Launch Lecture of the UNCTAD Trade and Development Report 2011

Post-crisis policy challenges in the world economy

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TRADE AND DEVELOPMENT REPORT, 2011

Post-Crisis Policy Challenges in the World Economy

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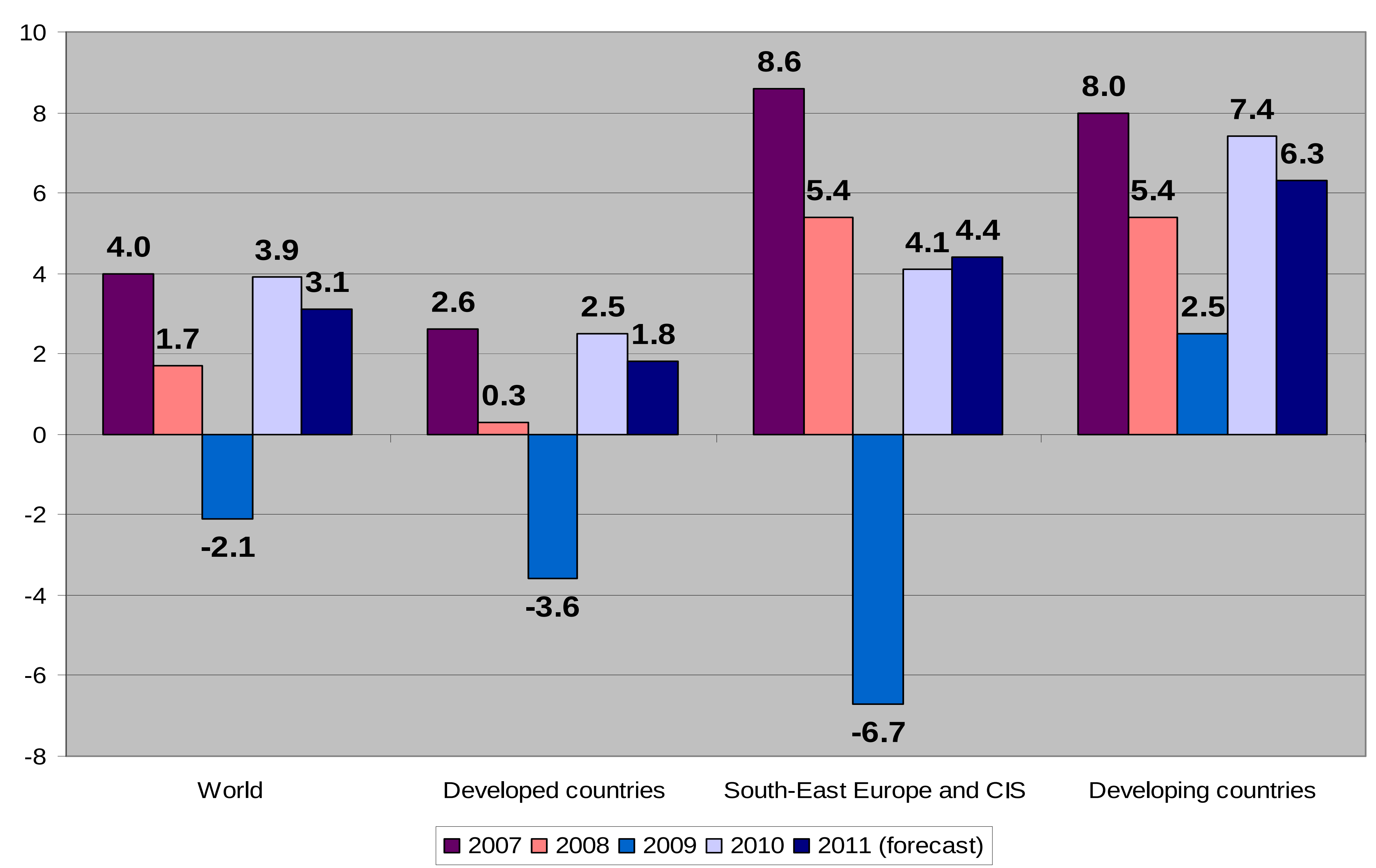
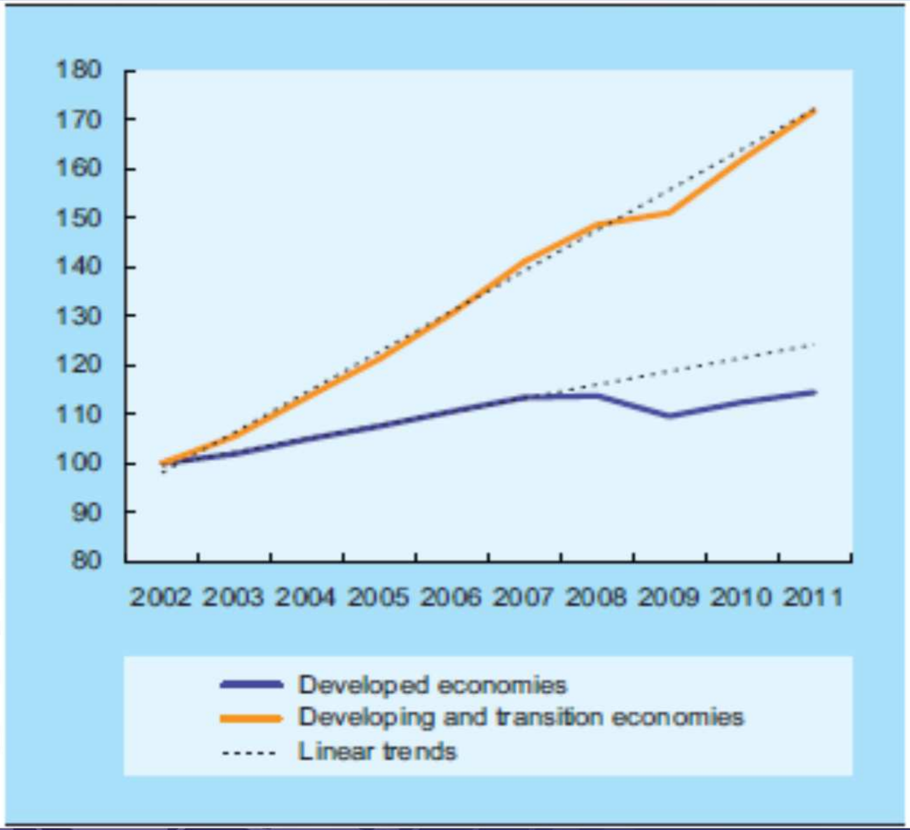
Recovery of the world economy is slowing down, with strong downside risks

