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Statement by Supachai Panitchpakdi
Secretary-General
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Secretary-General of UNCTAD

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Global and regional growth trends

United Nations forecasts for 2011 and 2012 show global GDP growing between 3 and 3.5 per cent, with notable differences among regions: developed economies, for example, are expected to grow at around 2 per cent a year, while transition and developing economies should record growth rates of about 5 and 6 per cent, respectively (Table 1).

Developed countries, where the global crisis originated, face the most difficulties to return to high and sustainable growth rates. In many of these economies, persistent high levels of unemployment, wage restraint and high indebtedness of households and governments are hampering domestic demand. Such a situation will continue as long as financial and non-financial private sectors continue the deleveraging that began with the onset of the crisis. In fact, despite having received massive support from governments, the banking systems of developed countries still appear reluctant to expand credit to households and firms.

Since private sector demand, in developed economies, has not yet recovered its pre-crisis dynamism and is unlikely to do so in the immediate future, policy makers should maintain supportive policy stances. However, most of them appear to be increasingly worried by public debt ratios and inflation. As a result, they are shifting from fiscal stimulus to fiscal tightening. The rationale for such a shift is to curb public debt ratios and maintain the confidence of financial markets, although this may prove self-defeating. To the extent that it weakens the incipient economic recovery and affects fiscal revenues, it may decelerate growth without reducing public debt ratios. It would be more effective to restructure public expenditure and revenues in a way that increases fiscal multipliers without necessarily expanding total expenditure or decreasing total revenues. For instance, increasing progressive taxes and reducing regressive ones, reducing defense budgets, and increasing transfers to the poor can be considered in this respect,

In the Eurozone, the European Central Bank has begun to increase policy interest rates from recent very low levels. This return to more "normal" rates has been accelerated by fears of an inflationary resurgence. Monetary tightening appears to be premature and may also be ineffective: this is because higher inflation is likely not the result of excessive domestic demand, but is rather being stoked by higher prices for primary commodities, in particular oil and food. If the idea is to offset price increases by decelerating economic activity, the cost to growth could turn out to be high at this stage of the recovery.

It is still too early to gauge the economic impact of the earthquake and Tsunami that hit Japan in March, but as Japan is the world's third largest economy, and a critical actor in industrial networks, the impact may well have global consequences. UNCTAD's estimations revised downward the initially projected global GDP growth rate for 2011 due to disrupted produc-

tion and a deterioration in business confidence in Japan. However, reconstruction investment and activity should support a Keynesian-style return to growth in 2012.

In contrast to developed economy regions, developing countries and transition economies recovered more rapidly from the 2008-2009 recession, and have maintained higher growth rates since then. Growth rates in developing economies will be relatively strong in 2011 and 2012, although slightly lower than those of 2010 – when high growth rates were partly inflated by the low basis for comparison in 2009. All developing regions will probably grow at rates that are relatively high in historical terms, with the likely exception of the Middle East and North Africa (MENA) region, where continuing turmoil will directly and indirectly dampen growth in some of the countries of the region.

In its economic dimensions, the upheaval in the MENA region is not only a reflection of discontent over jobs, low wages and poverty, but also represents a day of reckoning for the trade and economic policy choices made in the region over past decades. The UN Secretary-General Ban Ki-Moon has emphasised that such a "situation […] calls for bold reforms". This is therefore an opportune moment to rebuild neglected public institutions so they can lead the process of reshaping economic and labour governance, in part via the levers of growth oriented macroeconomic policy. This can trigger a virtuous circle of investment, productivity growth, income growth and employment creation, with the gains more equitably distributed between labour and capital (see: *UNCTAD Policy Brief No. 21*).

