Statement by
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to the International Monetary and Financial Committee
and the Development Committee

Washington, D.C., April 12, 2014

Overview

Despite some stronger numbers in the second half of 2013, the global economy is still struggling to find a robust and sustainable growth path. To move onto such a path, greater policy coordination at international and regional level will be needed. Moreover, it will be important to avoid the policy mistakes which led to the 2008 financial crisis.

World output, which grew at 2.2 per cent in 2013, is likely to accelerate to closer to 3.0 per cent in 2014 and 2015. Most of this improvement reflects better performance of developed economies, which are expected to expand at an average of about 2.0 per cent in these years, with a return to positive – albeit moderate – growth in the Euro area. Meanwhile, developing and transition economies are expected to maintain current growth rates, around 5.0 and 2.5 per cent respectively. As a result, developed economies will increase their contribution to global growth to almost 50 per cent. This is not far from their pre-crisis level, but still much less than the more than two-thirds contribution to global growth they delivered in the 1990s.

In recent years, most major economies and regions have had to rely on domestic demand as the main driver for growth. Global trade flows remained weak in 2012 and 2013, growing in volume at under 2 and 3 per cent, respectively, far below the 7.5 per cent annual average before the crisis. During the past two years, the contribution of external trade was negligible – or slightly negative – in the United States, Japan and China. A significant improvement in net exports was registered only in the European Union, although this resulted mainly from import restraint and made little contribution to growth. In general, growth in countries from Africa, Latin America and West Asia also relied more heavily on domestic demand, with a small or moderately negative contribution from net exports. Many countries in those regions (and also several transition economies) continued to benefit from relatively high terms of trade by historical standards, which strengthened domestic income and stimulated domestic demand. The situation has been more diverse in other Asian countries, some of which benefitted from positive net-exports contributions to growth in 2013, such as India, Indonesia, the Republic of Korea and Thailand.

A number of developing and transition economies suffered from increased financial instability during 2013 and early 2014. The announcement of a progressive reduction of monetary stimulus in the United States triggered a broad-based sell-off in emerging market economies' financial assets. This has led to currency depreciation, rising spreads on sovereign debt and less supportive monetary stances in some countries, which has had a negative impact on domestic demand and growth. This financial shock illustrates once again the volatility of global financial markets and the fact that developing countries are regularly affected by decisions taken by policymakers in systemically important advanced economies. It also underscores the importance of using macro-prudential policies – including capital controls – in developing countries to contain excessive inflows and outflows of short-term capital, and to reduce their possible adverse impact on the domestic economy.
These recent events serve as a reminder that developing countries, including relatively strong performers, have not "decoupled" their economies from the advanced economies, and that fragility and downside risks continue to pose serious policy challenges.

**Challenges facing advanced economies**

It is useful to group developed countries into three broad classifications based on their post-crisis performance. In a first group, which includes, inter alia, the United States, the United Kingdom, Australia and Canada, growth is mostly driven by asset appreciation and liquidity injections, rather than by income generation resulting from higher employment and real wage gains. The picture in these countries is starting to resemble, albeit in incipient form, the unsustainable pattern of the pre-crisis years.

Injections of liquidity, heightened merger-and-acquisition activity and rising corporate profitability due in large measure to cost-saving and wage compression have helped to push stock market prices to record levels, including in countries outside this group. ‘Margin debt,’ i.e., borrowing in the financial markets to buy financial stocks, has further fuelled this process. The global MSCI index, which shows the evolution of main stock markets in all regions, has risen by about 50 per cent since 2010. The rise of stock market indices has also been accompanied by rising real estate prices. By increasing the net worth of private agents, these asset appreciations may boost private sector spending, thus stimulating economic growth. However, public sector spending, including infrastructure and social spending, which remain essential to sustain productivity growth and employment, has generally been weak (and in the case of the US actually fell).

In a second group of developed economies, which includes Germany and a few other countries of Northern Europe, growth is mostly due to net export gains. These gains follow from wage restraint, labour-market flexibilization and other cost-saving measures, which have been strongly promoted as recipes for recovery after the crisis. While it remains clear that exports cannot stimulate a generalised recovery, expanding markets in the first group of (debt-driven) economies offers this second group export opportunities.

But even in this second group of countries, the recent positive external performance is as much due to fewer imports as a rise in exports. For example, during the last three years before the crisis from 2005 to 2007, Germany generated a trade surplus of about 6.5 per cent of GDP, mainly due to the fast rise of exports, while the volume of merchandise imports also rose strongly. Between 2011 and 2013 the average trade surplus was only slightly higher at 6.7 per cent of GDP, while imports in volume virtually stagnated. The recovery in this second group of developed economies is subject to two sorts of challenges. By pressing too hard on cost-saving measures, a "race to the bottom" could exacerbate the weakening of global trade growth; at the same time, by relying on demand from faster debt-driven growth in a few developed economies, global imbalances may re-emerge.