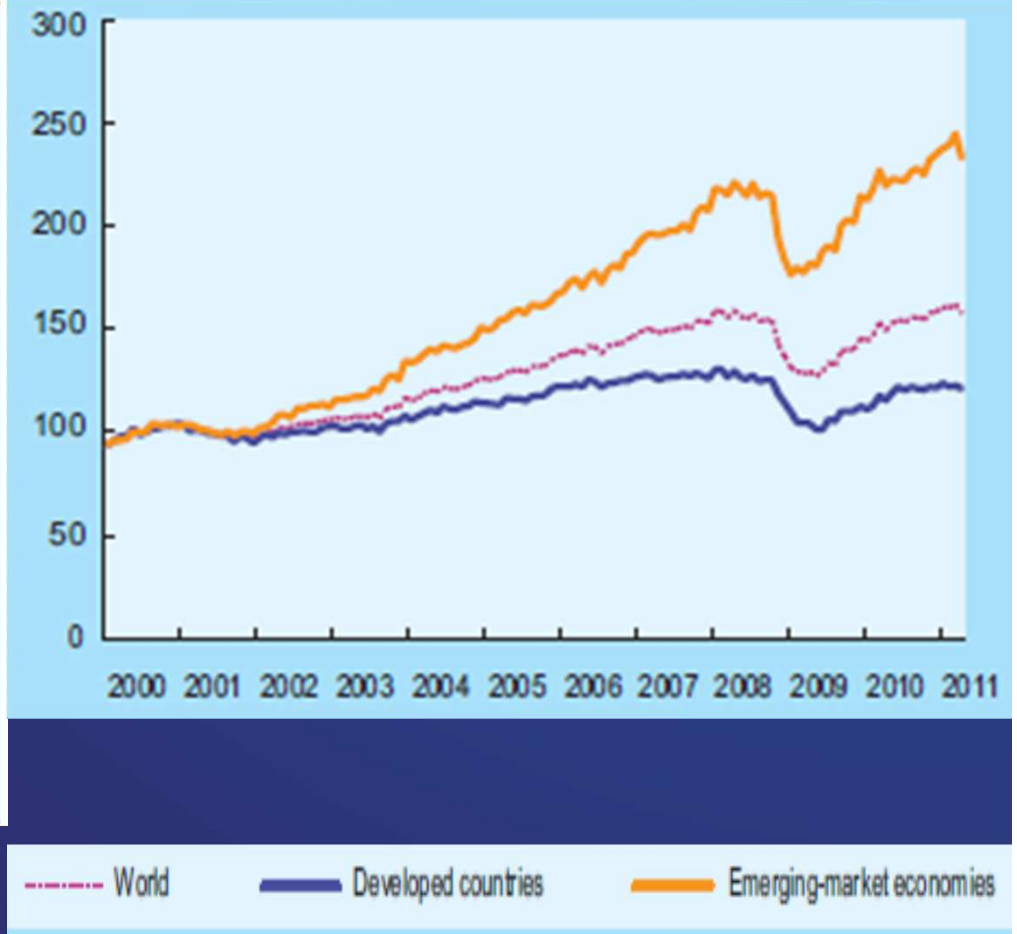


The "two-speed recovery" continues

Real GDP at market prices, 2002–2011
(Index numbers, 2002 = 100)



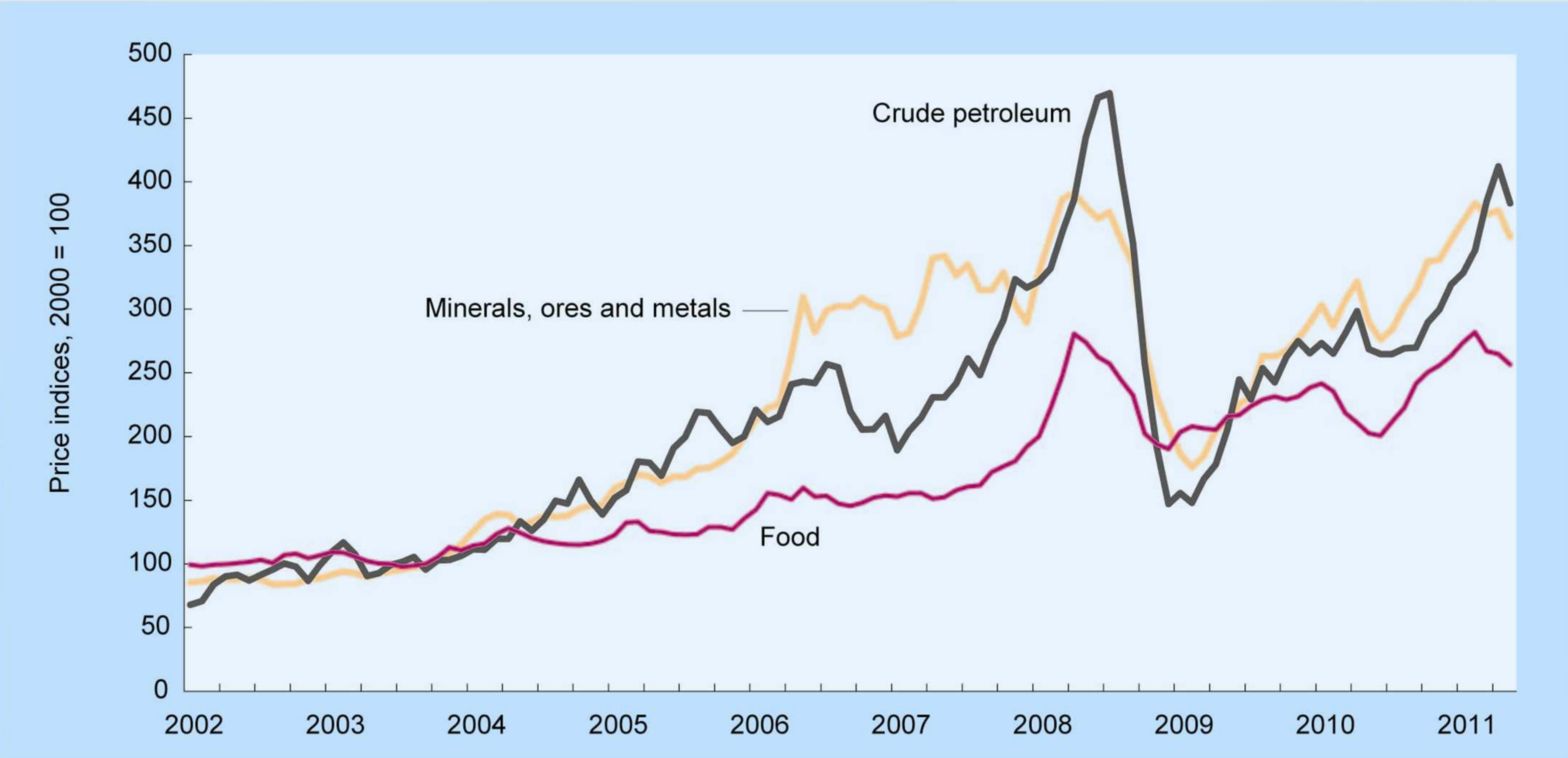
World import volume, Jan. 2000–Apr. 2011
(Index numbers, 2000 = 100)



Note: Linear trends correspond to 2002–2007.