The fact that many developing regions were able to recover their high growth rates so soon after the crisis, when growth in most developed economies remained slow, suggests that these economies are relying increasingly on domestic markets and South-South trade. This is reflected by the evolution of international trade during this period. In early 2010, emerging economy imports and exports had, in volume terms, already recovered their previous maximum level of mid-2008 and, by January 2011, they had exceeded that level by 10 and 14 per cent respectively. By contrast, in early 2011 exports from developed economies were still 6 per cent below their previous highs of the second quarter of 2008. Trade values have increased even more rapidly in emerging economies, owing to the recent rise of commodity prices. In commodity exporting countries, high export revenues increased national income, strengthened balance of payments and provided government revenues that could be used for expansionary policies without jeopardizing fiscal balances. As a result, they played an important role in supporting growth in Latin America, Africa, West Asia and the CIS.

However, rapid and volatile price movements can also represent a short-term risk for countries. As witnessed in the first half of 2008, high food and energy prices caused many problems in developing countries importing those commodities, where they often represent a high share of household income expenditure. Government responses to such price movements can also cause just as much damage and need to be carefully considered. Problems can arise from several policies, which were pursued by governments during the 2008 price hikes, such as monetary tightening with the aim of mitigating inflationary pressures. In the medium term, such policies may impact domestic investment and attract short-term capital flows, with consequences for the exchange rate and other asset markets. High but volatile prices may also cause problems for exporting countries: currency overvaluation, for example, can impact non-commodity tradable sectors and strategic development goals, such as economic diversification.

Commodity prices and world business cycles

It is well known that the most recent decline in world industrial output was by far the strongest of all downward cycles in the past 35 years. With a sharp drop of 12 % from its most recent peak, other recessions look like mild slowdowns in comparison. However, for commodity it is often overlooked that, in spite of very low utilization of global industrial capacities at the beginning of 2009, upward pressure on prices was much stronger than ever before. It seems likely that financial markets' anticipation of recovery has played a disproportionate role in this current bout of commodity price inflation.

The significant price impact of financial investors, which may be considered "the new normal of commodity price determination", affects the global business cycle in a very profound way. Commodity price inflation endangers a smooth recovery as it can provoke premature tightening of monetary policy and has played an important role in the tightening of Chinese and Indian monetary policy since early 2010 and, in April 2011, the first interest rate rise by the ECB since the beginning of the crisis.

Whereas commodity prices and share prices have historically moved in opposite directions during most past business cycles, there has been a remarkable synchronization of share price and commodity price movements in the most recent cycle, as was confirmed in the *World Economic Outlook* 2010. The *Outlook* warns against interpreting the increased synchronization as evidence in favour of the financialization of commodity markets and affirms that "increased co-movement, however, likely reflects the sensitivity of both markets to broader economic developments."

Such an interpretation, however, neglects the low level of capacity utilization in the wake of the "Great Recession" of 2008 and 2009. This in principle implies a low level of industrial use for commodities and thus a low level of demand for commodities from their most significant users. Under such circumstances steadily rising prices for commodities, even ahead of the rebound of stock market indices, appear to be related more to *anticipation* of future revival of demand rather than response to *actually* rising demand. The most plausible explanation for such price behaviour is financialization, which in 2008 eventually led to an overshooting of commodity prices in both directions over their "fundamental" levels. For example, a recent research note by Goldman Sachs suggests that in the wake of recent events in North Africa, the speculative premium in crude oil prices is about one fifth of the price.

The fact that monetary policy reacts to price pressure stemming from rising commodity prices rather than bottlenecks in industrial production points to another worrisome aspect of financialization: namely, damage to the real economy induced by the wrong signals for macroeconomic management. Only more effective regulation of commodity markets can lead modern market economies back to an environment of sound price signals and efficient allocation of resources.

Progress still to be achieved on global imbalances

In their Declaration at the Seoul Summit, in November 2010, G20 Leaders recognized the need for an assessment of the "nature and the root causes of impediments to adjustment as part of the Mutual Assessment Process" which are posed by "persistently large imbalances, assessed against indicative guidelines". The G20 Framework Working Group has worked hard to agree on a range of indicators to serve as indicative guidelines for timely identification of large imbalances that require preventive and corrective action, and a mechanism to facilitate such assessment.

