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**Statement by
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Chairperson,
Distinguished Ministers,
Excellencies,
Ladies and Gentlemen:

The global economy is at a critical juncture. The rapid recovery in numerous countries, particularly in developing regions, has been remarkable. Currently, the strongest recovery trends are apparent in developing countries, with emerging-market economies in Asia, led by China, experiencing a strong rebound from the crisis. Nevertheless, we must not forget that the relatively high growth rates in 2010 are partly the result of their low levels in 2009. Moreover, the exit from recession is unlikely to be either strong or durable if it continues to be based on temporary factors, such as inventory cycles and exceptional fiscal stimulus programmes.

The global industrial inventory cycle may give a misleading impression, leading to a belief in the briskness and sustainability of the turnaround. In fact, it should be a warning that businesses remain wary of the strength and durability of the rebound. Unless new sources of dynamism can be found, it is likely that growth rates will decline in most countries in 2011.

Recovery in the United States has been driven by monetary and fiscal stimulus measures, but the stimulus is now likely to have run its course. Fiscal adjustment in 2011 may drag the economy down. There are headwinds blowing from several directions: the property market, the further erosion of balance sheets of borrowers and lenders, persistent weakness in the labour market, and feeble credit growth.

United States authorities are pinning their hopes for recovery on strong growth in exports. A weaker dollar would support this strategy, which would also be in line with the needed global rebalancing. But the scope for faster export growth in the United States is limited because the main market for United States exports is Europe, where the recovery appears to be the most fragile, and which has recently become a new hotspot of instability.

In Europe domestic demand continues to stagnate, which may be compounded by continent-wide fiscal austerity starting in spring 2011. This may stall recovery in the region even before it has started, and there still remains the problem of financial instability. The subprime mortgage crisis in the United States acted as the trigger for a series of events that led to the European debt crisis of 2010. The root

cause of this crisis can be traced to serious intraregional divergences and to the related build-up of regional imbalances that had long been ignored by market participants and policymakers alike. The crisis in Europe suggests that the euro area's current policy regime may well be unsustainable, and that member countries' uncoordinated national policies are on a collision course.

Calls for an "early exit" from the demand-stimulating macroeconomic policy stance have been growing louder, especially in Europe, where austerity measures aimed at balancing government budgets were announced in the first half of this year. At this juncture any withdrawal of a stimulus policy seems premature, since in many countries private demand remains fragile, with no sign of approaching even its pre-crisis levels. This raises the very real threat of a double-dip recession that could push the global economy into a vicious circle of debt deflation.

Several developed countries seem to be promoting net exports as a possible driver of growth, but will there be room for all of them? Very dynamic regional growth in Asia, creating strong demand, contributed to the significant export-led recovery of Japan – one of the developed countries severely affected by the crisis. In Western Europe, too, policies have been aimed at increasing net exports, and the growth rate, albeit more modest, has also been lifted by external demand. Yet, if too many big players begin to rely on net exports, they cannot all be successful. Furthermore, this could lead to trade tensions among them and eventually to protectionist measures. Lastly, the underlying causes of the crisis are still in place which should cause grave concern: unregulated financial systems, income inequality and global imbalances are still more or less unaffected by reforms.

Need for global coordination in macroeconomic management

In a globally integrated economy, international coordination of economic policies is essential. At the peak of the global crisis, G-20 members managed to see eye to eye on the need for coordinated measures to generate a strong demand stimulus, as the sheer severity of the events precluded any alternative. That moment seems to have passed: there is now a strong belief among policymakers in the euro area that fiscal austerity will support, rather than harm, growth by restoring confidence. In contrast, policymakers in the United States fear that continued domestic demand stagnation in Europe will undermine any recovery of United States exports.

Coordination of the world economy at the current juncture does not mean that all countries should withdraw their stimulus programmes simultaneously; it primarily concerns the free-rider problem. As a rule, governments should withdraw stimulus in line with the recovery of private domestic demand in their country. Ending stimulus to domestic demand before that point means having to rely on exports for recovery, but this only shifts the demand burden onto others. Failure to coordinate policies at the G-20 level raises the prospect of global imbalances re-emerging.

Robust domestic demand growth in developing countries, led by China, together with strengthening currencies, helps global rebalancing. At the same time imbalances among developed countries risk becoming bigger and the continued weakness of the euro also militates against global rebalancing. While China's real effective exchange rate was rising in the first half of 2010, Germany's was declining. A re-emergence of global imbalances would be contrary to the declared objectives of the G-20 and signify a failure of international cooperation among the Group.

The task ahead: reforming the global monetary and financial system

The G-20 process has also fallen short of launching serious reforms of the international monetary and financial system, including the exchange rate system. Inadequate governance of the exchange rate system gives rise to the risk of competitive devaluations and beggar-thy-neighbour strategies, with a reliance on exports serving to offset countries' failure to manage domestic demand. A major concern is that unfettered markets cannot be trusted to determine exchange rates that reflect fundamentals and allow balanced trade. Experience has shown that, apart from generating excessive short-term volatility, currency markets systematically overshoot or undershoot, thereby causing serious trade imbalances and related instabilities.