Commodity prices have recovered amidst high volatility

Monthly evolution of selected commodity prices, January 2002–May 2011
(Price indices, 2000 = 100)



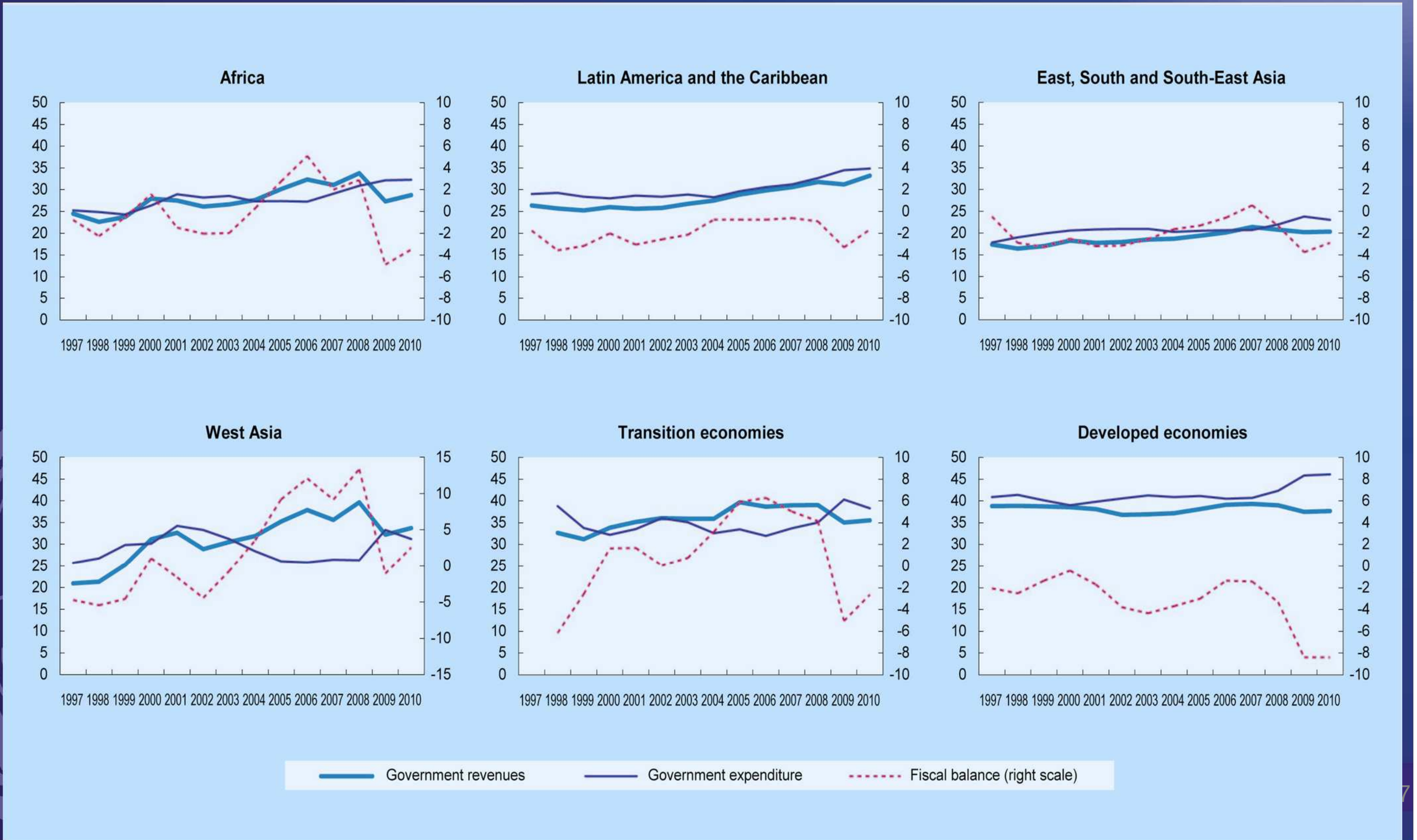
Risks remain on the downside

- The shift towards fiscal and monetary tightening represents a major risk of a prolonged period of mediocre growth in **developed economies** – if not of an outright contraction.

- Given the economic weakness in developed economies and the lack of significant reforms in international financial markets, **developing countries** are vulnerable to trade and financial shocks (trade volumes; prices of primary commodities)

