United Nations

TD/452

United Nations Conference on Trade and Development

Distr.: General
30 January 2012

Original: English

Thirteenth session
Doha, Qatar
21–26 April 2012
Item 8 (a) of the provisional agenda
Enhancing the enabling economic environment at all levels in support of inclusive and sustainable development

UNCTAD XIII Round Table I – Addressing the risks of a global recession: Towards comprehensive, supportive macroeconomic policies and structural reforms

Issues note prepared by the UNCTAD secretariat

I. Current challenges in the global economy: The need for a correct diagnosis

1. More than three years after the outbreak of the global crisis in September 2008, its consequences have not been surmounted. The causes and dynamics of the crisis need to be appropriately diagnosed before an effective policy response can be identified. The crisis was caused by financial, not fiscal, profligacy. Handling the crisis and preventing its spreading ever further require expansionary macroeconomic policies and tighter financial regulation. Fiscal retrenchment will not avert the risk of a new global recession.

2. Currently, the main problem in developed economies is a lack of domestic demand. Only growing domestic demand will be able to stimulate growth. And only with more rapid growth can fiscal consolidation succeed. Fiscal tightening will make things worse. When private consumption and investment stagnates, as has been the case for the past three years, governments must use expansionary monetary, fiscal and incomes policies to support the recovery of demand.

3. UNCTAD has consistently argued that the crisis was caused by financial, not fiscal, dysfunctions. Largely unregulated and highly leveraged financial activities have distorted relative prices, remunerations and incentives. They generated an unprecedented boom-and-bust process that affected the core of developed economies and spilled over into developing and transition economies. Rising private consumption was increasingly financed by debt. As real wages were not rising with productivity, primary income growth alone would not have been able to sustain private consumption. Volatile capital flows exacerbated a number of problems on the "real" side of the economy, including the deteriorating competitiveness

of some major countries with current-account deficits and the rising concentration of incomes that has occurred in many countries since the 1980s. These long-term factors interacted with financial exuberance to widen national and international imbalances, as well as over-indebtedness.

4. The fallout of the crisis negatively affected fiscal accounts. The drastic slowdown in growth reduced public revenues, while government expenditure rose, spurred by banking rescues, stimulus packages and recession-related financial transfers. Hence, high fiscal deficits and increased public debt resulted from the crisis, but were not its cause. The financial crisis has also pushed the balance sheets of firms, households, banks and governments into the red, thereby further undermining restoration of investment demand and household consumption.

5. A comprehensive approach is needed to address the crisis. Expansionary macroeconomic policies must be adopted to restore demand, employment and growth. Structural reforms must address the root causes of the crisis and put national and international financial systems at the service of the "real" economy. An appropriate participation of workers in the proceeds of economic progress is needed both to reduce income inequality and to support economic recovery.

II. Macroeconomic policy choices: where are they heading to?

6. At present, the most serious threat to the global economy resides in economic stagnation in developed economies. It may trigger a new major financial disruption. These risks are largely policy-driven, resulting from simultaneous adoption of fiscal tightening and wage restraint in several major economies. These policies pursue inconsistent goals as they try to reduce public debt and recover access to credit, on the one hand, and to improve competitiveness and expand exports, on the other. Not all countries can improve their external competitiveness at the same time. When many countries simultaneously cut labour cost to gain competitiveness, the most likely result will be a ubiquitous decline in domestic demand, rather than surging export and income growth. If spending cuts affect public salaries and employment, as well as expenditure on welfare, health care and pensions, as currently seems to be the case, growth reductions will be particularly high. Such fiscal retrenchment also has regressive distributional effects. It mainly reduces the disposable income of lower income groups, i.e. those with higher consumption propensities. Even if some large developing countries can maintain rapid growth, they are not large enough to compensate falling demand in the most developed economies.

7. A workable strategy for fiscal consolidation requires GDP growth and fiscal revenues to outpace the cost of servicing the debt, which in turn depends on interest rates and, for the debt denominated in foreign currencies, on exchange rates. This is a time-consuming process. Trying to hasten fiscal consolidation by adopting recessionary fiscal adjustment is generally self-defeating.