A third group of developed countries continue to be damaged by weak private demand and austerity measures. This group notably includes several Euro zone economies that have been particularly affected by financial imbalances in the private and/or public sectors, which worsened as the costs of bailouts and economic contraction eroded fiscal sustainability. Within the constraints imposed by the institutional setting of the Euro zone and under the influence of pro-austerity ideas, these economies shifted to a contractionary adjustment path from 2011: in the last three years, the economies of Greece, Portugal, Italy and Spain shrank by 16, 6, 4 and 3 per cent respectively. The recent return to positive growth in some of these countries is insufficient to close employment and output gaps.

Furthermore, growth acceleration in the third group of countries under the current circumstances is unlikely. The weaker capital formation and skills development that results from this type of adjustment
path weighs heavily on productive potential and competitiveness, making an export-led recovery even more challenging. Lower labour incomes and comparatively slower profit accumulation than in neighbouring countries reduces the prospects of consumption and investment growth. The only sustainable growth alternative for these countries would consist of international financial support combined with expanding global demand, or at least an expanding demand from their now surplus partners. But with little support for such an alternative, a deflationary bias is more likely to shape adjustment scenarios in these countries.

Japan cannot be easily placed among these categories. It experienced a long deflationary period before being strongly hit by the global crisis and the earthquake of 2011. Since then it has been adopting strong monetary and fiscal stimuli, with some degree of success. The impact on growth in the coming year of Japan’s recent consumption tax hike will serve as a useful barometer of the durability Japan’s reflationary policies overall.

**Challenges facing developing and emerging economies**

Growth in most large developing and transitional countries has slowed sharply since 2011. To evaluate the risk of that deceleration turning into stagnation or outright recession, it is necessary to place this trend in a longer time frame.

Up until the global financial crisis, developing economies had strengthened trade and production links with the more developed regions and among themselves. Financial globalization impacted developing economies through capital-flow cycles and the financialization of commodity markets, but overall developing economies managed to navigate the process of financialization better than many advanced countries. Finance in the developing countries maintained support for productive activities and employment generation, including during the financial boom that emerged in the early years of the new millennium. A number of developing economies increased their production of manufactured goods and integrated global supply chains, which accelerated trade with both developed and developing economies. Heightened manufacturing activity, urbanization and infrastructure development in large developing countries in turn raised demand for commodities and energy exports. In addition, governments in both sets of countries harnessed some of the gains of the enhanced economic activity to finance increased spending on social services and infrastructure.

During these years of rapid growth, many developing countries increased productive investment, reduced external and public debt ratios, accumulated foreign reserves and strengthened their macroeconomic fundamentals. All of this in turn enlarged their policy space for handling economic shocks. But even before the crisis, the new growth dynamics in the developing economies carried their own challenges. For example, manufacturing activity was heavily driven by demand from developed countries and depended on capital and technologies, which were to a considerable degree controlled by foreign companies. Many commodity producers found it increasingly difficult to move away from extraction and diversify into industry and service sectors, raising fears in some quarters of a middle-income trap. In addition, developing countries became increasingly vulnerable to shifts in financial flows, since capital controls were progressively removed as part of finance-led globalization.

Since the crisis, two broad sets of influences have shaped the economic strategies of developing economies. On the one hand, many developing economies have sustained reflationary policies for a longer period than developed economies. Since their financial and corporate sectors were much less engaged than those of developed countries in financial operations, the cost of repair from financial shocks was relatively lower, and pressure from market forces to impose fiscal adjustments was much weaker than in developed countries. On the other hand, the better performance of these economies vis-à-vis the developed economies meant that as policy in the latter shifted from fiscal expansion to monetary
expansion, part of the liquidity created was channelled towards the developing countries, and on a scale that exceeded their capacity for absorption.

Arguably, while the crisis slowed – or on some accounts even reversed – financialization in advanced economies, developing countries became more integrated into the international financial system, exposing them to heightened vulnerability. Several factors lie behind this trend. First, the post-crisis expansion of liquidity by the major economies has been extremely large, not only in relation to the size of developing countries financial markets, but even in comparison with that of major financial centres. Second, financial flows in this period have not been accompanied – at least not as much as in the pre-crisis period – by a growth of real demand from developed countries. Monetary expansion did not translate into increasing credit to households and firms wishing to expand consumption and investment; and the mobilization of this capital in developing countries did not respond primarily to real investment opportunities. Instead, these capital flows were predominantly oriented to short-term and speculative placements.

Such capital flows are inherently unpredictable, and may generate macroeconomic instability. On the side of the developed countries from which most of these flows originate, it is the pro-cyclical perceptions of investors about growth prospects and risks that influence both the total size of the liquidity expansion, as well as the proportions that flow from developed countries to the developing countries. On the side of recipients, most of these financial investments have flown into the private sector, making it more challenging to ‘manage’ such flows domestically, including through the use of counter-cyclical policies.