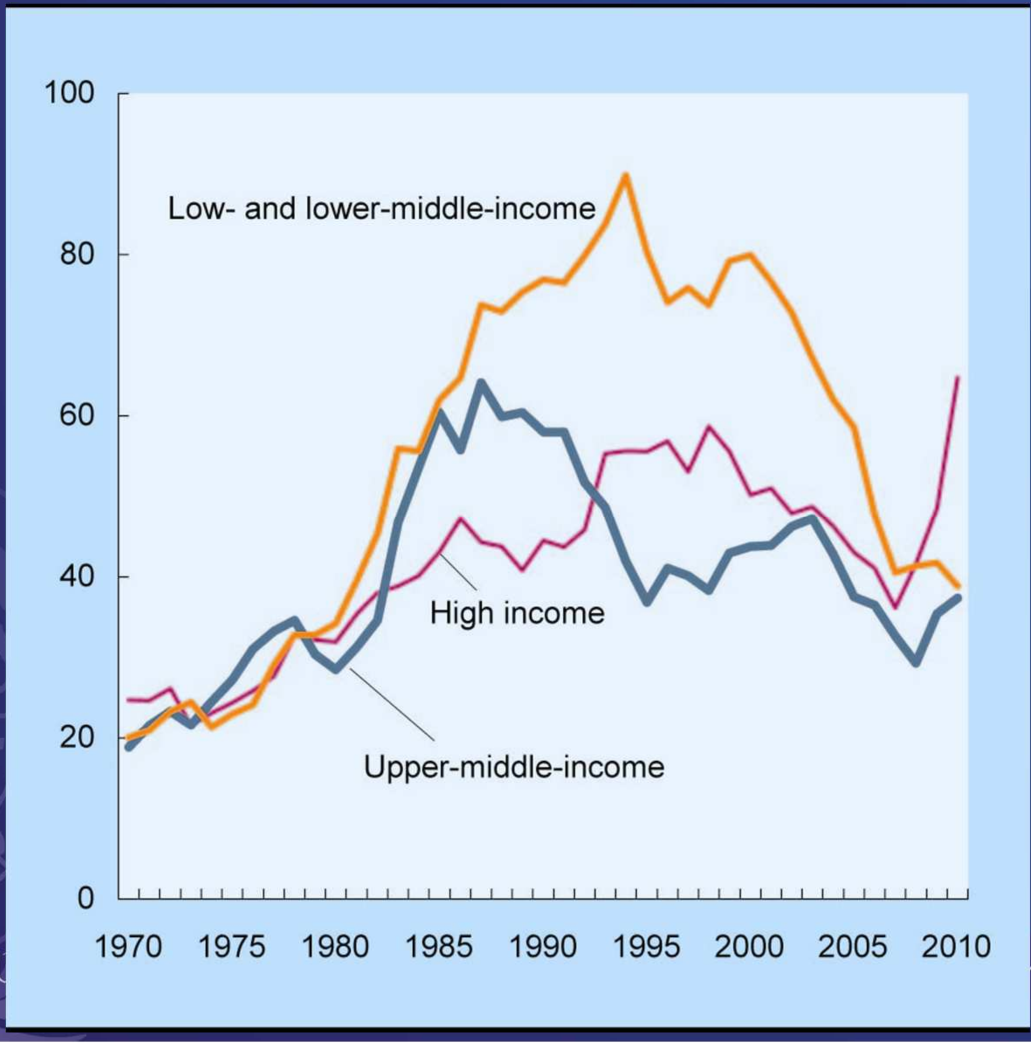
Fiscal imbalances were not a driving factor but a result of the crisis

Government revenues and expenditure and fiscal balance, 1997–2010, in % of GDP

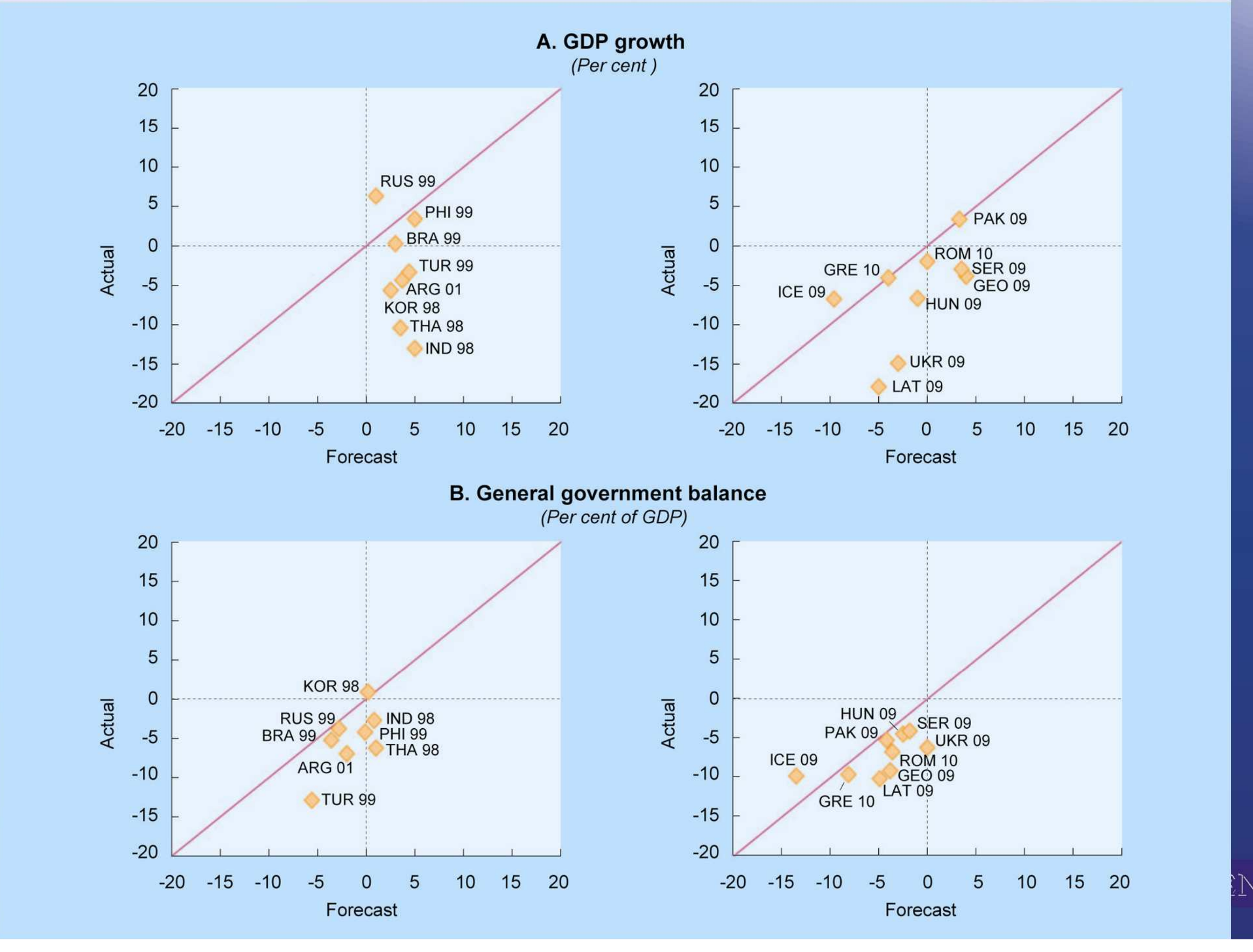


Recent trends in public debt in developed and developing countries

Ratio of public debt to GDP in developing countries, by income group, 1970–2010
(Median, in per cent)



IMF-sponsored programmes systematically underestimate their negative impact on GDP growth and fiscal balances



Growing out of debt

- The best strategy for reducing public debt ratios is to promote growth and maintain low interest rates
- Fiscal retrenchment seeking to cut fiscal deficit and thus "regain the confidence of financial markets" is likely to be self defeating, as it affects GDP growth and further reduces fiscal revenues.
- Fiscal space for applying pro-growth policies is not a static variable: an expansionary fiscal policy generates higher fiscal revenues
- To change the composition of public expenditure or public revenues can maximize their economic impact without necessarily modifying the total amount of expenditure or the fiscal balance
- Fiscal expansion tends to be more effective if
  - higher spending takes precedence over tax cuts
  - spending targets infrastructure and social transfers
  - tax cuts target lower income groups (higher propensity for spending)

Financial deregulation was one of the main factors leading to the global crisis

- Financial deregulation:
  - Led to a large, opaque and undercapitalized "shadow banking system"
  - Increased the concentration in the traditional banking segment in a few "to big to fail" (and "too powerful to regulate") institutions
  - Reduced the diversity of the financial system and increased the systemic risk

- While government regulation has weakened, its lender-of-last-resort support to the financial system has increased, and even extends to the shadow banking system.

