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Current trends and challenges in the world economy

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BRIEF SUMMARY OF THE FORTHCOMING TRADE AND DEVELOPMENT REPORT 2015

Making the international financial architecture work for development
Main messages

- With tepid recovery in developed countries and headwinds in many developing and transition economies, the crisis is not over and the risk of a prolonged stagnation persists.

- Insufficient demand in developed economies is the big constraint; combined with financial fragility and instability, and with growing inequality.

- To improve global growth and financial stability, and to realize the investment push required to attain the new development agenda, the systemic problems of the international financial architecture need to be addressed.

- Solutions are available – but need dedicated action by the international community.
GLOBAL ECONOMIC SITUATION
The world economy in 2015: still in the doldrums

Output growth, selected country groups, annual percentage change, 2010–2015
Slowdown in most developing regions, except in East, South and South-East Asia

Output growth, selected country groups, annual percentage change, 2010–2015
The volume of trade has not recovered its pre-crisis dynamism: stagnating developed country imports affected developing country exports

Volume of export and imports, selected country groups, 2005–2015 (index numbers, 2005=100)
Declining commodity prices...

Monthly commodity price indices by commodity group, Jan 2002–Aug 2015
Money manager positions and crude oil prices, March 2014–July 2015

... accentuated by the financialization of commodity markets as sharp reversals in financial investors' net commodity positions accelerate and exacerbate price movements.
MAKING THE INTERNATIONAL FINANCIAL ARCHITECTURE WORK FOR DEVELOPMENT
The global financial cycle is driven mainly by developed countries’ policy decisions but affect emerging economies.
The accumulation of sizable foreign-exchange reserves has provided valuable – yet still limited – self-insurance.

Foreign reserve stocks in developing and transition economies, 1970–2013 (% of GNI)

Cross-border liabilities and reserves of selected developing countries, 2005–2013 ($bn)
Other national policy measures can also increase resilience ...

- **Exchange-rate management:** managed floating
- **Capital-account management as part of ordinary policy toolkit**
- **Reduce debt denominated in foreign currency by debt denominated in domestic currency**

... but need for effective global measures to make the international financial system fulfill its three basic functions (providing sufficient liquidity; mitigating shocks and managing smooth adjustments; providing long-term stable development finance)

**Multilateral arrangements in IMS-reform (e.g. greater role of SDR)** remain the target but require institutional changes out of reach for now, developing countries can build on regional and interregional initiatives
Regulatory reforms, an unachieved task

- Financial re-regulation initiatives such as increasing capital requirements are positive, but remain too timid and narrow.
- Basel III maintained the risk-weighted system and the reliance on (discredited) credit rating agencies, thus failing to prevent high leverage and procyclicality.
- Proposed reforms have insufficiently taken into account the specific needs of developing countries, such as taming speculative cross-border capital flows.
- Developing countries should not be required to apply prudential rules conceived for countries hosting internationally active banks, which result in credit rationing to sectors that need support from a development perspective (e.g. SMEs, start-ups, long-term projects, innovation, etc.).
Despite recent regulatory initiatives, concentration has increased ...

Assets of the five largest banks as a proportion of total assets of the banking sector, 1998-2011
... and shadow banking remains high

Size of shadow banking sector by different measures 2001-2013

(Trillions of dollars)
Credit rating agencies follow ideological prejudices rather than macroeconomic fundamentals

Sovereign rating of developing countries, actual and fitted values

A. Actual vs. fitted values predicted by ideological variables

B. Actual vs. fitted values predicted by fundamental variables
External debt in developing and transition economies becomes a threat despite reassuring debt indicators

External debt, selected country groups and China, 1980–2013, billion $

Interest payments on external debt as a proportion of exports, selected country groups and China, 1980–2013, in %
The international economy urgently needs a debt resolution mechanism

- Private finance recurrently creates external debt crises that are frequently translated to governments. At a time of rising fragilities, the international economy lacks a fair and efficient sovereign debt restructuring mechanism (SDRM)

- The present system is fragmented, pro-cyclical and unfair; it deepens the depression in indebted countries and facilitates the bailing out of private creditors. In addition, it allows the action of vulture funds that make restructuring more difficult and affect the interests of both the debtor and other creditors
Ensuring long-term development finance

Despite abundant international liquidity and low interest rates, many developing countries struggle to obtain sources of long-term international finance for productive investment. This task cannot be entrusted to financial markets, which prefer short-term and low-risk operations.

Specialized public institutions and mechanisms are crucial:

- Development banks, which provide long-term finance to the real economy
- ODA: international commitments should be met and be better used to strengthening the productive economy
- Sovereign funds, to the extent that they reorient investment decisions
- Public-private partnerships could also help in financing infrastructure projects. However, they have a chequered record, generate unanticipated fiscal obligations and do not typically create additional finance.
Summary of main recommendations

- To avoid secular stagnation, developed countries need to combine monetary expansion with fiscal expansion and wage growth, and be mindful of international spillovers of their policies.

- To make provision of official international liquidity more stable and predictable, multilateral reform remains desirable target – in meantime, developing countries may build on regional and interregional initiatives, set swap arrangements among Central Banks and reduce the need for reserve accumulation.

- A bolder regulatory agenda is needed: strict separation of retail and investment banking; strong regulation of shadow banking; public oversight of CRAs and their progressive substitution by other mechanisms for risk assessment.

- Developing countries should not be required to apply prudential rules conceived for countries hosting internationally active banks; more active Central Banks with broader mandate.
Summary of main recommendations

- SDRM urgently needed: Sovereign debt management can progress in several fronts: contractual improvements (Collective Action Clauses, *pari passu* clause); internationally accepted Principles to guide sovereign debt restructuring; leading to a statutory approach based on a multilateral treaty defining a set of rules for a debt restructuring that restores growth and debt sustainability

- Specialized public institutions and mechanisms are crucial for provision of long-term development finance, in particular development banks. The international community needs to meet its ODA commitments and to tune it better to strengthening the productive economy