UNCTAD welcomes this G20 position which acknowledges that leaving current account and exchange rate developments entirely to the market does not always generate acceptable macroeconomic outcomes. This is revealed yet again, as Brazil, a major emerging-market economy running a current-account deficit, has faced huge capital inflows that have caused a damaging appreciation of its currency.

The world economy has been in a similar situation before. In 1985, the market's inability to resolve long-standing trade imbalances between Japan and the United States was finally resolved by the historic Plaza Accord, after all other approaches had failed. Today the need for coordination is greater, but achieving it is more difficult. Globalization means that virtually all of the world's economies are affected, rather than just the leading few. Also, by comparison with a generation ago, the magnitude of the trade and capital flows involved is immense.

In monitoring global trade imbalances and progress towards external sustainability it might seem logical to focus on the size of a country's current account deficit or surplus, as a percentage of its gross domestic product (GDP) to indicate when the overall scale of imbalances is moving away from sustainable positions. Other viewpoints favour looking at the relevant components for different countries of the current account, or at a wider range of indicators that contribute to imbalances and to consistency between fiscal, monetary and exchange rate policies.

However amenable it might be to cross-country analysis, reliance on the current account imbalance as the indicator of choice does not provide an appropriate guide for eventual policy decisions about macroeconomic adjustment. There are many good reasons why a current account may be in deficit or surplus at any point in time. In such cases, the temporary buffer of net capital inflows or outflows is needed to allow for a smooth functioning of the international trading system. In other words, **imbalances in the current account are not always indicative of a systemic problem that needs coordinated intervention**. However, current account deficits certainly signal a systemic problem when they are the outcome of a general loss of competitiveness. Such losses are actually reflected in the appreciation of the real exchange rate (RER), which can lead to an unsustainable deficit.

There can be significant differences in the measurement of the real exchange rate, depending on whether it is calculated on the traditional basis of changes in the consumer price index (CPI) or on changes in unit labour costs (ULC). The discrepancy between the two indicators has to be fully understood before countries in such a position are held accountable for "under-valuation". Based on the ULC-REER China is the only country among the four largest countries of the world (as measured by GDP, using 1995 as the base year) where the persistent surplus on the current account coincides with the expected loss of competitiveness. This discrepancy is much less surprising when the particularities of China's economic development over the past two decades are carefully considered (see for a more detailed explanation: *UNCTAD Policy Brief No. 19*).

The real effective exchange rate based on unit labour costs appears as the most useful benchmark against which systemic distortions of trade flows and capital flows can be measured at the same time. The ULC-based REER provides the only reliable information on a country's competitiveness even under the special circumstances of some emerging markets as a hub of manufacturing production. If labour costs increase sharply in relation to productivity the effect will show up in either a loss of market shares or a loss of profitability compared to the

past. On both accounts, competitiveness is reduced in relation to producers in other countries with a lower increase in labour costs.

Volatile capital flows

Private capital flows to emerging market economies picked up again in 2010, after a sharp drop during the financial crisis and the global recession. In 2010 net private financial lows (excluding FDI) had a strong comeback, mainly driven by private portfolio flows. The rebound has taken place in most regions, with the exception of the Commonwealth of Independent States and the Middle East and North Africa region. Developing Asia, Central and Eastern Europe and sub-Saharan Africa have seen "investors" returning at near full speed and this has again put increased upward pressure on the exchange rates of their currencies.

Today's experience of capital flows and currency misalignment has much in common with the "Dutch disease" experience of some commodity exporting countries in the past. In these cases, currency overvaluation resulted from fast increases in commodity export earnings (and, in some cases, related capital inflows). As a consequence, the producers of manufactures in the countries concerned lost competitiveness on both domestic and external markets. This caused a setback to the process of further industrialization and diversification, increasing their economic vulnerability.

While a multitude of factors is responsible for the movements of short-term capital flows, one factor clearly stands out in explaining the persistent inflows and the resilience of these flows after shocks: nominal interest rates are persistently high in the countries receiving these flows compared to rates in the countries in whose currencies they are funded. Today we can speak of a new form of "Dutch disease", although this time the disease is provoked by the international carry-trade rather than from commodity-exports. The effects of the disease are just the same, however: distorting exchange rates, and frustrating countries' efforts to develop their manufacturing industries and to diversify domestic production and exports.