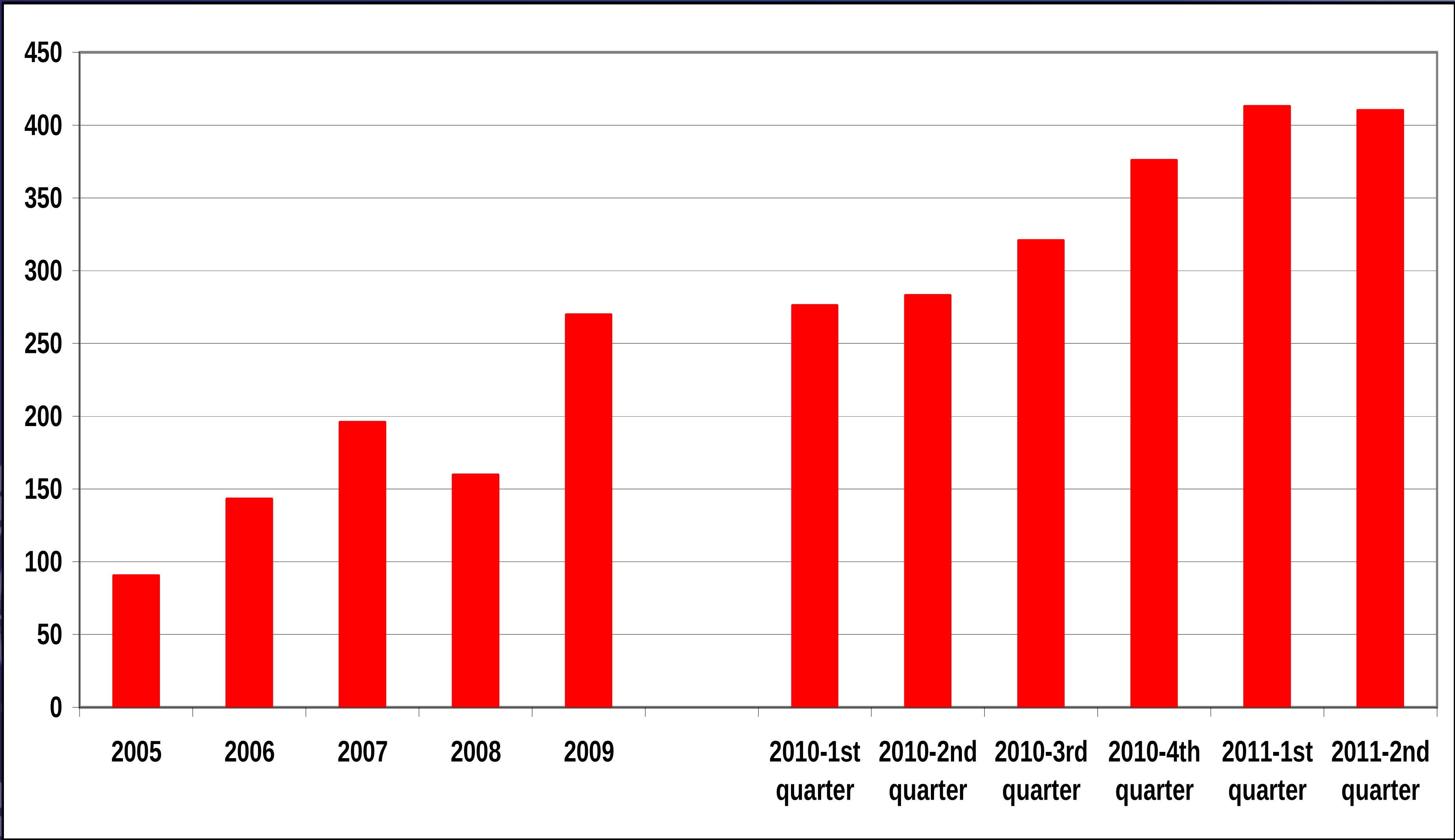
Financial Re-Regulation and Restructuring

- Strong re-regulation is urgently needed. It must:
  - Be tighter with the "too-big-to-fail" institutions
  - Cover the "shadow banking" and avoid regulation arbitrage
  - Incorporate a macro-prudential dimension, with anti-cyclical capital requirements and capital controls

- In addition, the financial system must be restructured
  - Re-regulation alone will not orient credit to real investment or make it accessible to small and medium-sized firms
  - Banking restructuring should aim at more diverse financial systems, with a bigger role for public and cooperative institutions
  - Giant institutions must be sized down
  - The activities of commercial and investment banking should be clearly separated, in order to reduce the risk of contagion

