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DRAFT REPORT OF THE TRADE AND DEVELOPMENT BOARD ON ITS FORTY-FIFTH SESSION

Rapporteur: Mr. Philippe Merlin (France)

ITEM 4 : INTERDEPENDENCE (continued)

Speakers:

Secretariat
China
Sri Lanka
Senegal
Switzerland
Malaysia
Cuba
Guatemala
Norway
Egypt
Poland
Uganda
Brazil
Bulgaria
South Africa
ICFTU
Uruguay

Note for delegations

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INTERDEPENDENCE AND GLOBAL ECONOMIC ISSUES FROM A TRADE AND DEVELOPMENT PERSPECTIVE: THE CAUSES, MANAGEMENT AND PREVENTION OF FINANCIAL CRISIS

(Agenda item 4)

(continued)

1. The **Director of the Division on Globalization and Development Strategies** said that one could ask six questions of a general nature arising from the progress of financial globalization and the current crisis of the world economy: First, when crises were provoked by large-scale capital movements, did the international financial system have the capacity to respond in an effective manner? Second, did the international monetary and development finance institutions prescribe policies that were the most appropriate to promote the recovery of the countries affected by the crisis? Third, was the burden of financial stabilization after a crisis shared equally between Governments, borrowers and private creditors? Fourth, were the policies of the industrialized countries well designed and likely to promote global economic recovery? Fifth, were there elements built into stabilization and adjustment programmes that protected the most vulnerable parts of the population? Sixth, were the developing countries that had been most affected by the crisis adequately represented in the decision-making organs of the international community and were they participating as fully as their representation committed them?

2. The **Chief of the Monetary and Development Policies Branch** and Coordinator of the *Trade and Development Report* said that, since the time of writing of the Trade and Development Report, a crisis had broken out in the Russian economy and global financial instability had deepened. A background paper on the Russian crisis, prepared jointly by the secretariats of UNCTAD and the United Nations Economic Commission for Europe, was being made available to delegations. The current global financial turmoil provided further support for the concern expressed in the *Trade and Development Report* about the dangers of a hands-off approach to finance and the adverse effects of financial instability on development and the process of globalization.

3. The *Report* concluded, *inter alia*, that the crisis in East Asia was yet another episode in the series of crises that had been occurring with increasing frequency since the breakdown of the Bretton Woods arrangements and the liberalization of capital movements. This conclusion had been supported by the global spread of instability, the recent hedge fund crisis, and massive gyrations in the dollar/yen exchange rate which were reminiscent of the runs on the Indonesian rupiah and the Russian rouble. One proposal of the *Report* was that the major industrial countries take expansionary action, that deflationary policies be reversed in East Asia, and that Japan provide an aid package to accelerate recovery in the region. A note making a quantitative assessment of such a package on growth, in the region and globally, was being made available. Certain policy measures adopted since the preparation of the *Report*, including the Miyazawa Plan, cuts in interest rates in the United States and elsewhere, and more accommodating monetary and fiscal policies in East Asia, were pointing in the right direction, but much more needed to be done to avert the danger of a global recession.

4. Among the proposals in the *Trade and Development Report 1998* for better crisis management, there was also the recommendation of an "automatic standstill", similar to the safeguard action foreseen under GATT rules. Such a mechanism, possibly in combination with IMF lending into arrears, would eliminate the need for large-scale bail-outs, contribute to a more equitable allocation of the cost of a crisis between lenders and borrowers, and allow the country a breathing space to design and negotiate an orderly debt re-organization plan. In the past few weeks there had been increased recognition that debt standstill and lending into arrears might be necessary under certain circumstances. The issue had been discussed both by the Managing Director of the IMF and in a G-22 report on financial crisis management.

5. The representative of **China** said that the *Trade and Development Report 1998* gave an accurate analysis of the causes, management and prevention of financial crises. Advocating financial liberalization should not mean Governments giving up their responsibility for financial regulation and supervision. Experience had shown that financial order and safety could only be ensured when strong financial rules and regulations and surveillance of banks and capital markets existed.

Otherwise, opening up the capital account would lead to a collapse of the financial system and economic crisis.

6. China had been seriously affected by the crisis through a reduction in exports and foreign investment. In response, banking regulations and surveillance by the central bank were being strengthened. Moreover, China had provided aid to other countries in the region, participated in the international programme of financial support for East Asia, and taken measures to increase domestic demand with a view to stimulating growth in the world economy, including a lowering of interest rates. The country would speed up and deepen the reform of its domestic financial system, while aiming to prevent and mitigate any financial risk. External financial liberalization would be pursued further when the time was ripe.