Such carry trade activities – both before and after the crisis – involve huge amounts of funds invested by highly leveraged financial institutions like hedge funds and banks. They have become the single most important determinant of cross-border capital flows, but are unrelated to "fundamentals", such as financing of trade or fixed investment in the destination economies.

The process is also self-reinforcing. As carry trade displays the usual pattern of herding behaviour that is characteristic of financial markets, the investment strategy of a single investor is quickly multiplied as others follow his example. A large movement of flows into a target country – like Iceland before the crisis of 2009, or Brazil and Turkey more recently – leads to an appreciation of the respective country's currency and a depreciation of the currency of the funding country. This movement reinforces the flows as it increases the profit margin of the investor, who, in addition to the interest rate differential, also expects to gain from the appreciation of the target currency.

The long-term effects of carry trade on currencies are of enormous significance for global imbalances. Typically, carry trade investors remain in the target country and keep entering as long as no shocks are occurring and no defence mechanisms are introduced in the target countries that would significantly reduce carry trade returns (such as the tax introduced on capital inflows in Brazil, last year). As long as there is no reversal of carry trade flows, the exchange rate of the target country's currency remains high or continues to appreciate. But even after big

shocks the carry trade flows return as soon as the situation has calmed.

Debt and Official Development Assistance

The series of global economic shocks beginning with the fuel and food crises, quickly followed by the global financial crisis and the ensuing great recession, were further complicated by commodity price volatility and ongoing sovereign debt difficulties in developed countries. These events have combined to test the strength of the international financial system. Sluggish growth forecasts and the ongoing challenges to the global economy carry important implications and challenges for debt and ODA in the years ahead. Indeed, a few areas of particular concern pertain to the sustainability of sovereign debt, the provision of official development assistance and their impact on development.

Prior to the recent recession, developing countries had managed to sharply reduce their average debt ratios and also made progress towards altering the composition of their public debt by reducing their dependence on foreign borrowing in favour of domestic creditors. This reduction in debt ratios was largely due to rapid GDP growth rather than a reduction in the stock of gross external public debt (which has remained more or less constant at around USD1.4 trillion over the past decade). Unfortunately the global crisis has so far put a stop to this trend, though it has not completely reversed it.

In the build-up to the global crisis, many developing countries had started to accumulate large external reserves, which enabled some developing countries to respond to the global recession with some form of countercyclical policy. Unfortunately, many low-income countries have quickly exhausted this fiscal space and are increasingly vulnerable to succumbing to unsustainable debt burdens.

Steps to mitigate and reduce the cost of potential debt crises must be taken soon. Several measures could alleviate the situation, and include: the promotion of newer and safer debt instruments; regulation aimed at reducing destabilizing capital flows; and the design of a set of guidelines aimed at limiting solvency crises by promoting responsible sovereign borrowing and lending to sovereigns.

In addition to the formulation of new policies to mitigate the cost of debt crises, due consideration must also be given to keeping international aid commitments. Official Development Assistance (ODA) provides an important source of financing for developing countries as they often lack the ability to broaden their tax base, while facing high GDP growth volatility and hence fragile revenue bases. Despite encouraging signs in 2010 that official development aid would remain buoyant, a recent OECD survey indicates that aid is likely to sharply slow in the coming years (2011-2013).

The global crisis has also led to a sharp rise in the debt ratios of developed countries, where austerity measures introduced in many donor countries are likely to negatively affect ODA. Fiscal consolidation in the advanced economies should not translate into reduced foreign aid, which has absorbed only a minuscule portion of total fiscal outlays of most donor countries. Reneging on aid commitments and abandoning global solidarity at a time in which many developing countries are being hit by large negative external shocks is a nearsighted policy, which can only lead to a lose-lose outcome. Repeated calls have been made for donors to increase ODA contributions to the 0.7 per cent of GNI target, which was reaffirmed at the Millennium Summit. Moreover, achieving the MDGs hinges on the provision of adequate financing while maintaining financing for other internationally agreed development activities.