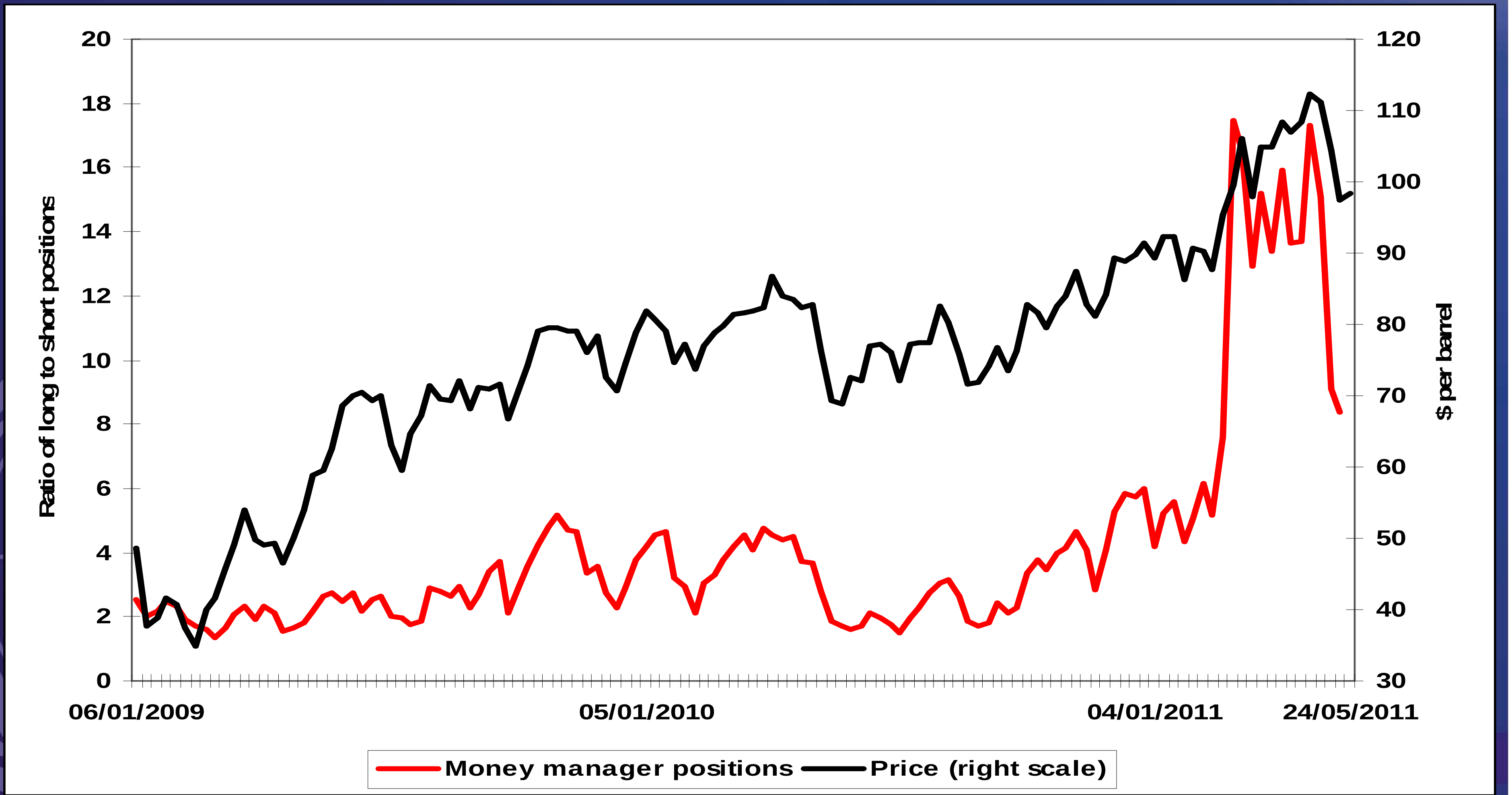
The financialization of commodity markets has continued unabated

Commodity investment, assets under management, 2005–2011 ($bn)



Herd behaviour of money managers probably caused oil-price gyrations

Ratio of money managers' long and short positions and WTI-oil price, 2009–2011

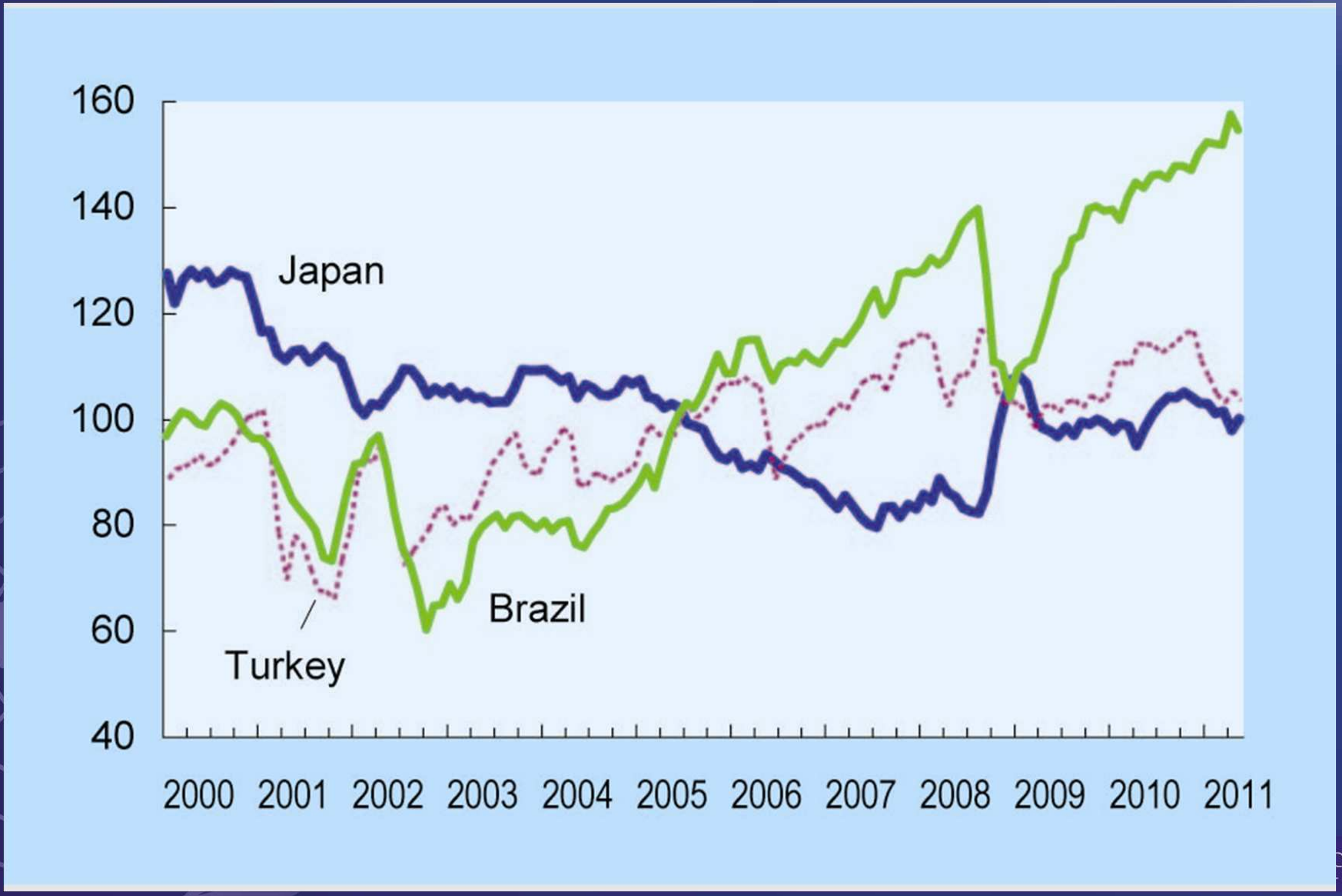


Policy recommendations to improve commodity market functioning

- Increase transparency in physical and derivatives markets
- Arrange for internationally coordinated tighter regulation of financial investors
- Consider occasional direct intervention to avert price collapses and deflate price bubbles

