

Contending with credit crunch, runaway prices, shaky jobs: UN calls for policy rethink to deal with economic insecurity

(UNITED NATIONS NEW YORK, 1 July 2008) In the wake of world summits on the threats brought on by untamed food and energy costs, the United Nations is issuing today an appraisal of economic insecurity and proposals for controlling it.

As serious political unrest brought on by high prices, inequality and uncertain job prospects are making economics a major leverage point for global security issues, the UN reports that insecurity is felt most sharply in the poorest countries. Recent optimism that the corner was being turned on poverty thanks to faster growth in emerging markets and even some very poor economies is turning to anxiety, as the global economy downshifts, prices spike and weaknesses in formal-sector employment are exposed.

In advanced countries also, economic insecurity is associated with rising inequality, indebtedness and the squeezing of social provisioning according to the *World Economic and Social Survey 2008**, published by the UN Department of Economic and Social Affairs (UNDESA).

Left to their own devices, markets are not delivering the desired levels of economic security, UN economists argue. They advocate steps to narrow the pendulum swings of economic cycles, reduce dependence on debt and finance instruments for economic growth, tailor macroeconomic policies to development priorities, and inject new life in to multilateralism. Repairing the social contract is a challenge for policy makers everywhere, the report contends.

An example of misconceived policies is the case of agriculture, where pressure on developing economies to open trade and finance markets preceded the means to build productive farms and rural infrastructure. This lack of capacity has now become a destabilizing factor in a bedrock feature of personal and social security – the ability of a country to feed its citizens.

UN economists recommend that integrated strategic interventions and public investment be deployed for agriculture, and call for renewed thinking on industrialization as well as a better balance of economic and social policies. This is the basis of the approach carried off with remarkable success by governments in East Asia.

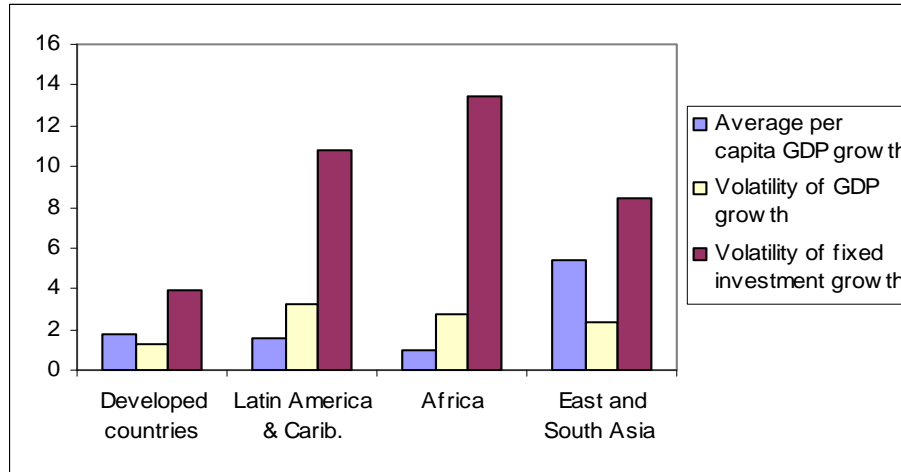
Afraid new world

Recent opinion polls indicate that insecurity is keenly felt by the public in developing and developed nations alike. And personal anxiety is now spilling on to the streets through demonstrations triggered by rising food and fuel prices.

In the United States, both financial as well as public insecurity was triggered by the sub-prime mortgage meltdown, which began nearly one year ago.

The key role of mortgage and asset-backed financial instruments, and their vulnerability, is symptomatic of the finding by UN economists that instability of investment has been high relative to output since the 1990s particularly in developing countries and with a negative impact on growth performance (*see figure 1*)

Figure 1 Volatility of output and investment and growth performance, 1991-2006
(percentage growth rates and standard deviation of growth rates in per cent)



Source: UN, World Economic and Social Survey, 2008.

Finance flows, investment falters

“Debt, leverage, collateral value and expected asset prices have become the dominant drivers of the [economic] cycle,” the report says. Elaborate mechanisms to manage risk by spreading it among financial players have served instead to spread the risk further, leading to crises in housing and credit markets in developed countries which have taken a global aspect.