8. UNCTAD has also repeatedly called for a combination of expansionary macroeconomic policies with active employment and distribution policies. Only such a combination can generate the global demand needed to achieve sustained investment and productivity gains. A more equal income distribution is thus important not only for social and political reasons, but also for economic reasons.

9. The policy space for improving social transfers and income distribution – and, as a consequence, economic performance – is frequently much wider than commonly presumed. In particular, the level and the composition of fiscal revenues and expenditures are the outcome of policy choices. A fiscal stimulus does not necessarily increase the current deficit. For instance, a country that reduced taxation on high incomes can reintroduce such

taxes and use their proceeds to finance transfer payments to the poor and infrastructure investment. The multiplier effects of such expenditures are higher than tax reductions for high-income households.

10. Similarly, aid commitments to low-income countries should be fulfilled, not only for social, political and ethical reasons, but also because this is positive for the world economy, including donor countries. Sustaining domestic and regional demand should also be high on the agenda of developing countries, since export-led growth appears to be a more difficult development strategy to follow in the new global economic framework. This is because many of the largest developed economies are likely to face subdued economic growth for several years to come. As a result, demand on those markets which have been the main destinations of the exports from many developing countries will remain well below the levels that prevailed prior to the crisis.

III. Linkages between short-term and long-term policies

11. Responses to the crisis necessarily address both short- and long-term issues. Policymakers should not only seek to overcome the present difficulties, they also need to prevent their reappearance. However, most of the short-term responses to the crisis actually have long-term consequences, even if they are not always part of an explicit long-term strategy. For instance, the way in which a banking crisis is handled (with publicly-funded bailouts, losses to private creditors or outright nationalization) will alter the future structure and operations of the banking system. Similarly, the response to sovereign debt distresses may either reinforce fiscal space and the role of the State in “growing out” of debt, or reduce public expenditure and dismantle the Welfare State.

12. Some international organizations propose a combination of short-term adjustment policies and “pro-growth” structural reforms, which would more than compensate for the recessionary impact of the former. But this “division of labour” between short- and long-term measures will hardly deliver the expected outcomes, especially if some of the proposed structural reforms tend to further depress domestic demand, by reducing public services and increasing the “flexibility” of labour markets in ways that compress workers income. In fact, the necessary recovery in domestic demand in crisis-hit countries requires both structural and short-term policies to focus on this goal; this would involve active fiscal support, as discussed earlier, along with long-term measures that improve income distribution.

13. The reforms proposed by UNCTAD – which include, inter alia, institutional arrangements for collective bargaining, regularly adjusted legal minimum wages, public employment and transfer schemes – would lead to improvements in income distribution. It would ensure, in particular, that real wage incomes rise along with average productivity growth. In many developing countries, where a modern sector coexists with a sluggish traditional sector with low productivity and precarious employment, specific policies will be needed to foster productivity and income growth, not only in the modern but also in the traditional sectors. This can be achieved by establishing closer integration of the latter in domestic supply chains, by higher prices paid to agricultural producers, by a better access of small businesses to financing, and by using tax revenue received from the modern sector to finance redistributional social policies.

14. Reforming the financial system would address another central cause of the crisis. It is necessary to re-regulate the financial system, not only the traditional banking sector but also the opaque and under-capitalized “shadow banking” system. A well-functioning banking system would not only require better regulation in terms of capital ratios and precautionary rules, it must also be restructured in order to be put at the service of the real

economy. This may require a separation between investment and commercial banks, and a larger role for cooperative and public development banks.

15. Other structural financial reforms – such as those of the International Monetary and Financial System and the increasingly "financialized" commodity markets, which go beyond the national level – are discussed in the next sections.

IV. Addressing the distortions of the International Financial Architecture

16. The crisis has also shown that the international monetary and financial system (IMFS) falls short of its original mission. According to the Bretton Woods agreements, the IMFS is to smoothly manage international payments, avoid large and persistent current account imbalances, and conduct the needed adjustments with minimal costs in terms of economic activity and welfare. In reality, the IMFS has not succeeded in reducing global imbalances, avoiding destabilizing capital movements, and designing an exchange rate system that would ensure reasonably stable exchange rates at levels reflecting economic fundamentals. In addition, conditionality involved in the financial assistance by International Financial Institutions has frequently accentuated economic contraction in crisis-hit countries.