Unilateral exchange-rate management may lead to political tensions, since it conflicts with the multilateral character of exchange rates. Therefore, a multilaterally agreed arrangement for exchange-rate management could introduce greater stability into the world economy as well as a higher degree of coherence between the multilateral trading system and international financial governance.

This could be achieved through a system of managed flexible exchange rates which aims for a rate that is consistent with a sustainable current-account position. Implicitly featuring the purchasing power parity condition as the key guiding rule, nominal exchange rates would be periodically adjusted to compensate for inflation differentials. Other factors such as terms-of-trade shocks and the state of countries' development would also need to be taken into account to assure a system-wide effort to achieve balanced trade. An internationally agreed exchange-rate system aimed at ensuring stable and sustainable real exchange rates (RERs) for all countries would go a long way towards reducing the scope for speculative capital flows.

In addition, symmetric intervention obligations under the "stable RER" rule would greatly reduce the need for emerging-market economies to hold international reserves as a means of self-insurance against currency crises.

Closely related to exchange-rate instability and misalignment is the problem of destabilizing capital flows. Possible measures to deal with this problem include taxes on international financial transactions as well as various capital-account management techniques that may target both the level and the composition of

inflows. In many cases, instruments directly targeting private capital flows may also be appropriately combined with, and complemented by, prudential domestic financial regulations.

The global crisis has shown all too clearly that it is in the legitimate interest of countries to contain uncontrollable risks taken on by the private sector in unfettered global financial markets. One important aspect of reform of financial regulations and supervision should be to ensure the system's functional (or social) efficiency in contributing to growth and stability in the real economy. At the same time, it should control or eliminate products that provide no real service other than the ability to gamble and increase leverage, which is often the case with financial derivatives.

So far, there has been only limited progress in making the financial systems of the leading developed countries any safer. Reforms of financial regulations and supervision have been pursued at the national level without due consideration to the need for a global architecture that would guarantee a degree of coherence.

At this point in time, financial reform in the United States is more advanced than in Europe. The mere fact that national financial reform is proceeding at different speeds and along different routes is a possible indication of conflicting policy views and/or interests. This may further impede proper coordination by the Financial Stability Board. It also still remains essential to conduct an inquiry into why the main international institutions charged with identifying risks to global financial stability may have failed to flag early warning signs in the build-up to the global financial crisis.

Outlook

It is unlikely that developed countries as a whole will return to rapid and sustainable growth rates in the near future. The main reason is that, in general, domestic demand remains weak owing to continued high unemployment and low private consumption. And it is quite likely that balance-sheet adjustments in financial and non-financial private sectors will continue to dampen domestic demand.

A faltering global recovery would mean rising unemployment and increasing poverty, and – almost certainly – failure to meet the Millennium Development Goals. Global growth is vital for employment creation, which is a precondition of sustained poverty reduction and development in the poorer economies.

It is becoming clear that not all countries can rely on exports to boost growth and employment, especially in the current global economic situation. Greater attention will therefore have to be paid to strengthening domestic demand, but it is unlikely that the United States' former role as the global engine of growth can be assumed by any other country or groups of countries. In order to prevent the recurrence of imbalances similar to those that contributed to the outbreak of the global financial

crisis, the shift in focus to domestic-demand-led growth is especially necessary in developed and emerging-market economies with large current-account surpluses and underutilized production potential. But it is also important for many developing countries that have become heavily dependent on external demand for growth and for creating employment for their growing labour force. These countries must further pursue their integration into the global economy, at the same time as strengthening domestic demand as an engine of employment creation.

Job creation results from a virtuous circle of high investment in fixed capital leading to faster productivity growth; in turn, corresponding wage increases in line with productivity growth enable a steady expansion of domestic demand. For developing countries in particular, this may call for a rethinking of the of export-led development paradigm, based on keeping labour costs low. Such a rethinking could expand the menu of policy instruments and institutions available to support domestic investment, wage increases and an expansion of domestic consumption, in line with productivity growth.

There will be greater scope for central banks to pursue an investment-friendly monetary policy when disruptions to the financial sector and currency volatility and misalignment have been minimised. This is a systemic problem which could be solved through an appropriate multilateral framework for exchange-rate management that aims to prevent large current-account imbalances by keeping the real exchange rate relatively stable at a sustainable level, as outlined above.

At the current juncture the world economy is befitting from fast domestic demand growth in a number of emerging market economies, led by China. The demand stimulus these countries provide will be crucial to help the global economy restore its pre-crisis growth path. But it will be insufficient: continued policy stimulus in the major developed economies is needed to maintain the momentum, and global macroeconomic policy coordination in this context is critical.