Table 1: World Output Growth, 2006-2012 a/

	2006	2007	2008	2009	2010	2011	2012
World	**4.0**	**3.9**	**1.6**	**-2.1**	**3.9**	**3.2**	**3.4**
Developed countries	**2.8**	**2.5**	**0.2**	**-3.6**	**2.5**	**1.9**	**2.3**
of which:							
Japan	2.0	2.4	-1.2	-6.3	3.9	0.7	2.7
United States	2.7	2.1	0.0	-2.6	2.9	2.5	2.4
European Union (EU 27)	3.1	2.8	0.5	-4.2	1.8	1.6	1.9
of which:							
Euro area	2.9	2.7	0.5	-4.1	1.7	1.5	1.8
France	2.2	2.4	0.2	-2.6	1.5	1.5	1.6
Germany	3.0	2.5	1.0	-4.7	3.5	2.6	2.2
Italy	2.0	1.4	-1.3	-5.0	1.1	1.1	1.4
United Kingdom	2.8	2.6	-0.1	-5.0	1.3	1.1	1.8
European Union (EU 12)	6.5	6.1	4.0	-3.6	2.1	2.9	3.7
South-East Europe and CIS	**8.0**	**8.3**	**5.1**	**-6.7**	**4.0**	**4.9**	**5.0**
South-East Europe	5.2	6.1	4.3	-3.7	0.1	2.4	3.2
CIS	8.2	8.5	5.2	-7.0	4.4	5.2	5.2
of which:							
Russian Federation	7.7	8.1	5.2	-7.9	4.0	5.0	5.0
Developing countries	**7.3**	**7.6**	**5.4**	**2.5**	**7.3**	**6.2**	**6.0**
Africa	5.8	6.0	4.9	2.3	4.3	3.6	4.9
North Africa (excl. Sudan)	5.3	4.7	4.6	2.9	4.1	0.9	4.7
Sub-Saharan Africa (excl. South Africa)	6.4	7.3	5.9	4.2	5.3	5.6	5.5
South Africa	5.3	5.5	3.7	-1.8	2.6	3.7	4.0
Latin America and the Caribbean	5.5	5.6	4.0	-2.1	5.8	4.5	4.0
Caribbean	9.4	6.0	3.0	0.6	2.5	3.4	2.2
Central America (excl. Mexico)	6.4	7.0	4.3	-0.4	3.4	3.6	3.6
Mexico	4.8	3.4	1.5	-6.0	5.5	4.3	3.6
South America	5.5	6.6	5.3	-0.5	6.3	4.7	4.3
of which:							
Brazil	4.0	6.1	5.2	-0.6	7.5	4.5	4.0
Asia	8.2	8.6	6.0	4.1	8.2	7.1	6.8
East Asia	9.3	10.3	6.9	5.8	9.4	7.8	7.5
of which:							
China	11.6	13.0	9.6	9.1	10.3	9.4	9.0
South Asia	8.4	8.7	5.8	5.6	7.1	6.8	7.2
of which:							
India	9.4	9.6	7.5	6.7	8.5	8.2	8.5
South-East Asia	6.1	6.5	4.2	1.1	7.5	5.1	5.6
Western Asia	6.2	4.7	4.3	-1.3	5.9	6.0	4.5
Eastern, Southern and South-Eastern Asia	8.6	9.4	6.3	5.1	8.6	7.2	7.2
Asia and Oceania	8.2	8.6	6.0	4.1	8.2	7.1	6.8
Oceania	1.6	1.6	2.5	1.2	2.7	3.2	3.6

Source: UNCTAD secretariat calculations based on United Nations, UN/DESA, National Accounts Main Aggregates database and World Economic Situation and Prospects (WESP) 2011; ECLAC EDD database; Country Reports to the Project LINK; and national sources.
a/ Data for 2011 and 2012 are preliminary forecasts. Calculations for country aggregates are based on GDP at constant 2005 dollars.