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ON TRADE AND DEVELOPMENT**



**Review session on chapter VI of the Monterrey
Consensus:**

**Addressing systemic issues: enhancing the coherence and
consistency of the international monetary, financial and
trading systems in support of development**

Note by the UNCTAD Secretariat

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Addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development

Among the systemic issues considered in the Monterrey Consensus, most, if not all, are still equally pressing today as they were five years ago. In addition, it seems that several new issues emerge that cannot be dealt with exclusively at the national level and that have a systemic dimension. I will briefly discuss some of them.

In para. 52 of the Monterrey Consensus, the Heads of State and Government identified the "urgent need to enhance coherence, governance, and consistency of the international monetary, financial and trading systems", inter alia through a "reform of the international financial architecture" in combination with "sound domestic financial sectors"(para 53).

In para. 54 they found that "strong coordination of macroeconomic policies among the leading industrial countries is critical to greater global stability and reduced exchange rate volatility", and in para. 55 they acknowledged the need for "the multilateral financial institutions ... to give high priority to the identification and prevention of potential crises, to strengthening the underpinnings of international financial stability", and they also urged the international financial institutions to "strengthen their surveillance of all economies".

None of these recommendations has been followed by appropriate action, and this is one of the reasons why today the world economy is in a very fragile state and at the brink of a global recession. UNCTAD has made numerous proposals over the past few years on how to strengthen global policy coherence and global economic governance in a world where economic interdependence and the integration of financial markets has increased dramatically without a commensurate strengthening of the global economic governance system. UNCTAD has also repeatedly urged policymakers in the major economies of the world to go beyond a narrow national focus and to assume their responsibilities for the world economy as a whole, through serious and meaningful policy coordination between surplus and deficit economies. But so far, no coordinated policy action that could reduce the risk of a hard landing of the world economy has been taken. Moreover, steps to enhance the role of the IMF in policy surveillance of the main industrial countries, whose policies have a global effects, have remained half-hearted and ineffective.

The IFIs are still ill-equipped to respond in a timely and appropriate way to the needs of developing countries when a crisis looms, because progress in reforming lending facilities and making them more suitable to the needs of the IMF's main clients has been extremely slow. Similarly, there has been practically no progress towards the creation of a mechanism for orderly international debt workouts.

By contrast, and partly in response to the slow progress in the reform of the international financial system, monetary and financial cooperation at the regional level has been strengthened and advanced and has increased its potential to play a stabilizing role.

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The lack of progress in solving the systemic issues that are related to financing for development is not without consequences for the prospects of developing countries. Should the present substantial downside risks in the world economy materialize, the consequence would be a halt or even a reversal of the developmental progress that has been achieved in recent years. To a considerable extent, these downside risks are related to shortcomings in the system of global economic governance, in particular a lack of coherence between the international trading system, which is governed by set of internationally agreed rules and regulations, and the international monetary and financial system, which is not.

At present, economic prospects world-wide depend on the outcome of turbulences in financial markets that started last summer with the sub-prime mortgage crisis in the United States. The lessons for dealing with the systemic aspects of the current crisis still remain to be drawn, although it should have become clear by now that the international financial system in its present form is unable to function for more than three or four years without an unsettling crisis. Recurrent episodes of financial volatility appear to be driven by a financial alchemy that is based on massive leverage and opaque instruments, on the one hand, and the need of realigning the value of financial assets with that of the underlying real assets, on the other. More effective regulation may be necessary to promote sustained and innovative financial development while preventing financial engineering that rewards excessive risk-taking.

The large global imbalances in current account positions are mainly the result of a lopsided geographical distribution of domestic demand, which has grown much faster in the United States and other deficit economies than in the developed countries with large surpluses, especially Japan and Germany. This indicates an incoherence over many years of macroeconomic policies among the major developed countries. Moreover, the fact that for a long time exchange rate developments did not mirror the current account positions of countries points to a major problem with the exchange rate system. The delay of exchange rate adjustments that would help prevent the build-up of unsustainable imbalances is largely the result of a predominance of speculative capital flows, especially the so-called carry trades, but it is also attributable to a lack of effective international monetary cooperation and coordinated macroeconomic management in the major economies.

The question of when and how the global imbalances will be corrected presently implies the greatest risk for sustained economic growth in the world economy, and in the developing world in particular. If the financial turbulences will bring about a large and abrupt unwinding of carry trade positions – which have been estimated at around \$1 trillion – it is likely to result in a global recession and financial crisis. Under this scenario, emerging markets would receive negative shocks in the real sector of their economies (because of reduced demand for their exports) as well as in the financial sector (because of considerably higher financing costs). A recession would most likely also trigger a sharp decline of commodity prices and stunt economic growth in many developing countries, including many of the poorest.

