International Monetary and Financial Committee

Twentieth Meeting
October 4, 2009

Statement No. 20-10

Statement by Mr. Panitchpakdi
UNCTAD

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Supachai Panitchpakdi
Secretary-General of UNCTAD

to the International Monetary and Financial Committee

Istanbul, 4 October 2009

AS PREPARED FOR CIRCULATION

Chairperson,
Distinguished Ministers
Excellencies,
Ladies and Gentlemen:

The current financial and economic crisis is unprecedented in depth and breadth. It has affected virtually all markets and all countries. Global GDP is expected to fall by 2.5 per cent in 2009. Output in the developed countries will contract by some 3.6 per cent this year, and in the transition economies it is expected to fall by more than 6 per cent. In developing countries, growth is expected to decelerate from 5.4 in 2008 to 1.3 per cent in 2009, implying a reduction of average per capita income.

Almost all developing countries have experienced a sharp slowdown of economic growth since mid-2008. Many have also slipped into recession, although some countries in Asia and Latin America have proved less vulnerable than in previous crises, thanks to their relatively strong macroeconomic positions before the crisis; they avoided large current-account deficits, or even posted surpluses, in the years preceding the crisis.

Nevertheless, Latin America is the developing region that has been hit most severely by the crisis, with a fall of GDP of around 2 per cent in 2009. We are also particularly concerned about the sharp drop of output growth in sub-Saharan Africa, where it has now become practically impossible to achieve the United Nations Millennium Development Goals in terms of poverty reduction.

East and South Asia are likely to fare better, with real income expected to grow in the order of 3–4 per cent in 2009. The leading economies of these regions have resisted recessionary forces better than others because their domestic market plays an increasingly important role in total demand. Moreover, the rebound in China in the second quarter of 2009 proves the efficiency of government deficit spending if applied quickly and forcefully.

Different groups of developing countries are affected in different ways: A few emerging markets have been subject to some direct financial contagion. Many developing countries and transition economies have seen a decrease of workers' remittances and foreign direct investment. But in all developing and transition economies the crisis has impacted the real sector through a sharp decline of export revenues. In many cases the volume effect has been exacerbated by a marked decline of commodity prices. International trade was further affected by increasing difficulties with trade financing. In 2009, world trade is set to shrink by at least 11 per cent in real terms and 20 per cent in current dollars. For countries with a high percentage of their GDP generated by export earnings the outlook is therefore dismal.

Overcoming the global crisis requires a global effort, to which all countries should contribute in line with their economic potential. However, this potential is quite limited in most developing countries. The outlook for official assistance is highly uncertain, although many donor countries have repeatedly emphasized that they stand by their aid pledges. UNCTAD's analysis of previous banking crises suggests that aid can fall by 30% in the five years following a crisis; other studies have put that figure at between 10% and 60%. In the current dramatic crisis situation, low-income countries require more support in the form of an internationally coordinated effort to effectively increase ODA. Such a measure would also provide an element of greater countercylical stimulus to global demand.

The impact of the global economic crisis on foreign exchange earnings and fiscal revenue, has affected developing countries' ability to maintain the level of essential imports and also to meet their external debt service obligations. In recent months, UNCTAD has consistently called for a temporary moratorium for poorer countries on their debt payments to official creditors. The IMF interest freeze on its concessional lending is a step in the right direction. Similar to an increase in ODA, a broader moratorium would potentially benefit all countries as scarce foreign exchange earnings could be used to buy imports instead of being directed at debt servicing.

Some observers have pointed to the improvement of several financial indicators, including stock market indices and bank profits, as "green shoots" announcing a quick recovery from the crisis. In UNCTAD we remain cautious in this regard, given that global unemployment is projected to rise by 50 million people this year, and that more than 4 million people are falling into hunger every week. Moreover, in the first half of 2009 gross fixed capital formation and manufacturing output in most of the world's major economies fell at double digit rates. Meanwhile problems with solvency in the non-financial sector in many countries have begun to feed back into the financial system. Thus, the likelihood of a recovery in the major developed countries that would be strong enough to bring the world economy back to its pre-crisis growth path in the coming years appears to be quite low. Neither consumption nor investment growth can be expected to revive significantly due to very low capacity utilization and rising unemployment.

This is also why the risk of deflation continues to be much greater than that of inflation. In order to halt the contraction of GDP and prevent widespread deflation, it will be necessary to maintain, or even further strengthen, the expansionary stance of monetary and fiscal policies.

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While short-term responses are necessary to deal with the emergency of the global economic crisis, it is equally important to look ahead and to design a more stable post-crisis environment. The current economic situation creates both the necessity and the opportunity for a change in direction in public policy at both the national and the global level. The efforts being made to reform international institutions such as the IMF and World Bank and to create a more inclusive Financial Stability Board to replace its previous incarnation, the Financial Stability Forum, certainly deserve to be acknowledged. They reflect the recognition that diversity of representation not only enhances legitimacy, but also provides a necessary range of views and positions in monitoring and regulatory institutions.