7. In order to reduce the instability of the international financial system, all countries had to work together against excessive short-term financial flows and speculative attacks. The major industrial countries should expand their domestic demand, open their markets and contribute to the stabilization of the Asian economies, which still had great growth potential.

8. The representative of **Sri Lanka** said that while developing countries were pursuing structural reform, particularly with regard to trade liberalization, the debate on capital account liberalization had taken on renewed interest. The crisis had highlighted the importance of orderly, gradual liberalization of the capital account, taking into account the specific circumstances of each country.

9. Several other lessons had emerged from the crisis. First, countries with a relatively weak financial system had been affected more severely than those with a stronger financial system. Thus, effective prudential supervision was critical. Second, it was important that macroeconomic policies be consistent with exchange rate policy. Third, there should be an equitable sharing of the financial burden arising from crises among private creditors, borrowers and the Government of the affected country.

10. In Sri Lanka, macroeconomic policies had secured a reasonable degree of stability. The policies included the maintenance of some capital controls,

enhanced surveillance of financial market activity and a rise in short-term interest rates. The concentration of Sri Lanka’s foreign borrowing in long-term maturities was also a positive factor. Nevertheless, the country would not escape the indirect negative impact of the East Asian crisis, which took the form of a loss of competitiveness of exports vis-à-vis those countries that had devalued their currency, lower import demand from the crisis-ridden countries and a decline in investment inflows from these countries.

11. The representative of **Senegal** said that, due to the huge speculative capital flows in a deregulated financial system, the current crisis had become a global one. While there was no doubt that the Asian countries would sooner or later overcome the crisis, they still needed external support. There was broad agreement that a return to protectionism had to be avoided, but the international financial system required more transparency and greater discipline. Government policies had to be based on prudence, and solidarity and universal cooperation were indispensable.

12. Efforts towards the liberalization of capital movements had to strike a balance between the interest of different actors. UNCTAD's proposals for a reduction of financial instability and for the reform of the international financial system were of great relevance. International surveillance over national economic policies should be strengthened, taking into account the interests of the developing countries.

13. For Africa, the main lesson from the crisis was related to prudential regulation. Africa was indirectly affected by the crisis through falling international commodity prices. Many African countries were in need of debt relief and better access to the markets of developed countries in order to continue their reforms successfully and accelerate growth.

14. The representative of **Switzerland** said that the *Trade and Development Report 1998* contained a useful analysis of the current situation from the perspective of the developing countries. There was a broad consensus that the causes of the crisis lay in inadequate macroeconomic policies, including insufficient financial supervision and transparency, on the one hand and structural disequilibria, including the use of short-term funds for the financing

of long-term loans/assets, on the other. International investors had underestimated the structural problems, and these had now to be tackled as a matter of priority.

15. Measures that cured only symptoms or were inflationary had to be avoided, since they would aggravate budget deficits and delay recovery. The full impact of the crisis was still unclear, but even the developed countries were now affected, and growth forecasts were constantly being revised downward. The management of the crisis required strengthened cooperation among all countries and among international institutions.

16. Liberalization of trade and capital flows remained a medium-term objective, and any restrictions introduced in these areas must be limited in time. Free international capital movements were a key factor for the development of emerging economies, but in the management and prevention of financial crises, private creditors had to bear their share of the responsibility. Moreover, a liberalized economy needed an effective system of surveillance.

17. The representative of **Malaysia** said that globalization had not led to wealth creation and prosperity for all; rather, the world economy had fallen victim to the rapid process of globalization, as the financial crisis was spreading from Asia to other regions. Malaysia had been hit particularly badly, with per capita income falling dramatically, from around US$ 5,000 to US$ 3,000, under the joint impact of a 40 per cent currency depreciation and a severe contraction of the real economy. The conventional austerity measures that had been implemented to combat the crisis initially had only aggravated the depressed state of the economy. The Government had recently changed its course, trying to insulate Malaysia from the hostile external environment by the imposition of foreign exchange controls. However, such action must be seen as emergency intervention, which was no substitute for sound macroeconomic and financial policies; controls would be removed once the storm was over, and a global solution would have to be found to what was essentially a global problem.

18. At the international level, the debate on the remedies for the global financial crisis was still far from producing an adequate solution. The overall architecture of the international monetary system had to be reformed, with the

creation of an international regulatory body to oversee the functioning of capital markets. Other international financial cooperation proposals, such as the establishment of an international lender-of-last-resort facility, as proposed by UNCTAD, should be seriously pursued.