In the present situation the impact on the world economy resulting from declining imports of the United States in connection with slower growth or even recession in that country, could be counterbalanced by more demand-stimulating policies in other countries, the main candidates being the developed countries with large current account surpluses, such as Germany and Japan. Some of the oil-exporting surplus countries may also have scope to increase their imports. By contrast, the macroeconomic situation in China does not allow for a similarly strong stimulation of domestic demand, but a continuation of the measured appreciation of the Chinese currency, as is already under way, may be equally important. In any case, an orderly

restructuring of global current account position requires much greater multilateral concertation of international action than at present.

The apparent failure of foreign exchange markets to bring about changes in exchange rates that reflect shifts international competitiveness and in current account balances suggests the need for reviewing the institutional framework of the international exchange-rate system. The recent exchange-rate misalignments and financial turbulences have also shown, once again, the need for financial sector reforms at both the national and international levels, including the design of more appropriate international rules and regulations and more effective international financial institutions. In particular, it is necessary to strengthen the supervision of financial markets and increase the transparency of structured financial products. Instability in international currency and financial markets is the result of unregulated international financial activities and clearly cannot be remedied by national policies alone.

As in international trade, strengthened multilateral rules and institutions could help reduce uncertainty and instability in international financial markets and induce greater compatibility of national macroeconomic policies. If we recognize that financial markets are much more integrated and interdependent internationally than goods markets, the idea of closer multilateral monetary cooperation is at least as plausible as the idea of a multilateral trading system.

Moreover, in order to achieve greater coherence in global economic governance it will be necessary to strengthen the institutional framework to address the potential impact of volatile capital flows more adequately and effectively. Emerging markets and developing countries would be in a better position to face this challenge if they could have more confidence in receiving timely multilateral financial support, for which a new IMF liquidity instrument is required.

The recent boom in the markets for many internationally traded primary commodities should not obscure the problem of large commodity price fluctuations and commodity dependence, which makes many developing countries extremely vulnerable to cyclical variations in global demand and to structural shocks, something that represents a major obstacle in their efforts to combat poverty and narrow the gaps that separates the income level of the poorest countries from the world average. The risk of a sharp drop in commodity prices due to a marked slowdown of global growth, on the one hand, and increased supply capacities, on the other, is very real. Again, the international economic system would gain coherence if new efforts were made to create mechanisms that would contain or mitigate their impact on commodity-dependent developing countries.

The effectiveness and public support function of the Bretton Woods institutions could also be improved by restoring their legitimacy through a significant redistribution of voting power in favor of emerging market and developing countries as a group that reflects the increased importance of this group of countries in world output and international trade and financial transactions. A redistribution of quotas should better reflect the degree of openness of the different countries and their vulnerability to external shocks.

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On top of these issues related to the macroeconomic and financial aspects of development a number of new systemic issues have emerged since the Monterrey Conference, and these will also require action at the level of the international economic system.

One of them lies in the area of public finance, especially taxation and other forms of collecting public revenue. Fiscal competition is emerging as a systemic issue, as countries aiming to provide attractive conditions for investors from abroad offer them lighter fiscal treatment. This tends to lead to a race to the bottom, with developing countries losing potential development gains to multinational companies, if no coordination takes place at the supranational level.

Similarly, the proliferation of bilateral free trade agreements between developing and developed countries is a systemic issue insofar as it is a response to the lack of progress in multilateral trade negotiations and leads to a situation where developing countries feel obliged to enter into such FTAs for fear of seeing their market access deteriorate relative to those of their neighbours that are negotiating such agreements. Again, the only way to avoid a race to the bottom in concessions made by developing countries in negotiating bilateral FTAs would be common or coordinated action.

Another systemic issue in the area of trade is related to biases and asymmetries in the international trading system resulting from the difference between legal and economic equality: WTO rules and regulations apply to all members equally in legal terms, but can have a different impact in economic terms on countries, depending on their level of development. For example, restrictions on the use of certain policy instruments in support of trade and industrial development have a much stronger impact on developing countries that are at early stages of their industrialization and trade integration than on the more mature economies. Policy space has, thus, become a systemic issue that is of particular importance for developing countries.

But probably the most pressing systemic issues in the years to come will be that of how to deal with the challenge of climate change. Here, it is important to recognize that developing countries and especially the poorest countries and communities, which contribute little to global warming, are likely to suffer the earliest and hardest from climate change, which arises mostly from present and past emissions generated in the most advanced economies: current per capita carbon emissions in developing countries are only a fifth on average of those generated in advanced countries.

Climate change is an issue of worldwide dimension with a consequent need for global action and institution building, not only because causalities and impacts are global, but for policies to mitigate the impact and to stop or reverse the trend to be effective they will also need to be adopted at the international level and involve all countries. Innovative and additional financing mechanisms will be needed to expand the supply of, and access to, alternative sources of energy, to support low-carbon policies and programs in developing countries, and to finance the costs of adaptation. Greater international cooperation to develop and transfer low-cost technologies to developing countries would be critical to meet the challenges of both mitigation and adaptation.