The crisis has been accompanied by the rise of the G-20 as the leading international forum for deliberations and decisions related to global economic governance. While the participation of a number of emerging-market economies in this forum is a major progress compared to the earlier exclusion of developing countries from global decision-making processes, it will be important to ensure that the voice of the smaller economies that remain unrepresented will also be heard. The United Nations, with its truly inclusive membership of all 192 countries, remains the most legitimate institution to address global concerns, including the shaping of the international economic system.

Given the unique historical opportunity offered by the crisis, it is regrettable that the G-20 has not been bolder in its ambitions and more far-reaching in its actions regarding international crisis management and system reform. It has strengthened the IMF without initiating a serious reform of that institution - which has been unable to comply with its mandate to ensure stability of the international monetary and financial system. Despite rhetoric to the contrary, policy conditionality applied to IMF lending has remained procyclical in many cases. While this type of conditionality appears to be applied in order to restore "confidence" to the financial markets, it is often unwarranted and has a serious negative impact on employment and poverty in the countries concerned.

Nor has the broad recognition that the financial crisis was the outcome of serious systemic failures led to fundamental reforms of the international financial and monetary system. Indeed, the initial momentum for such reforms has vanished over time, and financial market participants, including those that have benefited from unprecedented bailout operations, appear to be on their way back to business as usual. Initial panic has given way to complacency and an unwillingness to recognize the impact of excessive financial liberalization, as well as the interaction of securities, commodity futures and currency speculation.

Deregulation of financial markets was at the root of the crisis. The world has experienced regular financial crises at least every decade since the early 1970s. Each crisis has some specific elements, but there is a typical pattern. A positive shock generates a wave of optimism among market participants that reduces risk aversion and encourages greater leverage, causing asset prices to rise. Higher asset prices confirm the initial optimism raising it further and leading to even greater leverage and higher asset prices. For some time, sceptical observers will claim that asset prices cannot rise forever at such a high rate, but the enthusiasts will answer that "this time it is different". However, since things are not different, the asset bubble will inevitably burst at some point, triggering a de-leveraging process and a financial crisis. A regulatory framework based on a clear understanding of this mechanism could have prevented some of the excesses that led to the current crisis.

Blind faith in the efficiency of ‘free financial markets’ encouraged governments and regulators to underestimate risk and pursue excessive deregulation. This allowed uncontrolled innovation of financial instruments that have obscured creditor-debtor relations and invited excessive risk taking. As a result, finance has come to predominate over the real economy. A large part of the financial sector has become detached from the productive sectors and the influence of speculative forces not only in financial markets, but also currency and commodity markets, has been strengthened. Financial speculation leads to upward and downward overshooting of prices, or even to price movements in a direction that is not justified by fundamentals. In particular, it has increased price volatility in commodity markets and instability and misalignment of exchange rates. These can cause lasting damage to the real economy and to the international trading system, as they raise uncertainty for potential real investments and lead to the misallocation of resources.

There is a lesson for developing and emerging-market economies, and for international advisors, to be learned from this crisis: contrary to the “conventional wisdom” advocated for the past 30 years, dismantling all obstacles to cross-border private capital flows is certainly not the best way for countries to advance economic development. Indeed, more finance does not always lead to faster output growth; there is a threshold after which larger financial systems can have a negative effect on output growth.

In order to weed out financial instruments with no social returns and to prevent future financial crises from again causing major damage to the real economy, stronger and more effective regulation of financial market activity is indispensable. However, regulatory reform should be coordinated internationally and be part of a profound overhaul of the entire international monetary and financial system.

Overall, the reforms that can be expected are likely to fall short of what is needed to prepare the world economy for a future recurrence of a similar crisis. The financial system – including exchange rates, the reserve currency and monitoring and regulation - desperately needs more and better management in order to avoid these cycles of boom and bust. UNCTAD has long advocated a strengthened multilateral approach to international finance.

Regulation of international trade and national trade policies is rendered ineffective if the financial system is left to function without multilaterally agreed rules and regulation. It is generally accepted that trade rules are necessary for fair relations between trading partners and a predictable trade environment for participants in international markets for goods and services. Similar principles should also be applied to international finance – for example, with regard to the management of exchange rates and destabilizing short-term financial flows.

There remains a need for a greater role for the international financial institutions in crisis resolution and crisis prevention. UNCTAD’s analysis has long highlighted the importance of such changes for sustained growth and structural change in developing countries. An important question that also needs to be pursued further is the linkage between financial markets and markets for commodity futures, which have contributed to recent price hikes and increased volatility in commodity prices.

Promoting proactive capital-account management may be able to contain the volatility of private capital flows. But neither capital account management, nor a new international reserve currency that is increasingly being discussed, will solve the main problem of exchange-rate management. UNCTAD's Trade and Development Report 2009 - published last month – elaborated a multilaterally agreed framework for managed flexible exchange rates, which would target a real exchange rate that is consistent with a sustainable current-account position in all countries. This would go a long way towards reducing the scope for speculative capital flows that generate volatility in the international financial system and distort the pattern of trade.

Thank you.