19. The measures implemented by Malaysia were starting to show positive results in terms of increases in reserves and the first signs of recovery in the domestic economy. In the long run, Malaysia remained committed to globalization and liberalization.

20. The representative of **Cuba** said that orthodox liberalization and deregulation policies had been catastrophic for the East Asian economies, which were as vulnerable to external factors as they were attractive for international capital flows. Their regulatory and supervisory systems had turned out to be inadequate in the face of the increased risks resulting from the enormous capital inflows.

21. However, the crisis was a systemic one, with external origins and worldwide consequences for output and employment. With deregulation and loosening of control of economic and financial activities, the possibilities of preventing crisis situations of this kind were much reduced. Given the interdependence of economies worldwide, speculation represented a real danger. It was deplorable that the costs of the failure in global markets and of the measures to bail out creditors were borne by ordinary people.

22. It should remain possible for a country to declare a debt moratorium and to apply foreign exchange restrictions to counter an attack on its currency. The role of the State in the economy had to be strengthened and the functions of the Bretton Woods institutions had to be reviewed.

23. Many developing countries needed better access to official external financing, a solution to their external debt problem, and improved access to markets of developed countries. Cuba had been suffering from an economic, commercial and financial blockade for more than 37 years.

24. The representative of **Guatemala** said that the proposals on the control and prevention of international financial crises in the *Trade and Development Report 1998* were very important. All developing countries were seriously concerned about the current crisis, and although the Central American subregion had not been badly affected so far, some negative impact was being felt due to the fall in international commodity prices.

25. Globalization was an irreversible trend involving considerable development potential for all parties involved but also an increased risk of international financial crises, hence the importance of the diagnosis provided by the UNCTAD secretariat. Particularly interesting and welcome were the proposals to establish a new "lender-of-last-resort" facility and to allow countries under severe speculative attack to declare a unilateral debt standstill on the basis of criteria analogous to those of Chapter 11 of the United States Bankruptcy Code. A procedure of that nature had already been applied with success by the Government of Costa Rica. Other measures for crisis prevention proposed by UNCTAD, such as increased information and transparency, enhanced supervision and monitoring of financial activity, and control of certain types of capital flows, would also be given positive consideration by Guatemala. The role of UNCTAD in the analysis of the international financial system and in the proposals for its reform should be strengthened further.

26. The representative of **Norway** said the recent crisis had made it clear that the process of globalization, while significantly contributing to growth and development, was also accompanied by risks and dangers. The management of the process of globalization at the national and the international level had to be improved to ensure that all nations be given the opportunity to enjoy the fruits of globalization, while mitigating the possible adverse effects of the process.

27. The international financial architecture needed to be improved. Policy recommendations of international institutions had to be more coherent. In this context synergies could be found more easily now, given that the mainstream of world economic thinking was moving towards UNCTAD’s views. The independent voice should, nonetheless, not be discouraged.

28. A sound financial sector, good governance, broad-based social investments, respect for human rights, and transparency in both the public and private sector were factors at the national level conducive to economic and social growth and development. Investment in basic social services, including health and education, yielded the highest returns. A mutual commitment should therefore be made by developed and developing countries to allocate 20 per cent of ODA and 20 per cent of national budgets to basic social programmes.

29. The Asian crisis illustrated that even well managed economies were vulnerable to external shocks. There was a need for a more supportive external environment, with better schemes for debt relief, improved market access and a higher share of capital flows directed to productive use rather than to short-term speculative gains. The HIPC initiative was the most constructive multilateral scheme launched so far, but additional measures were required. Norway had adopted a debt relief strategy which, in addition to supporting existing multilateral schemes, included bilateral debt reduction measures. Other creditor nations should develop similar arrangements. The UNCTAD secretariat's good analytical work needed to be translated into effective policy advice to individual countries so as to enable their Governments to adopt proactive policies to avoid the adverse effects of globalization.

30. The representative of **Egypt** said that financial instability had occurred with increasing frequency in the 1990s in both developed and developing countries. While in developed countries financial crises typically took one form, in developing countries they took several, including widespread disturbances in the financial markets, currency turmoil and external debt crises. A common feature of the different financial crises was that they had been preceded by liberalization of domestic finance and the capital account, and they had been triggered by a sudden reversal of financial flows caused by herd-like behaviour of investors and creditors. Whereas inflows were attracted by domestic factors, outflows were triggered by external ones. Domestic policies should not, therefore, be regarded as the sole reason for the crisis. Moreover, the fact that countries which had followed interventionist policies had not experienced similar crises suggested that dismantling state guidance of private financial flows and investment could be dangerous.