17. Indeed, the IMFS has been unable to control pro-cyclical short-term capital movements, which have become a major factor of economic instability. Massive capital inflows followed by sudden reversals have frequently created overvaluation and induced financial crises, in particular in emerging market economies. To stem such adverse effects, many countries have adopted capital controls, which are permitted by the international Monetary Fund's (IMF's) Articles of Agreement, or they have accumulated stocks of foreign-exchange reserves. These reserves have represented a kind of "self insurance" that could be relied on in times of necessity, providing them with ready access to credit without having to accept undesired policy conditions. However, a profound reform of the IMF, or the creation of a new entity, with a view of establishing a true international lender of last resort may be a better response to the shortcomings of the current IMFS.

18. Moreover, widespread currency speculation and consequent exchange-rate misalignments call for a new international financial architecture that would support exchange rates to move in accordance with fundamentals. UNCTAD has made a proposal in this respect recently (*Trade and Development Report 2011*). In addition to such multilateral measures, developing countries may wish to enlarge their policy space through national and regional cooperation strategies, which would allow them to reduce external financial vulnerability and strengthen the effectiveness of their domestic and regional policy instruments.

V. Commodity price levels and volatility

19. Financial sector activities have also affected the level and volatility of commodity prices. Commodity price developments have traditionally been discussed in terms of changes in fundamental supply and demand relationships. The changes in commodity price trends over the past decade have indeed in some cases coincided with major, and well-documented, shifts in market fundamentals. However, UNCTAD research and a number of recent academic papers and analyses are supporting the view that the greater involvement of financial investors and their consideration of commodities as financial assets have fundamentally altered the functioning of commodity markets. Widespread herding behaviour of financial investors results in high correlations between returns on investment

in commodities and those on other asset classes. It indicates that financialization has become a normal feature on commodity markets.

20. The fact that some countries have tightened monetary policy in reaction to price pressure stemming from commodity price hikes, which may well be speculative bubbles, indicates a worrisome aspect of financialization that has so far been underestimated, namely its potential to inflict additional damage on the real economy induced by sending the wrong signals for macroeconomic management.

21. To improve commodity market functioning, there is a need for increased transparency in physical and derivatives markets, as well as for internationally coordinated tighter regulation of financial investors – for instance, by imposing position limits or a transaction tax. Moreover, market surveillance authorities could be mandated to intervene directly in exchange trading on an occasional basis by buying or selling derivatives contracts with a view to averting price collapses or deflating price bubbles. Such intervention could be considered a measure of last resort to address the occurrence of speculative bubbles if reforms aimed at achieving greater market transparency and tighter market regulation were either not in place or proved ineffective.

VI. Conclusions

22. Multilateral policy coordination is a powerful tool. However, depending on the direction that such coordinated policies take, they may either support economic recovery or risk pushing the global economy into a new recession. The current policy stance seems to be going in the latter direction. By pursuing simultaneous fiscal tightening, countries generate “head winds” for each other, as not all countries can compensate depressed domestic demand by net exports at the same time. Hence, while policy coordination is important, it must consist of supportive policies. This is true especially for economies that have a large current-account surplus but are growing below potential, such as Germany and Japan.

23. Macroeconomic and structural policies must head in the same direction. It is unrealistic to expect benefits from structural reforms to compensate the adverse effects of contractionary macroeconomic policies. Both kinds of policies must address the roots of the crisis and avoid the risk of a downward spiral of faltering demand affecting growth and revenues (both public and private) and deteriorating the solvency of Governments and banks.

24. National policies need a supportive international framework that would minimize external vulnerability and contain destabilizing forces. They should also provide the necessary access to markets and financial resources in a way that enlarges, instead of reducing, policy space and guarantees the national ownership of development strategies and processes.

25. Addressing the risks of another global recession requires comprehensive and coordinated actions on all these fronts: (a) a simultaneous shift towards expansionary policies in major countries; (b) structural reforms consistent with pro-growth macroeconomic stances; and (c) an international financial system supportive to sovereign countries in applying the macroeconomic policies and implementing the structural reforms of their choice.