Exchange rates have become disconnected from macroeconomic fundamentals

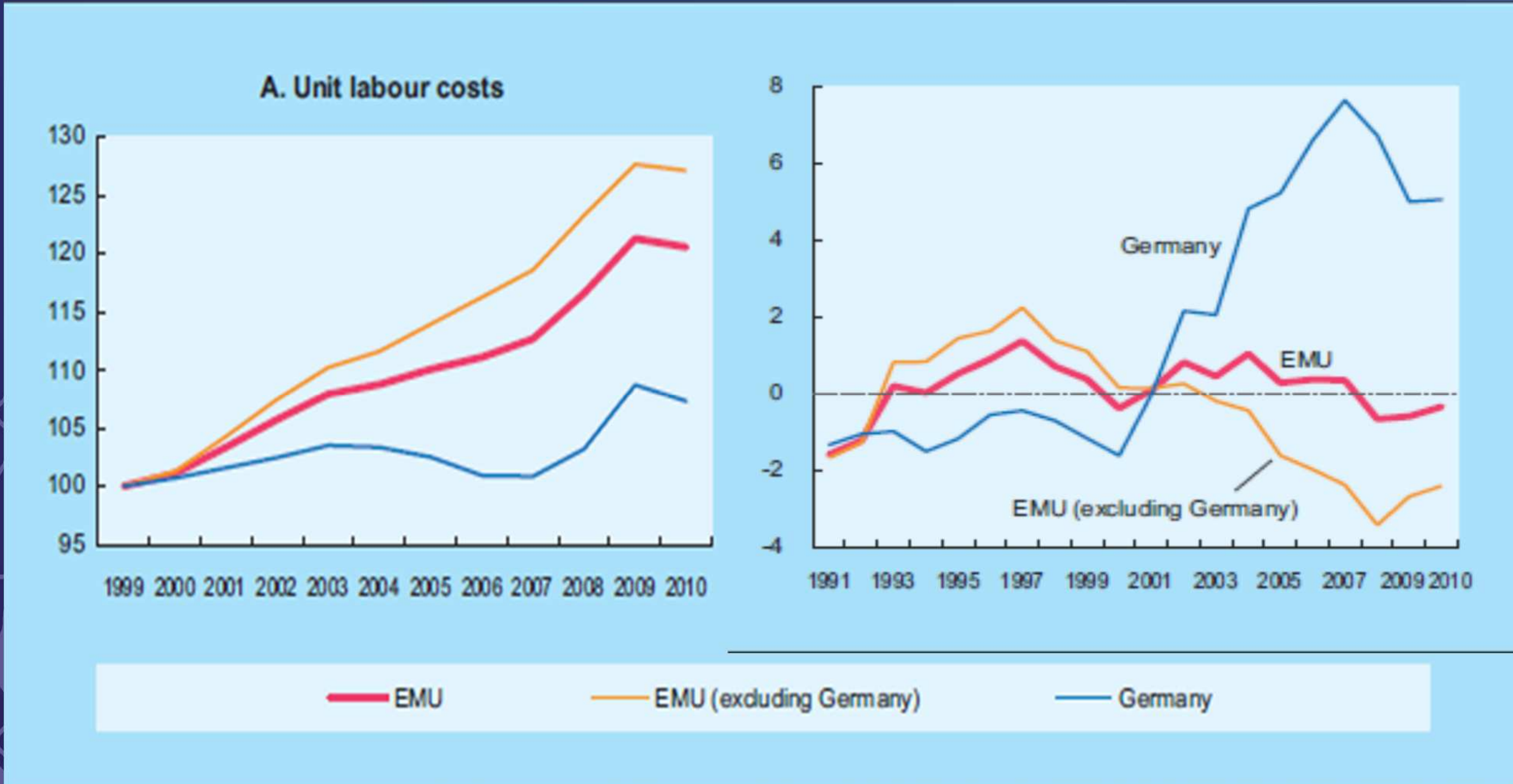
Real effective exchange rate, selected countries, January 2000–May 2011
(Index numbers, 2005 = 100, CPI based)



EMU: divergent unit-labour costs had enormous and cumulative impact on trade flows

Unit labour costs in EMU, 1999–2010
(Index numbers, 1999 = 100)

Current-account balances in EMU, 1991–2010
(Per cent of GDP)



Leaving currencies entirely to market forces entails considerable risks for both the global financial system and the multilateral trading system

- Instead, a rules-based managed floating can deliver
  - sufficient stability of the real exchange rate to enhance international trade and facilitate decision-making on fixed investment in the tradable sector
  - sufficient flexibility of the exchange rate to accommodate differences in the development of unit labour costs or national inflation rates across countries
- Such a system could be based in two approaches:
  - Adjustment of nominal exchange rates to inflation differentials. This would address more directly the need to avoid imbalances in trade flows.
  - Adjustment of nominal exchange rates to interest rate differentials. This is more directly related to limiting financial speculation in the currency markets.
- This currency regime can be practiced as a unilateral exchange-rate strategy but would be of greatest benefit to international financial stability if applied at multilateral level

