International Monetary and Financial Committee

Eighteenth Meeting
October 11, 2008

Statement by Mr. SHA
Under-Secretary-General
United Nations

UNITED NATIONS **NATIONS UNIES**

Statement by
MR. SHA ZUKANG
UNDER-SECRETARY-GENERAL FOR ECONOMIC AND SOCIAL AFFAIRS
TO THE INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE
Washington, DC, 11 October 2008

World economic situation and prospects

The global financial crisis has markedly intensified. Equity prices have fallen sharply worldwide, a number of major financial institutions have collapsed, while liquidity has evaporated in financial markets. These financial strains are exerting tremendous downward pressure on economic activity worldwide. A large number of developed economies are already in recession, and growth in many developing countries is decelerating significantly.

The UN expects world gross product (WGP) growth to decline to a recessionary pace below 2 per cent for 2008, down from the 3.8 per cent of 2007, implying zero growth in world per-capita income and likely falls in income for a large proportion of the population, particularly the poor. The outlook for 2009 will be even worse, with the growth of WGP expected to drop to about 1 per cent.

The debate about “decoupling” from the US economy may be finally laid to rest. The contagious credit freeze has spread through the European economies, as well as other developed economies, to a lesser degree. While economies of the euro area and Japan are already in recession, the prospects for other developed economies have also deteriorated markedly.

In the US, the financial catastrophe has begun to manifest its impact on the real economic sector, as both household consumption and business spending retrench. The Emergency Economic Stabilization Act (EESA), directed mainly at transferring bad assets from financial institutions, is unlikely to prevent a US recession beginning in the last part of 2008.

The impact of the global financial crisis on developing economies and economies in transition has also been deepening markedly, through both financial and trade linkages. Amid the synchronized global sell-off, equity markets in a large number of emerging economies have plummeted much more than their counterparts in developed markets. An increasing number of financial institutions in developing countries and economies in transition, particularly in Asian economies, are bearing sizeable losses from holding troubled assets of US financial institutions. The much larger impact, however, is expected to come from the significant weakening of demand in most developed economies. Growth in developing countries and economies in transition is expected to decelerate on average by about 2 percent in 2008, from the previous year, and by another one percent or so in 2009.

The broad international economic environment for developing countries and economies in transition has deteriorated considerably. At the same time that external financing costs are rising, a reversal of capital inflows is already evident in many countries, even though the degree of financial constriction for these countries is still not as pronounced as in the Asian and Latin American financial crises of the past. The heightened global financial turmoil has also led to considerable volatility in the prices of commodities. For a group of low-income developing countries, which suffered from steep rises in the prices of food and energy in early 2008, the current high level of these prices continues to threaten progress toward the Millennium Development Goals, particularly the primary goal of reducing poverty and hunger. For oil-exporting and commodity-exporting developing countries, increased volatility in commodity prices and a significantly dimmed outlook for global demand portends growing vulnerability in the prospects of these economies.

The potential severity of this crisis was underestimated by most policy makers worldwide which has led to failure to contain the crisis in its early stage. Despite some unusual policy actions and a few coordinated attempts among the central banks of major developed countries to inject more liquidity into credit markets, most policy measures so far have been piecemeal, and not adequate or appropriate for dealing with a systemic global crisis.

The present crisis marks the end of a prolonged period in which the world economy boomed on the basis of strong consumer demand in the US, stimulated by easy credit and booming house prices. Growing US deficits were financed by increasing trade surpluses in China and other developing countries willing to use increasing reserves to buy dollar-denominated assets. Increasing financial deregulation made it easy to move capital around the world and contributed to keeping the cost of borrowing low, further fueling a US consumer demand-led widening of the global imbalances.

All parties seemed to benefit from the relaxation of credit standards and the progressive underpricing of risk, despite repeated warnings that mounting household and public indebtedness in the US and elsewhere would not be sustainable.

The root cause of the global financial crisis is deeply embedded in policy deficiencies in the international financial system and in the unsustainable fundamentals of the world economy. As has been reiterated in UN publications over the last few years, the accumulation of global imbalances before the eruption of this financial crisis was an early warning signal of unsustainable global growth. The creation of the housing bubble in the United States was one consequence of the pattern and dynamics of recent growth. The UN has long advocated an internationally coordinated policy to adjust the global imbalances in an orderly manner, to avoid an abrupt slowdown in the world economy which would have serious consequences on an over-extended international financial system. With the heightened risk of widespread breakdown of the international financial system and of global recession, an internationally coordinated policy is even more badly needed.

International Cooperation to Restore Growth and to Regulate Finance

The prospect of a systemic world financial breakdown – and, consequently, a long lasting economic slowdown – is real. In recent weeks, individual country policies – both to do nothing and to undertake drastic measures to rescue their domestic financial sectors – have inflicted new vulnerabilities on other economies and have been attended by international political recriminations, reminiscent of the 1930s, when only *ad hoc* processes for coordinated action existed.

