). It found that the growth dynamics in China had positive effects on many developed and developing countries that benefit from rising exports to China and other emerging-market economies. However, these developments did not fundamentally change the interdependence of markets and policies. First, much of the South-South trade involving China was linked closely to China's exports to developed countries (05: VI). Second, variations in the growth performance of fast-growing, large developing countries were seen to have a strong influence on the volume and terms of trade of other developing countries. Third, China's increasing participation in international trade posed new challenges for many countries, since it could contribute to a fall in the export prices of the types of manufactures that it produced and exported along with other developing countries (05: ch. II). Fourth, even if continuing growth in China and other large emerging market economies was likely to sustain the demand for primary commodities, the basic problem of instability in those prices remained unresolved (05: IX).

Regarding the interdependence of markets, an important new feature is the substantially closer interaction between the markets for different commodities, particularly energy commodities (08: ch. II), as well as between financial markets and the markets for primary commodities, which has been studied in great detail in the most recent issues of the TDR, especially in 2011. The increasing influence of financial market actors has accentuated the fluctuations in commodity prices and the level of uncertainty for both producers and consumers, besides adding to the balance-of-payments and fiscal problems of several poor developing countries (11: ch. V; also 09: ch. II). However, another aspect of interdependence related to commodity prices has remained as relevant today, as it was when observed in TDR 1990, namely that *any tendency for commodity prices to rise would be read in industrial countries as a resurgence of inflation and would trigger a response by the monetary authorities (even in circumstances in which interest rates were already high)* (90: IV; also 08: 38; 10: 21; 11: IV). With the rapidly rising consumption of certain primary commodities, this aspect of interdependence has also become an important issue in fast-growing emerging economies.

Clearly, the interdependence between the functioning of financial markets, on the one hand, and macro-economic developments and the performance of goods markets, on the other, has also become more complex since the time the first TDRs were launched. A particular concern of the TDR has therefore been the instability and unpredictability of private capital flows to developing countries (88: ch. II; 90: Part Two, ch. I; 98: ch. III; 99: ch. III; 03: ch. II). Recurrent financial crises have often been triggered by events outside the countries affected by such crises. This led the TDR 1999 to warn against an international system in which developing countries become overly dependent on capital inflows: *The international community must face up to the need for exports rather than unstable capital flows to underpin a return to rapid and sustained growth in the third world* (99: IX).

It is also widely accepted that imbalances between the major economies in the world contributed to the eruption of the financial and economic crisis of 2008–2009 – an issue repeatedly raised in every issue of the TDR since 2000. Looking back in history, TDR 2000 said in this regard: *The experience of the 1960s and 1980s shows that large imbalances in external payments and capital flows between the United States and other major industrial countries can pose serious threats to global growth and stability, since the willingness of investors in surplus countries to hold dollar-denominated assets can come to an abrupt end* (00: IV).

As early as 1982, the TDR pointed to a problem for developing countries that would take on increasing importance in the subsequent decades: the loss of policy space. It interpreted the development crisis of the 1980s not simply as *a set of poor growth figures for one or two years,* but as the result of the *progressive alteration of the international environment in ways that narrow the range of feasible policies open to developing countries to promote their own development, and that reduce the effectiveness of those that are available* (82: 5; also 90: XII). But with the increasing degree of integration into global production and financial markets, external influences over national policy targets became even stronger and policy autonomy was further reduced – an issue that was discussed in depth in TDR 2006 (06: chs. II, IV, V; see also section 5.3.3 below).