Trade and Development Report 2011

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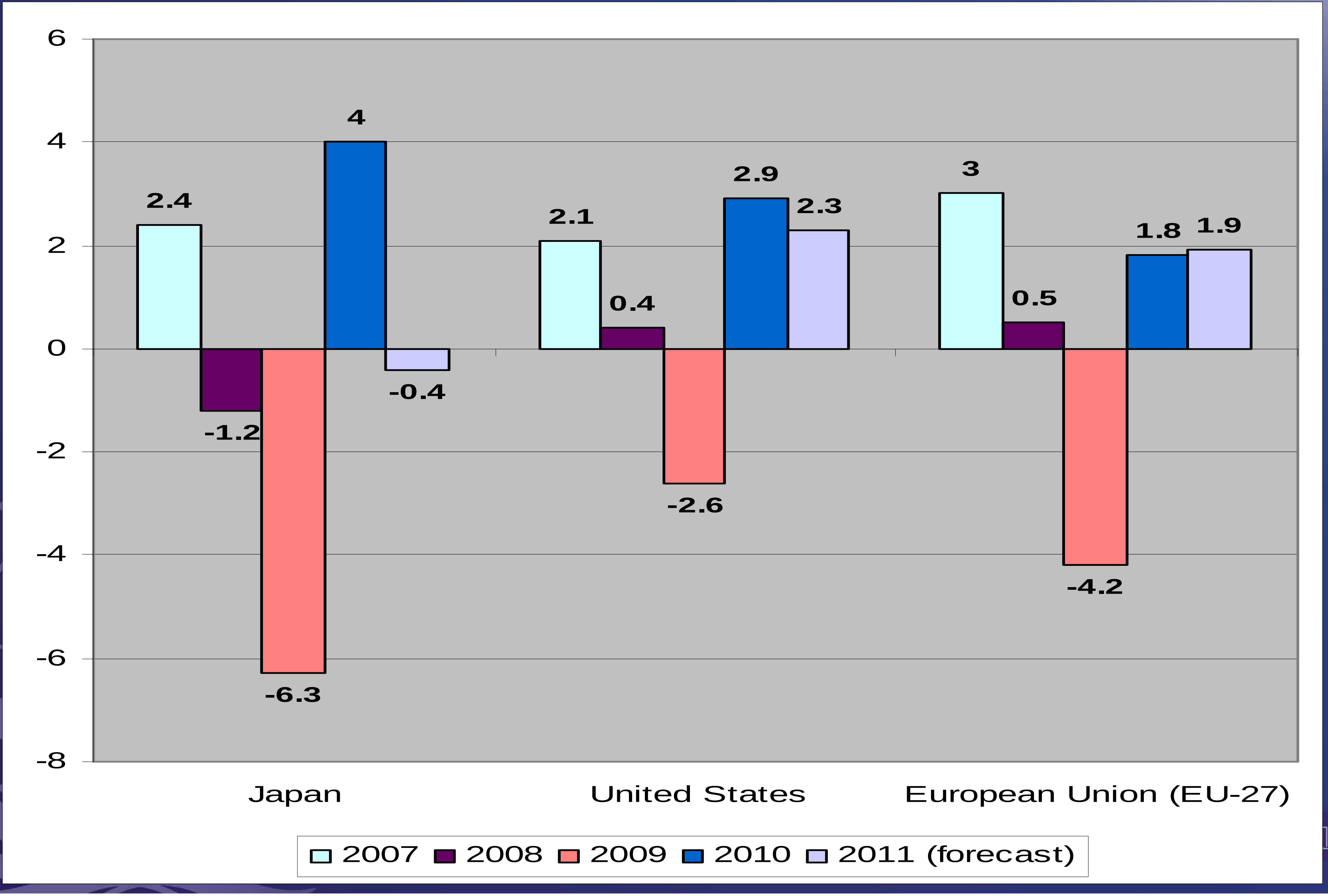
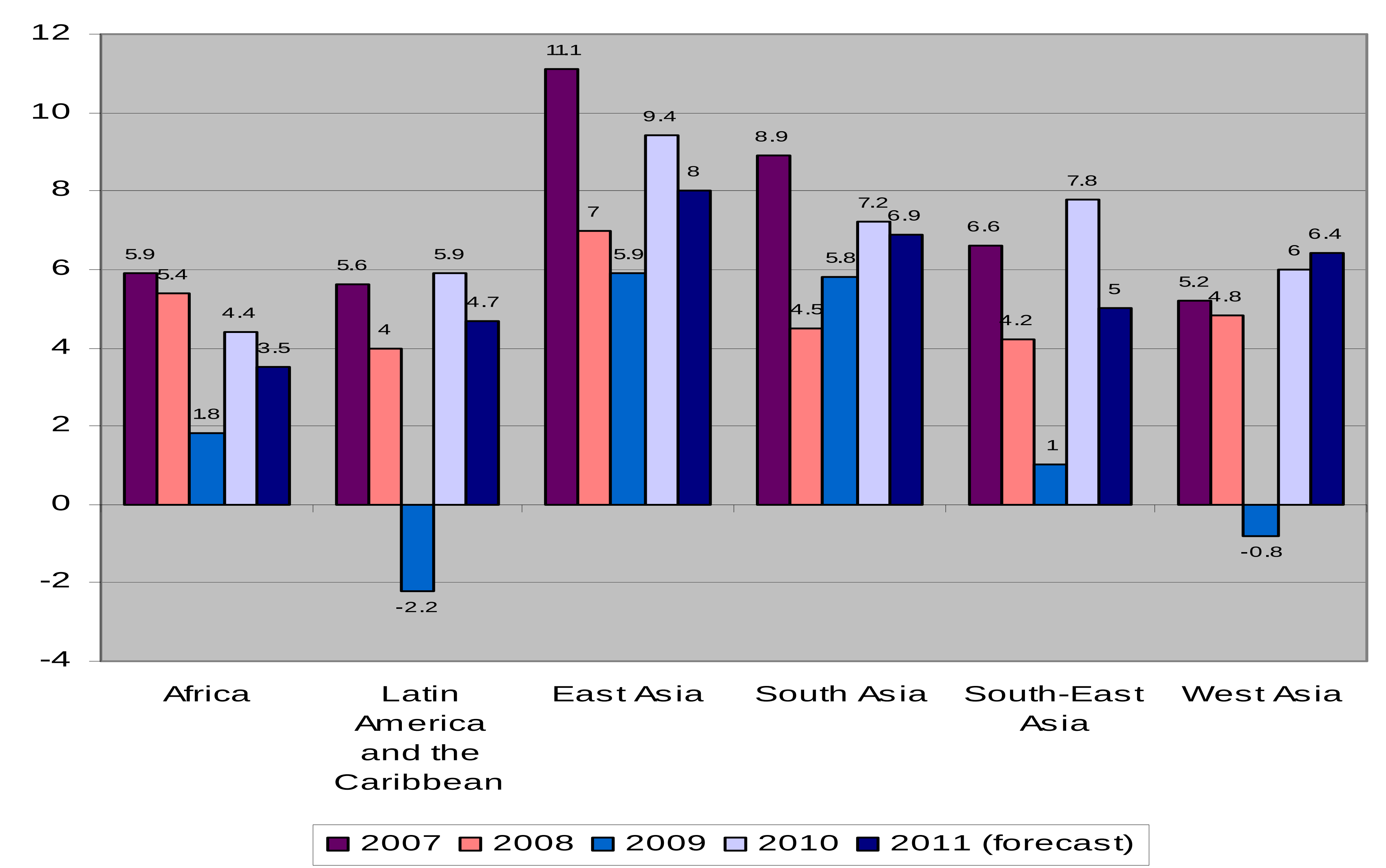
Growth in developed economies remains very sluggish



Developing economies driving the recovery



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