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Statement by
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TO THE HIGH-LEVEL POLICY DIALOGUE OF
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Short-term world economic conditions remain positive for developing countries, but risks are increasing

As shown in the update of the *World Economic Situation and Prospects* before you, the world economy has performed well this year. Some moderation in global growth is expected, however, in the second semester of 2006. This reflects a number of downside risks that have heightened recently, as partly seen in the conspicuous increase of volatility in global financial and commodity markets over the past two months.

At the same time, the rapid and fairly broad growth of the developing countries—undoubtedly the most positive global economic trend in recent years—persists. In 2006, the developing world will again, as in the two previous years, register a growth rate of more than 6.0 per cent, comparing favourably with 2.7 per cent for the industrialized world. The LDCs in particular will reach an unprecedented rate of over 7 per cent.

The solid growth figures of developing countries reflect a very favourable international economic environment. Among the elements that make up this environment, let me mention first debt relief for some of the world's poorest countries and the increased commitments in relation to official development assistance. Developing countries have also benefited from strong growth in world trade, from strong commodity prices fuelled by economic expansion in some large developing economies and, until the first quarter of 2006, from exceptional access to international private capital markets.

Yet, this mix of exceptional conditions is threatened by increasing risks. The first are the uncertainties surrounding current trade negotiations. The increased volatility of commodity markets in the first half of 2006 also signals the risks that commodity-exporting economies face in the current conjuncture. And rising interest rates in industrialized countries have been accompanied in recent months by a "flight to safety" by investors in financial markets, implying less financing at higher costs for developing countries.

The global economic outlook itself features increased uncertainties. As is well known, some of the major risks are associated with the global imbalances, particularly the high current account deficit of the United States, which is expected to reach over $900 billion in 2006. This continues to create the possibility of a sudden and sharp disorderly adjustment of global imbalances, especially through a large devaluation of the dollar, or a significant slowdown of the

US economy, both of which would have adverse effects on the world economy. In turn, although high oil prices have so far not had major adverse effects on world economic growth, we are seeing a rise in the risks posed by adverse supply shocks and contractionary monetary policies in response to higher inflation.

To maintain a solid, broad-based and stable world economic growth, we need more international cooperation to address these risks, particularly to redress the global imbalances while avoiding recessionary adjustment in the US. Given its nature, the International Monetary Fund (IMF) should take a leading role on this front. We thus welcome the agreement reached by the International Monetary and Financial Committee (IMFC), during the 2006 spring meetings, to place multilateral surveillance at the centre of the IMF's work.

Rising international inequality in the long-run is a major concern

Despite the improved breadth of performance by developing countries, both recent and past experience indicate that some of the currently favourable conditions tend to be highly volatile. In fact, as argued in the other report before you—the *World Economic and Social Survey 2006*, over the past three decades, the incomes of developing countries have on average fallen further behind those of the developed world. International economic inequality has thus increased. More precisely, since 1980, the world has witnessed a process of *dual divergence*: an increasing income gap between developed and developing countries, paralleled by a process of growth divergence among developing countries.

Let me underscore the four major findings of the *World Economic and Social Survey 2006*. First, success and failure in achieving sustained economic growth appear to be concentrated in time and space. This means that the growth of individual developing countries depends not only on their domestic economic policies—the focus of debates in recent decades—but also on the regional and global economic environments. During the so-called golden age of 1950-1973, most developing regions experienced rapid economic growth. In contrast, the final two decades of the twentieth century brought a worrisomely large number of "growth collapses", with only a few developing economies able to sustain fast rates of growth.

This finding helps to explain our concern about greater international economic inequality. The divergence seen in recent decades has come mainly from growth failures in a large number of countries. This is quite different than a situation in which global inequality is rising because some economies are growing faster than others, but in the end all countries gain. Moreover, widening global inequality itself diminishes the growth prospects of the less advantaged countries. This is so because markets may exacerbate inequality, as successful countries accumulate richer endowments and as capital follows success, while those left behind remain more vulnerable to shocks in international financial and commodity markets.

The second major finding of the *Survey* is that, compared to growth in industrialized countries, growth in developing countries is much less about pushing the technological frontier than about changing the production structure in order to shift resources towards activities with higher levels of productivity. More broadly, sustained economic growth is associated with the capacity to diversify domestic production structure: that is, to generate new activities, to strengthen economic linkages *within* the country and to create domestic technological

capabilities. The industrial and modern service sectors typically contribute dynamically to this diversification process. In contrast, de-industrialization and concentration of growth in informal service activities is a certain recipe for growth failure.