Since the 1980s, *ad hoc* international coordination has been coming back into vogue and this has coincided with the reduction in the capabilities and the narrowing of the policy agendas of global institutions set in place after the 20th century Great Depression. In the 1930s, a retreat by all countries from global commerce did not reduce competitive actions and counter-actions, but actually intensifie them, to the detriment of all.

The disjointed policy initiatives undertaken by developed countries in response to the market failures that originate in their jurisdictions reflect the incapacity of national authorities to commit their public resources to rescue institutions in other industrial economies in the absence of a commonly recognized framework of regulatory oversight. Existing institutions, all dominated by developed countries, including the IMF, OECD and the Financial Stability Forum, have, so far, not provided a platform facilitating effective coordination in response to crises and their prevention.

Beyond the obvious failure of concerted action, ongoing developments indicate that the most significant policy initiatives undertaken so far have not addressed the fundamental basis of the crisis. While these interventions ostensibly aim to avoid damage to the real sector, they have focused on restoring the viability of financial companies instead of addressing the process of reconciling overvalued financial assets with long-term rates of return in the real sector.

The immediate future is highly uncertain. Even if the US bailout package helps to restore market confidence, it will take time before economic activity will resume. There is now widespread recognition that the problems are global and systemic, requiring solutions that are global and systemic. The present system of global economic governance has proven to be inadequate to prevent the global financial (capital account) imbalances from ballooning into the current crisis. The reliance on a single national currency – the US dollar – as the world's reserve currency is one reason for the emergence of these imbalances. To address the global imbalances, the world community continues to rely almost exclusively on national policies. When there is a crisis, this leads to ad hoc fixes, instead of a transparent global system of policy coordination, reserve management and financial supervision and regulation.

The ability of the International Monetary Fund (IMF) to safeguard the stability of the global economy has been undermined by the vastly greater resources and volatility of globally integrated private actors and uncoordinated national policy responses as well as the emergence of exclusive multilateral institutions such as the G7, OECD and the EU. In effect, the IMF has been effectively sidelined in handling the present crisis. The perceived irrelevance of the Bretton Woods institutions in today's crisis also stems from their skewed voting structures and governance and the disconnect, at times, between their policies and the nature of the global economy.

Developing countries now represent a much larger proportion of world economic activity than they did in 1944. Developing countries – as a group – are now net creditors to the global economic system and have an abiding interest in a rules-based and impartial debt workout system. Given the large and persistent trade and fiscal deficits in the US, the bulk of the financing for the $700 billion US bailout will likely be funded, directly or indirectly, from savings generated by developing countries.

There is clearly an urgent need to reform the international monetary and financial system to ensure that it is more inclusive and equitable, and thus enable credible and effective global economic governance. Already some developed countries, such as the UK and France, and many developing countries, such as those in the Commonwealth, have called for an international conference to redesign the system of international economic governance into a new post-Bretton Woods system, designed to restore accountability and transparency in international economic policy-making and to overcome existing systemic weaknesses.

Doha Follow-Up Conference on Financing for Development

In 2002, the Monterrey Consensus, reached after the Asian financial crisis and the "9/11" terrorist attacks in the United States, appeared to represent a revival of multilateralism, under the framework of Financing for Development as a shared responsibility of both developed and developing countries. Developing countries committed to improve their macroeconomic management while developed countries promised to increase aid, alleviate debt distress, and ensure a global economy supportive of investment and growth.

The current crisis throws a spotlight on the international community's failure to adequately address systemic issues. The UN General Assembly is convening a follow-up conference on financing for development in Doha, Qatar in 29 November to 2 December 2008. Member countries of the United Nations have begun intensely negotiating an outcome document that seeks to address obstacles encountered in meeting their commitments and to respond to new and emerging issues.

The United Nations conference on Financing for Development in Doha beginning in late November provides an early opportunity to send a clear signal of the urgency of considering these matters while ensuring counter-cyclical and other measures to contain the consequences of the ongoing financial turmoil. We urge the international community to recall the spirit with which the institutions of global governance were established in 1944 – against the backdrop of a ruinous depression and millions of lives lost in a world war, and to reform global institutions and mechanisms based on rigorous and appropriate analysis, by taking the necessary decisions in the Financing for Development conference at Doha. The following areas require critical attention:

1 more effective regulatory frameworks, particularly in financial markets;

2 more effective, globally coordinated, counter-cyclical policies and institutions;

3 improved risk monitoring and crisis avoidance as well as management better suited to the realities of contemporary global financial integration;

4 more universal and equitable distribution of voice and representation in global decision-making bodies; and

5 follow through, in an accountable manner, on all international commitments made in the areas of aid, trade, debt reduction, and

access to technology and affordable medicines in support of developing country efforts to achieve the MDGs.