31. Since a sudden reversal of financial flows caused severe liquidity problems, there was a need for an international lender of last resort, and countries facing a crisis should have the possibility of resorting to debt standstill. In the most recent crisis, the assistance coordinated by the IMF had only come after the currency collapse and had taken the form of bailouts protecting creditors and putting almost the entire burden on debtors.

32. Global surveillance had not been successful in preventing financial crises due to its inherently unbalanced nature. Its modalities were not adequately geared to responding to the consequences of shifts in the monetary policy and exchange rates of the major OECD countries, which exerted a strong influence on international capital movements. Governance in the area of global finance lagged behind that of global trade.

33. Financial reforms at the national level did not provide full immunity against financial crises originating in the global system, but they could limit the consequences. Controls to regulate international portfolio investment flows should be contemplated, since such flows were increasingly motivated by the possibility of short-term capital gains and not by long-term prospects of companies and countries. Against this background the proposals contained in the *Trade and Development Report 1998* for the reform of the international financial system deserved to be discussed further in different international forums, particularly in the context of the reform of international financial institutions.

34. The representative of **Poland** said that, after nine years of shock therapy, the Polish economy now showed some promising results, including fast GDP growth of 6.9 per cent in 1997, an increase in investment, lower inflation, a strong export performance, a decline in unemployment to below 10 per cent in 1998, and higher household income and private consumption.

35. This was, however, accompanied by trade and balance-of-payments deficits, and export growth might slow due to lower external demand, particularly in the European Union, and currency appreciation. Despite a large external debt burden, the country had accumulated significant foreign exchange reserves, and inflows of FDI represented an important factor in the transformation of the economy to

a market-based system. Poland would also be affected by the current crisis due to the relatively high share of primary commodities in its exports, which rendered the country, like most developing and transition economies, vulnerable to volatility in the international prices for such goods.

36. The representative of **Uganda** said that the spread of the present economic crisis demonstrated the inherent risk of globalization. In order to benefit from integration into the world economy, countries must first attain a certain degree of social and physical infrastructure development, increase agricultural productivity, acquire technological and managerial capabilities, and create institutions to regulate and facilitate the functioning of markets. Before the crisis, economic orthodoxy had held that a current account deficit was acceptable and sustainable if it stemmed from investment as opposed to consumption and if it was a result of private sector activities. The current crisis illustrated the fallacy of that belief.

37. Many LDCs had succeeded in establishing macroeconomic stability, but this had not always been accompanied by faster growth rates, and economic reforms had led to higher unemployment. Moreover, the fact that LDCs had difficulties in attracting private external financing remained a critical problem, especially in view of the continued stagnation in ODA flows. The HIPC Initiative was an important step, but debt relief under the Initiative should be provided faster and with maximum flexibility. One lesson from the crisis was that full liberalization of capital flows increased the volatility of short-term flows but did little to increase investment and growth. Another was that the free market alone could not be expected to lead to socially optimal results. UNCTAD had an important role to play in contributing to the debate on these issues and in proposing solutions.

38. The representative of **Brazil** said that, despite prudent policy measures, Brazil had been affected by the current international crisis through capital outflows and an impending attack on its currency. The causes were entirely exogenous and related to the volatility of worldwide financial capital flows. Development prospects for Brazil and most other Latin American countries were therefore clouded, although their economic policies had been widely praised over many years.

39. When a developing country was caught in this kind of predicament, it was quite legitimate for its Government to defend its economy and to call for internationally coordinated policy action. In the current situation, world leaders should therefore act jointly to promote increased coordination of monetary policies and an upgrading and strengthening of international financial institutions. There was also a need for a global strategy for crisis prevention.

40. The representative of **Bulgaria** said that the *Trade and Development Report 1998,* with its in-depth analysis of the East Asian crisis, was one of the best reports by UNCTAD and was of particular interest to developing countries and countries in transition, since it treated the crisis in a global perspective and not as a local phenomenon. Possible contagion was a problem not only for the developing countries and economies in transition, but even for the developed countries. This was one of the negative aspects of globalization.

41. Since the beginning of 1997, Bulgaria had implemented a number of structural reforms with the support of international financial institutions. It was expected that these reforms would lead to an improvement in the country's economic performance in the coming years.

42. The impact of the recent international financial turmoil and the effects of global interdependence on the transition economies should continue to be analysed in future issues of the *Trade and Development Report*. Of special relevance were issues related to interdependence between countries in transition and developing countries.