Observation of growth patterns suggests that the *domestic* factors that determine the capacity of a given economy to succeed in structural transformation of production structures are more important than integration into world markets *per se*, and that not all patterns of integration into international markets have the same effect on economic growth. According to the *Survey*, the countries that profit most from FDI are those whose domestic firms and institutions have the requisite absorptive capacity and help to build domestic technological capability through linkages created between domestic firms and foreign affiliates. At the same time, countries that have integrated into the more dynamic world markets for manufactures and services have performed better than those that have specialized in primary goods and natural resource-intensive manufactures. For the success of the latter, diversification seems to be a *sine qua non*. Finally, specializing in low-value added activities with weak domestic linkages generates low economic growth. In sum, a successful export strategy is a question not of *how much* countries export but rather of *what* they export and how their export sectors are integrated with other *domestic* economic activities.

The *Survey's* third major finding is that macroeconomic stability, investment and growth are mutually reinforcing. But stability means more than low inflation; it also means avoiding strong swings in economic activity, as well as avoiding external imbalances and/or financial crises. This is why *counter-cyclical* macroeconomic policies play such an important role in economic growth. In this regard, the *Survey* argues that in recent decades macroeconomic policy in most developing countries has become excessively pro-cyclical, largely reflecting the volatility of financial markets and commodity prices. Stimulating developing country growth and reducing world inequality will therefore require encouraging and opening up more space for counter-cyclical macroeconomic policies in the developing world.

Insufficient fiscal space, associated with pro-cyclical fiscal adjustment, has also been detrimental to long-term investments in infrastructure and human capital. The *Survey* finds, for instance, that lagging infrastructural development likely accounts for as much as one-third of the income gap between East Asia and Latin America. In contrast, the analysis shows that official development assistance, when not determined by geopolitical factors, has a strong positive impact on long-term growth—essentially because it tends to support long-term investments in infrastructure and human development.

In its fourth major finding, the *Survey* puts forward a broader definition of institutional reform, encompassing more than creating markets and guaranteeing property rights. It also includes creating the regulatory and institutional framework that markets require to function, providing necessary public goods, and guaranteeing the fairness of rules. Equally important, the analysis shows that institutional reform does not need to be large-scale and comprehensive from the outset, and, indeed, that "big bangs" in institutional reform may generate more harm than good. In contrast, minor and gradual institutional change can have a great impact on growth if it is perceived as initiating a further process of credible reform.

Overall, some of the *Survey's* findings may not appear to be particularly surprising to those familiar with classical perspectives on economic development, but they certainly provide new and meaningful insights in light of the more recent debates on economic development. In this sense, the *Survey* helps to explain why the conventional strategy followed since the 1980s for closing the income gap between the developing and developed worlds—focused on unleashing market forces and integration into global markets—has been only partially effective.

An agenda for reducing international economic divergence

Based on these findings, the *Survey* advances a strategy for reducing international economic divergence, centred on an assertive but flexible agenda for domestic development, facilitated by international cooperation and rules that guarantee the appropriate "policy space" for developing countries. Such an agenda should address, among others, the following four issues:

- One, *fostering active trade and production sector policies* to encourage the structural transformation of developing country economies, aimed at encouraging the diversification of production sector structures, creating strong domestic linkages among production activities, and upgrading technologies. International rules should be reviewed in this light, while avoiding at the same time some mistakes of past industrial policies.

- Two, *open up more space for counter-cyclical macroeconomic policies,* striking a better balance between fiscal and monetary prudence and flexibility, and making price stability less an objective in itself than an intermediate goal of economic growth and employment creation. The effectiveness of these domestic policy efforts will also require policy interventions at the international level to dampen financial volatility.

- Three, e*nsuring sustained levels of public spending* to make the necessary investments in infrastructure and human capital. This means that additional fiscal space needs to be created through increased efficiency of public expenditures, through improved governance and strengthening of the tax base and, for the poorest countries, through additional official development assistance (ODA).

- Four, *promoting gradual, country-specific and home-made institutional reforms*. International cooperation can help in this regard by supporting such gradual domestic processes, by fully respecting the principle of ownership of domestic policies and institutions and, particularly, by avoiding the proliferation of institutional conditionality.

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I hope these two reports from the Department of Economic and Social Affairs (DESA) will enrich the deliberations of the Economic and Social Council. Reducing global inequality should be at the centre of the UN development agenda, and can help avert economic and social crises and even political instability. I urge you, Mr. President and distinguished delegates, to focus more concerted attention on this issue, so that people and states alike can reach their full potential.