**Challenges to debt sustainability**

Debt sustainability remains a challenge for many countries, advanced and developing alike. While exploding public debt in some developed countries has attracted much attention, the challenges for developing countries to maintain debt sustainability must not be overlooked. Prior to the global financial crisis, there was an impressive and across the board improvement of debt indicators in developing countries, but the crisis has slowed the trend drastically; 2012 marked the third consecutive year that the growth of external debt has exceeded 10 per cent following nearly a decade of average annual growth of about 7 per cent, and 2013 is not expected to see any change in this trend.

Moreover, as noted earlier, the composition of debt has been changing. Bonded debt has increased at a very fast speed along with a much larger percentage of debt issued in domestic currencies. More than a dozen sub-Saharan sovereigns have started to tap international bond markets for the first time since 2007, almost all over subscribed. However, with the clustering of the issuance of both sovereign and corporate bonds since 2007, the maturity profile of debt has been shortening. Short term debt continued to increase from the 2011 elevated level, now constituting more than a quarter of total debt stocks. As a result of increasing debt and short maturity, debt servicing has been increasing in many emerging economies along with growing concerns about heightened vulnerability to shocks.

For the 49 least developed countries (LDCs), 2012 saw the total external debt increase by an estimated 7 per cent in nominal terms compared to 2011. As a result, the ratio of debt to GDP and the ratio of total debt to exports increased by almost 4 per cent in 2012. Both debt ratios were higher than the respective ratios of other developing countries. As of April 2013, there were two LDCs in debt distress and ten LDCs in high risk of debt distress.

Some Caribbean countries are stuck in a high debt and low growth trap which has made debt servicing difficult. Five Caribbean Countries are assessed in DSAs to be at a high risk of debt distress or in debt distress. They are among the most vulnerable countries given their reliance on tourism, remittances and frequent exposure to hurricanes.
The HIPC initiative is coming to an end. But maintaining debt sustainability has proved to be challenging for some completion point countries, a number of which are already at high risk of debt distress. Non-concessional external debt increased significantly for many countries.

In light of the recent debt crises and litigation relating to sovereign debt, there has been gathering political momentum to develop further avenues for the timely, efficient and fair resolution of sovereign debt crises. In addition to decades of research and analytical work, UNCTAD began technical assistance on the design of a debt workout mechanism in 2013. The need for a sovereign debt workout mechanism is an evolving issue that has been recognized in the international community as an increasingly pressing one. This message was reiterated at the 9th UNCTAD Debt Management Conference, held on 11-15 November 2013 during a session on Sovereign Debt Restructurings in which UNCTAD presented its project on the Debt Workout Mechanism (DWM).

At the same time, there has been extensive external borrowing during the recent period from private corporations and financial agents. Indeed, by the second half of 2013, the external debt (loans and securities) of the private sector of the eleven major developing and emerging economies (excluding China and South Korea due to insufficiently disaggregated data) was about 60 per cent of the group’s GDP, while that of the general government was only 18 per cent of GDP.

However any suggestion that the significantly lower external debt burden of the public sector may be sufficient to avert macroeconomic problems ahead is dangerous. The experience of the global financial crisis shows that crises caused by failure of risk perception by private agents end up badly damaging public sector finances. In the aftermath, persistent financial instability, coupled with austerity policies have been a proven recipe for a damaging deflationary spiral. While predicting financial crises in the developing world is a hazardous business, it is time for the multilateral community to draw lessons from recent events and put forward policies to avert a repeat of past crises.

**Recommendations for an internationally coordinated strategy to revive growth**

The analysis proposed above shows that individual economies are strongly interconnected through real demand and financial linkages. Developed countries following the path of austerity cannot credibly emerge without financial and real-demand support from their main partners, namely the surplus countries of the developed world. Developed countries now engaged in a path of debt-led, asset-backed private spending could only change strategy if supported also by surplus countries. Successful export performers cannot continue to rely on growth in external demand and large surpluses and can only grow in a more sustainable manner if they allow for real currency appreciation and domestic demand injections. Developing countries would not succeed in their mid- to long-term strategies if they continue to be battered by huge surges of capital flows in a deregulated global financial system. Therefore, the recommended policies will require a considerable degree of international coordination, ideally at a global level, minimally at the regional level.

The elements of such an internationally coordinated strategy can be simply spelled out. First, for growth to be sustained, domestically and globally, labour compensation has to grow at par with aggregate productivity. This will represent wage appreciation in most surplus countries, triggering the desired strengthening of global aggregate demand. Second, the support of the public sector in the provision of social and physical infrastructure is essential, as both in developing and developed countries physical and human capital investment have been neglected for far too long. Third, investments, both public and private, could focus on the research and development of environment-friendly technologies, particularly those which are employment intensive. Fourth, domestic finance has to be re-engineered and re-regulated with the aim of supporting employment creation and productive activities. Fifth, the system of international payments and transactions has to be made more consistent with sustained global economic
growth and convergence. This means that regional and global financial arrangements should facilitate more trade in non-reserve currencies, that imbalances are corrected before they get out of control, with a strong contribution of surplus countries and by proper intervention of regional or global lenders of last resort.