International Monetary and Financial Committee

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Statement by Supachai Panitchpakdi
Secretary-General
United Nations Conference on Trade and Development

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Chairperson,
Distinguished Ministers,
Excellencies,
Ladies and Gentlemen:

The world economy and global trade are recovering. But we are still on a bumpy road. Due to the weakness of the recovery, which has been supported by unprecedented government action, we cannot rule out a double dip recession.

Output across regions

Output in the developing world is projected to expand by 6.4 per cent in 2010 after only 2.4 per cent last year. Despite this re-acceleration, it is expected that growth will still be about 1 to 1.5 percentage points below pre-crisis rates in all developing regions. In the case of Africa, such a performance will be insufficient to maintain the continent on track to meet the MDGs. However, higher commodity prices are contributing to the recovery in Africa and also in Latin America, West Asia and the CIS.

The return of developed economies to positive growth rates in 2010 will be uneven. The United States is expected to show a stronger performance, whereas the euro area will expand at a much slower pace, in particular in Germany, the economy with the largest trade surplus in that area. Thus, a number of structural imbalances give rise for concern, including the risk that the current-account imbalances that contributed to the crisis will not be fully corrected and may even increase. Moreover, a number of countries are still suffering from high indebtedness and high and rising unemployment, which threatens a potential jobless recovery and presents a Hobson's choice of whether to cut budgets or stimulate demand.

Budget deficits and government debt

With the first signs of recovery, debate started about how to reduce the high budget deficits created by the rescue of the world economy in the wake of the financial crisis. A number of governments, some under constitutional constraints, are already planning to reduce government spending or to raise taxes. However, given the still fragile state of the international economy, a quick exit is a dangerous strategy. Globally, neither private consumption nor private investment has recovered in a way that would justify the expectation of self-sustained growth in the foreseeable future. Financial markets are also putting pressure on governments to radically dampen economic activity through fiscal restraint.

Although government debt has reached record levels, it should be kept in mind that this resulted from their attempts to stabilize the financial sector and offset the impact of the crisis on the real economy, not from profligacy or excessive tax cutting. The need to bail out systemically important debtors and maintain demand was a higher priority than balanced budgets. Taking private and public together, global financial balances are in a better state than before the crisis, and fears of government bankruptcy are unfounded.

Inflation and fiscal stimulus

The same is true for fears of inflation: the main danger for the world economy remains deflation, and in this regard, the Japanese experience of the 1990s holds a stark warning. Without government stimulus, overly indebted private agents would recover only if new bubbles are created, that is, if business continues as usual - with the risk of a new round of financial crises. Fiscal stimulus is therefore a necessary condition for a successful exit from the recession in the short to medium term. However, it is not a sufficient condition for the full recovery of domestic demand, especially in the big surplus countries. Recovery can only be assured if a downward spiral of wages and prices is avoided. In addition therefore, to sustaining the expansionary stance of monetary and fiscal policy, governments should use instruments at their disposal to encourage reasonable wage growth.

Debt, stimulus and aid in developing countries

In developing and transition economies the financial crisis has led to an increase in the average debt-to-GDP ratio by more than 8 percentage points since 2007, in net contrast with the trend over the previous 4 years when that ratio fell by more than 20 percentage points. Although it indicates a higher future debt service burden in absolute terms, the increase in the debt ratio is not necessarily a bad thing: it helps countries to dampen the impact of the international crisis on their national economy and it has a modest stabilizing effect on the global economy. However, developing countries found it difficult to maintain expansionary fiscal policies (and therefore accumulate more debt) due to conditions on the international financial markets and the lending practices of the IMF. In some cases credit rating agencies issued downgrade warnings to emerging market economies which had low debt levels and were adopting cautious expansionary fiscal policies.

Low income countries and small and vulnerable States which have been severely hit by the crisis are facing special difficulties, and debt burdens for these countries are of course qualitatively different from larger emerging and advanced economies. About half of them are either already in debt distress or at high risk of debt distress. In this situation, many low-income countries would greatly benefit from higher flows of official development assistance (ODA) or debt rescheduling or even cancellation. As I have mentioned on several occasions in the past, the UNCTAD secretariat estimates that when donor countries suffer financial crises the cumulative drop in ODA over the following 5 years may reach 30 per cent. It is essential that policy-makers and opinion-makers in the developed countries recognize that the world's poor should not pay the price for the excesses of Wall Street.

Regulatory reform

At the G-20 Summit in Pittsburg, in September 2009, Leaders pledged "to reform the global economic architecture to meet the needs of the 21st century". So far, the focus of policy action has remained on crisis management and on strengthening the regulation and supervision of financial markets.

