Speaking notes for
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ECOSOC High-Level Segment

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AS PREPARED FOR DELIVERY

Excellencies,
Distinguished delegates,
Ladies and gentlemen,

Let us get straight to the heart of the matter: is austerity in advanced countries the best policy choice to achieve sustainable growth and how does this impact developing countries? I would like to outline several reasons why UNCTAD believes this is not the best choice, and the mechanisms by which the policies around austerity and debt deflation negatively affect developing countries. I will also propose how coordination efforts at the international level, particularly via the G20, should be oriented towards sustainable growth and more inclusive social outcomes, as envisioned by the "Seoul Development Consensus for Shared Growth", proposed last November.

Firstly, a quick look at global growth prospects

The global crisis and its aftermath have provided a reordering of the world economy. As we all know, the United States acted as the foremost global growth engine in the 1990s, contributed sizeably in the early 2000s and, to a lesser extent, since 2009. By contrast, China has emerged from the global crisis challenging the United States as global growth engine no. 1. The euro area, which is the single largest negative contributor in 2009, has played a disproportionately small and declining role as a source of global growth, despite being the world's largest trading region.

Apart from a group of "crisis countries" concentrated among transition economies in Central and Eastern Europe and the Commonwealth of Independent States, the developing world at large experienced the crisis as a sharp but brief slowdown in the rate of GDP growth, rather than as a protracted absolute decline in GDP. Despite growth resuming or even exceeding its pre-crisis pace in 2010, considerable unemployment (or underemployment) still exists in many parts of the developing world, especially among the poorest and highly indebted countries.

A focus on inflation is harming growth prospects

In advanced economies inflation fears are vastly overblown at this juncture. Enormous labour market slack exists in the United States and Europe, where wages are barely growing and real wages are under pressure due to food and energy price shocks. Weak employment growth together with stagnant wages hinders a sustainable domestic demand-led recovery. Especially in certain peripheral euro area countries debt deflation represents an additional threat.

Nor does faster wage growth in China pose any imminent global inflation threat but may actually be an important element in rebalancing the Chinese economy towards private consumption growth. While private consumption expenditure has grown very strongly throughout the 2000s (at an average annual rate of 8 percent), as a share of GDP private consumption has declined to a level of only 34 percent. Moreover, the share wages in Chinese GDP has shrunk from 57% in 1983 to 37% in 2005, meaning that the bulk of productivity gains have been accruing to capital. This very low share of wages in GDP even led commentators [the Financial Times] to describe China as "the most 'Capitalist' large economy in history".

The surge in headline inflation in China to above 5 percent was mainly driven by food prices, where – as for most developing countries - commodities represent a greater weight in the consumer price index. Developments in China are of critical importance to both developing and advanced economies, and at the price front, China's global impact is especially felt in commodity markets and markets for industrial products. It is true that faster inflation in developing economies, if uncompensated for by exchange rate movements, could mean rising import prices and worsening terms of trade in advanced economies (in contrast to the dis-inflationary effects of falling import prices in the pre-crisis era). Whether rising import prices might trigger an acceleration of underlying inflationary pressures in the importing advanced economies depends on the state of the economy. Presently risks of overheating in the euro area are nonexistent and the fear of inflation and consequent monetary response is exerting a downward pressure on growth and employment.

A combination of deflation and export-led recovery could harm developing countries

Perhaps the most important contribution of very easy monetary policies is that of keeping the costs of rising public debt in check. Other than that, the Quantitative Easing 2 (QE2) policy initiative has been of limited domestic effectiveness, even including some counterproductive side-effects. One critical issue concerns the distributional impact: at the top of the income distribution, rising stock prices have benefited the top quintile; at the other end, QE2 has failed to rescue the housing market slump.

Historically, the dollar has been inversely correlated with commodity prices, which would suggest that Federal Reserve easing and dollar depreciation are linked to recent commodity price rises. In fully recovered and fast-growing developing economies the impact of rising commodity prices and asset bubbles is creating pressures for monetary tightening, with potentially destabilizing consequences. Rising interest-rate differentials attract capital inflows, especially the kind of hot money associated with the carry trade. In developed economies, such as the US, the effects of easing and a depreciating dollar while helping exports have in fact, via commodity price increases, created a tax on lower income consumers especially.

For developing countries there are only a few policy options available to counter the pressure from a depreciated dollar and inflows of hot money – the upward pressure of which, on the exchange rate, is creating a new incarnation of the "Dutch Disease". With little room for interest rate movements, governments have resorted to an effective, albeit expensive form of self-insurance. This principally involves currency market interventions and reserve accumulations, with some countries using additional capital account controls or taxes. A far better solution would be greater coordination and management of exchange rates, which I will come to in a minute and which is proposed in our forthcoming Trade and Development Report 2011.

Growth could be further jeopardised by a contractionary fiscal policy stance

Whilst the issue in many developing countries is one of avoiding overheating and premature growth slowdown, the situation in major advanced economies is far more worrisome. In this group of economies, the pressures are growing by the day for unconditional austerity without regard for the still fragile state of the economy.