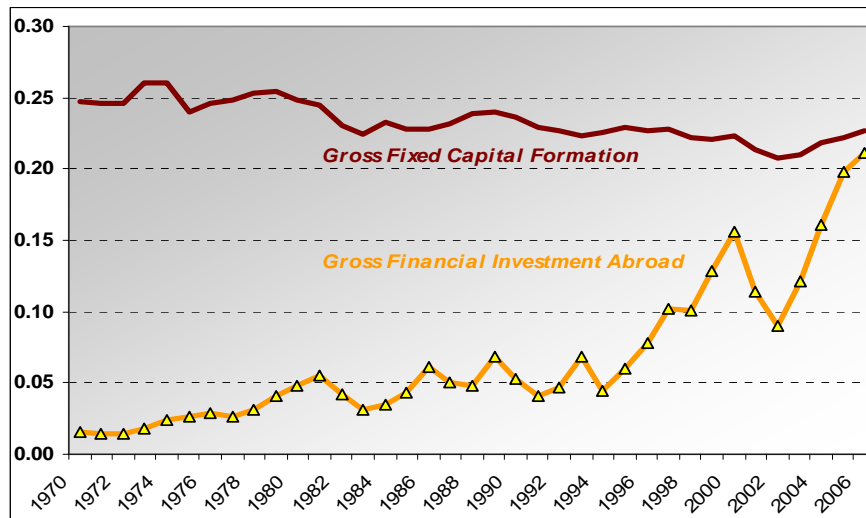
The triumph of exotic financial instruments over productive investment has been aided by the concept of the self-regulating market, an *idée fixe* of the late twentieth century. It is a tempting obsession, in terms of its promise of largely automatic economic growth. But careful observers realize that markets do not regulate themselves, the *Survey* points out, calling for renewed attention to the array of institutions, rules, regulations and norms on which effective markets depend.

A more secure economic environment will require more productive investment but despite all the talk of an improved investment climate associated with deregulated financial markets the explosion of cross-border capital flows, the desired trend has not emerged (*figure 2*). Lop-sided investment patterns have been dominated by the buying and selling of existing assets, even where profits have been on the rise.

One of the most pronounced habits of unrestrained financial markets is pro-cyclical bias. When times are good and market exuberance is strong, investors pile in. While a certain amount of paper investments can support growth processes and promote development, large transactions and rapid flows can be inflationary, market distorting and destabilizing. In reverse, once a negative trend is established, capital flows out as rapidly, or more so, than it came in.

Figure 2 The triumph of financial flows over productive investment

(capital formation and financial flows as percentage of gross world product)



Source: UN/DESA.

The UN recommends that governments respond with counter-cyclical fiscal measures – setting aside resources in boom times, stimulating economic activity during busts. Such measures require effective institutional supports and additional rules for fiscal discipline and debt management.

Pro-cyclical finance flows also tend to stimulate volatility in commodity prices. The recent increase in commodity prices associated with the strong demand from China has helped exporting countries, especially in Africa and Latin America, to improve growth. But volatility in commodity prices has been and is a source of instability, the *Survey* says.

Managing commodity booms is particularly difficult, and downturns can inflict lasting damage. Moreover, the recent surge in fuel and food prices is placing pressure on inflation, leading to a squeeze of household incomes.

As global economic integration proceeds, maximising gains and minimizing risks depends on the ability of countries to develop dynamic competitive position based on innovation, upgrading and diversification.

Back to the future; multilateralism revisited

One step that many developing countries have taken to protect themselves from the volatility of financial flows and commodity markets is to set aside massive foreign reserves as a form of self-insurance. However, the fact that these savings are largely kept idle, costs these countries roughly \$100 billion a year, the *Survey* estimates. The UN recommends continuing and extending the trend by which foreign reserves are placed in

more productive sovereign wealth funds, and especially of using these funds to invest directly in development projects in other developing nations.

While domestic governments are seeking measures to overcome shocks and provide for security, international cooperation can be most effective in advancing the economic security agenda. The Survey calls for:

- Renewing the Bretton Woods system: more effective compensatory mechanisms to deal with external shocks; support for counter-cyclical macroeconomic measures and stronger global financial regulation; inclusive policy coordination.
- Revisiting the Marshall Plan: a more effective aid architecture that takes national ownership seriously and supports local priorities and capacities.
- Recreating the New Deal on a global level: The World Bank has called for a new deal for agriculture, seeking trade liberalization for farm products as well as greater investment in agriculture. But like the policy response to the Great Depression of the 20th century, action is needed to curb abuses in market power, and to better share the burden of shocks.

This year's edition of the UN's *World Economic and Social Survey* also assesses insecurity posed by weather, natural disasters and climate change; and the inherent insecurity of seeking livelihoods in countries riven by civil wars that on historical trend are become longer and more disruptive (*see affiliated press releases*).

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