It is now generally acknowledged that the most serious financial and economic crisis since the Great Depression has demonstrated the fallibility of assumptions underlying far-reaching financial deregulation over the past two decades. As countries clean up the more extreme activities of casino finance, including both the games and the payouts it offers, a key component of financial sector reform is the prevention of banks from becoming too big to fail. In the financial sector, economies of scale are rapidly exhausted. Very large banks therefore pose a threat to systemic stability without providing any return in terms of efficiency. But financial crises may also arise from the activities of small and interconnected institutions if their managers all rely on the same information and behave in the same way, as is frequently the case in financial markets.

The activities of the shadow banking system also constitute a serious risk factor. It is thus necessary to adopt comprehensive regulatory reforms which will limit the possibility of regulatory arbitrage though the creation of off-balance-sheet investment vehicles. Such regulatory reform should guarantee an adequate capitalization of financial intermediaries but also regulate financial innovation, possibly though the creation of an agency that has the task of evaluating the risk of new financial products and weeding out products that only add risk without providing any social return.

Reform of global economic governance and architecture

However important they are to reduce the impact of speculative activities on financial and economic performance, such reforms will be insufficient to solve the more deep-seated problems of the current global economic governance system. While financial regulation aims at influencing the behaviour of *private actors* in financial markets, the global governance dimension relates to the international framework for *public action* in the management of cross-border financial transactions, exchange rates, and macroeconomic policies.

A consequent further step towards successful economic reform would be to subject exchange rates to greater public scrutiny and disciplines, as well as institutionalizing international coordination of macroeconomic demand management, with a view to avoiding the build-up of large imbalances and subsequent adjustment crises. This would contribute significantly to greater coherence in the global economic governance system as capital flows, exchange rates and macroeconomic policies can have far larger repercussions on other countries than, for example, trade policies.

The experience of various financial and currency crises since the breakdown of the Bretton Woods system have shown that adjustments of nominal exchange rates are necessary in order to reflect diverging cost and price developments across countries. On the other hand, the scope for such nominal exchange-rate changes must be restricted as excessive volatility encourages financial speculation. Because changes in the real exchange rate have a strong influence on the international competitiveness of all producers, they cannot be left to a market that is influenced by strong speculative forces. UNCTAD has proposed working towards a multilateral agreement on principles and rules to govern exchange-rate management, focussed on maintaining the real effective exchange rates stable or within a narrow range. This could be achieved through mandatory adjustments in the nominal exchange rate of all currencies, in line with changes in variables such as the GDP deflator, unit labour costs or central bank interest rates. For certain countries and at certain times, some flexibility in the application of the basic rule may be called for. Compliance with these rules and principles would be subject to surveillance by an international body - perhaps a reformed IMF.

Macroeconomic surveillance

Greater effectiveness of macroeconomic policy surveillance also requires that its focus be shifted away from generating "market confidence" to the need for counter-cyclical demand management, through monetary, fiscal and incomes policies. Monetary policy should be judged to the extent it is able to keep interest rates low, to provide favourable conditions for the financing of investment - rather than focussing on narrowly defined inflation targets or the "attractiveness" of a currency for capital inflows. Fiscal policy would best be assessed against its contribution to stabilizing aggregate demand and employment - rather than against the ideal of a balanced budget. And incomes policy - the scope for which depends on country-specific institutional frameworks for labour markets – should be assessed against a macroeconomic perspective that considers wages as a key determinant for demand, rather than from the micro perspective that only considers wages as the largest component of production costs. With such an international coordination mechanism in place, the large global imbalances that built up before 2008 could certainly have been mitigated, and perhaps even avoided.

Cross-border capital flows

Without international rules, the management of cross-border capital flows requires heightened attention at the national level, in particular in emerging-market economies. In these economies, capital account management is not only a financial policy issue, in the sense that it may help avoid speculative bubbles and opaque, excessive risk-taking by financial institutions. It is also a macroeconomic issue because it affects the international competitiveness of producers and the environment for real, productive investment. It would certainly be a step forward if surging capital inflows were no longer perceived as a sign of a strong receiving economy, but rather, as having the potential for instability, with negative repercussions on monetary management and trade. A recent IMF staff note recognised the value of capital controls; the IMF should therefore change its official stance by more actively encouraging countries to use capital controls, as provided for in its Articles of Agreement, and advise countries on their implementation.

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The efforts of the international community to lift the world economy, and especially the developing world, out of the current crisis through direct intervention have been crucial, and will continue to be so for the foreseeable future. However, the risk of similar crises happening again will not abate unless deeper reform of the global economic architecture is undertaken, including reform of global economic governance institutions. In coordination with the different bodies of the United Nations, with their universal membership and diversity of thinking on this subject, the G-20 must assume a proactive role in this reform process.

Thank you.