43. The representative of **South Africa** said that the ongoing financial crisis was not the end of the Asian miracle, but a systemic correction which, after some restructuring in the countries affected by it, would serve to enhance Asian competitiveness in the future. South Africa's economy might suffer from the repercussions of the crisis in Japan, the United States and Europe. The exchange rate and stock prices in South Afric had fallen significantly. The local markets had now been stabilized but it was very dangerous to bring down domestic interest rates before stability had returned to the international markets.

44. The international financial architecture had to be reformed in such a way that financial market activities and capital flows were made more transparent. The Asian crisis had exposed the fault lines in the global system, which required a regulatory framework designed to avoid excessive speculation and unsustainable capital flows. Moreover, economic policy had to be linked to social development.

45. There was a need for mechanisms, information systems and technical assistance to prevent financial crises and to neutralize their effects, and for a reform of the international monetary and financial system incorporating a multilateral surveillance mechanism. UNCTAD should continue to play a key role in the analysis, management and solution of the current crisis and the systemic issues involved.

46. The representative of the **International Confederation of Free Trade Unions** (ICFTU) said that the recent financial crisis had seriously affected the level of employment around the world. In Asia alone, the economic turmoil had caused unemployment to increase by 10 million, and the heaviest burden of economic distress had to be borne by the most vulnerable groups in society.

47. In order to prevent these adverse effects from spreading further, international policy action to improve the functioning of financial markets should be integrated with international strategies to eradicate poverty. A key issue in that connection consisted in redefining the role and responsibilities of the Bank of International Settlements, IMF, the World Bank, OECD and the Basle Committee on Bank Supervision.

48. In order to ensure that protectionist pressures were removed and workers got a fair share of the benefits of trade liberalization, international trade agreements should contain a social clause which would grant a set of basic rights to workers to be applied universally.

49. The representative of **Uruguay**, speaking in his capacity of chairman of the informal debate on item 4, said that the debate had been very useful. It had become clear in the discussion that many features of the present crisis were universal, but its manifestations differed across countries. Consequently, universally applicable models could not be devised. An important lesson from the

crisis was the role of systemic factors, exogenous to national economies. There were numerous examples showing that national efforts over many years to attain macroeconomic equilibrium and to develop the domestic financial system were insufficient to protect a country from financial crises when the external environment was unfavourable. National policies to overcome the crisis should be geared not only to restoring macroeconomic equilibrium and to strengthening the domestic financial system, but also to restoring growth and attracting new capital inflows, while international efforts were required to improve the external environment. It was also crucial, at the international level, to improve the monitoring and supervision of capital flows, particularly short-term speculative flows.

50. It had become clear that the international financial system had a number of shortcomings, deficiencies and limitations and that its architecture had to be reformed. Distinct positions had emerged on the extent and scope of the reforms, with suggestions ranging from marginal improvements of the present rules and regulations through more radical changes in international financial institutions, in particular the IMF, to the establishment of a new international financial authority with functions going beyond those of existing bodies. The conclusion of regional financial agreements could be a useful complement to reform efforts at the global level.

51. The lack of a lender of last resort had been singled out as a major weakness of the present system. While, in the view of some, this function should be incorporated in a reformed institutional system, others questioned the feasibility of the proposal and stressed the need for better instruments to prevent or contain financial crises. A lender of last resort had to take into account the specific needs of the least developing countries, which in many cases were unable to attract private capital.

52. In the debate on protective measures which might be adopted by countries confronted with problems resulting from international financial instability, reference was made to the safeguard measures provided for in trade agreements. While in the view of some delegations a temporary debt standstill was an important measure to be considered in an emergency situation, others had mentioned the introduction of controls over short-term capital movements,

moratoria, or taxation of capital flows as possibilities for the better management or prevention of financial crises. However, some delegations had felt that such measures would be counterproductive. On the other hand, greater transparency and better information on the activities on financial market were necessary to ensure an adequate functioning of these markets.

53. There had been broad agreement that international trade was not a cause of the crisis, but, on the contrary, could help to overcome it. Recourse to protectionism in response to the effects of the crisis therefore needed to be avoided.

54. The crisis had shown that UNCTAD could make an important contribution to analysis and policies in the field of international money and finance. The secretariat had provided a sound, independent and timely analysis of the crisis. Not only should the organization's existing mandate in this area be consolidated, but UNCTAD should also contribute to the elaboration of national and international measures for the prevention of financial crises and participate actively in the reform of the international monetary and financial system, focusing on the interdependence of trade, finance and development.