It is important to bear in mind that sharply increased budget deficits and rising public debt ratios are a consequence of the global crisis, a crisis which began as a private debt crisis. With the exception of Greece, fiscal profligacy was neither the cause of the global crisis nor responsible for its fiscal aftermath. It is undisputable that the causes of the global crisis lay in private debt binges and "out of control" financial markets. While taxpayers are presented the bill for these private debt excesses, blaming the current predicament on fiscal profligacy would be wholly misplaced. The sustainability of public finances critically hinges on GDP growth and on the interest rate paid on the public debt.

Ignoring these fundamental determinants would be hazardous and austerity may therefore worsen rather than improve the fiscal position. The primary policy focus has to be on sustaining growth and employment, with cooperative monetary policy needed for purposes of keeping the interest burden in check. To do this, stimulus measures are still required

Fiscal retrenchment shows that employment and wages are not being prioritised

Many governments have pinned their hopes of recovery and employment generation on export-led growth. However, trade is a zero sum game and so not everyone can be a net exporter, like Germany for instance. In such cases domestic demand is constrained by low consumption and people don't have the money to consume because currently they are cautious, they have lower real incomes due to wage restraint and, additionally, most people in rich countries have been compensating for falling purchasing power with increasing indebtedness, which has now been restricted.

As my example of China showed earlier, trends in personal income distribution confirm that income inequalities within many advanced as well as developing countries have increased significantly in the era of finance-led globalization. The extent to which "mass incomes" have fallen behind is creating hazardous headwinds in the current recovery. Stagnant domestic demand gives way to downward price and wage pressures, risking a deflationary spiral that constrains domestic demand while pushing countries towards export reliance for their growth.

Japan's "lost decade(s)" are a warning of the challenge that is mounting at the global level today. Failure to halt deflationary pressures on prices and domestic demand has left the Japanese economy excessively dependent on exports. As the compensation of Japanese employees stopped growing, so did private consumption. The association between growth in compensation of employees and private final consumption expenditures is generally very close. Owing to deliberate wage compression since the mid 1990s Germany is trailing the Japanese experience quite closely, with vastly destabilizing consequences inside the euro area. In the United States, relative wage compression was magnified by redistributive tax policies, but the impact on domestic demand was offset by easy credit policies - an experiment that ended in disaster.

Any revival of pre-crisis trends in income distribution would jeopardize the global recovery. Globalization has shifted the balance of power in favour of large globally active corporations and players, including financial institutions, leaving employees at large more exposed to global forces, with weaker or non-existent national safety nets. In many developed as well as developing countries the forces unleashed by globalization have produced significant shifts in income distribution away from wage income and towards profits. In major advanced economies the inherently deflationary consequences of these trends for domestic demand were temporarily offset by easy credit and rising asset prices. But the global crisis has exposed the limits of the "finance-led growth" model in a rather calamitous way.

On top of the risks immanent to premature fiscal consolidation there is a heightened threat today that policy may accentuate downward pressures on wages and labour incomes arising from labour market slack, ignoring the vital role of private consumption expenditure in rendering the global recovery sustainable.

The role of international coordination and the G20

The global crisis highlighted major shortcomings in global governance, especially concerning the global monetary and financial system. The G20 should be commended for its positive actions on the governance of the global economy, and in particular the coordinated fiscal response of countries at the time of the crisis in 2008 and 2009. Continued G-20 efforts for international economic cooperation are important because globalization requires proper global governance.

However, since then, members have diverged in their policy approach to growth generation and their enthusiasm for coordination appears to be waning. That global policymakers no longer see eye to eye as to the global policy requirements that may be warranted at the current juncture is making matters worse. In the absence of effective global coordination the balance of risks to global recovery and demand rebalancing is clearly skewed towards the downside.

Moreover, the lack of a global monetary order guaranteeing stabilizing exchange rate movements and smooth balance of payments adjustments still stands as the biggest issue for global imbalances and related systemic risks. Financial globalization without proper global regulation and supervision has squeezed peripheral countries' monetary policy space, but increased their vulnerability to unfettered and generally destabilizing capital flows. The progressing financialization of commodity markets and observed negative correlation between commodity prices and global monetary conditions set by the reserve currency issuer have further raised the stakes.

Have we learned the right lessons from the crisis? Has the global crisis inspired initiatives for the right kind of global governance reforms?

As a revival of the pre-crisis global growth model seems neither feasible nor desirable, a general policy reorientation is warranted if the declared G20 objective of sustainable recovery and global rebalancing is to be achieved. Rethinking fiscal policy and avoiding premature consolidation is one issue. Halting and reversing unsustainable distributional trends is another. Sustainable growth and development will require more balanced income developments than experienced during the last three decades. To quote the Seoul Development Consensus: "for prosperity to be sustainable, it must be shared". Thank you.