
Ravneet Kaur
Chairperson & Managing Director,
Export-Import Bank of India

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**Exim Bank Commencement Day
Annual Lecture**

on

**“Reconstructing Economic Governance:
An Agenda for Sustainable
Growth and Development”**

by

Dr. Supachai Panitchpakdi
Secretary-General,
United Nations Conference on Trade and Development

on Thursday, March 18, 2010 at 6.00 p.m.

Dr. Subir Gokarn
Deputy Governor,
Reserve Bank of India

will preside

Venue :
Yashwantrao Chavan Pratishthan, (Y. B. Chavan Centre),
Near Mantralaya, Gen. Jagannath Bhosale Marg,
Mumbai – 400 021



EXPORT-IMPORT BANK OF INDIA

**“Reconstructing Economic Governance:
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“Reconstructing Economic Governance: An Agenda for Sustainable Growth and Development”

Dr. Supachai Panitchpakdi

The economic crisis of 2008-2009, which is still persisting in many parts of the world, signalled a radical change in government policy and international economic governance. Here are a few examples: First, the so-called “market fundamentalism” that had given rise to innovative but often unregulated and opaque financial instruments has been savagely criticized for not in fact serving the interests of the real economy. Second, the small exclusive group of seven advanced industrialized economies has found itself needing to become more inclusive – and should become more inclusive still. Third, the neoliberal preoccupation with inflation and tight fiscal policy was turned on its head when global demand fell off a cliff and governments had to pump various stimulus measures into their economies to keep them alive. And fourth, the dogma that governments should not underwrite their industries let alone nationalize them was brushed aside to salvage leading financial institutions whose imminent collapse threatened the foundations of the entire global economic system.

I don't think there is anyone in this room who would consider this hyperbole, or who doesn't recognize

the quite radical change in government policy that has occurred in the midst of the crisis. However, this is not the end of the story: the signs of recovery that we see today, albeit weak and not yet sustainable, should not tempt us to return to “business as usual”. We should not go back to the boom-and-bust cycles that characterized the last 30-to-40 years of economic growth, in which the world experienced roughly one major international crisis every decade, and numerous regional crises in between. UNCTAD had been warning about the coming crisis for several years¹, and moreover about the dangers of focusing economic policy and governance on a restricted set of macroeconomic targets in the hope that rising productivity, increased employment and technological upgrading would automatically follow. My purpose here today, therefore, is to argue that not only have we needed to change economic policy and governance to halt the economic crisis, but we should continue to refocus the goal of economic activity on building productive capacities and hence sustainable employment and growth opportunities. That process requires reforms to economic governance structures as well as changes in policies that have governed economic activity for many years at both the national and international levels.

By way of a working definition, we can say that economic governance relates to the institutions,

¹ See, for example, UNCTAD (various editions). Trade and Development Report. United Nations publications, New York and Geneva.

rules and policies that guide, regulate and coordinate economic activity in support of socially desirable outcomes. Economic governance could be seen as the relationship between governments and the national-level institutions create by governments, on the one hand, and between member States and supranational level institutions, on the other².

In the current context of the global economy, there are two principal views of economic governance, which are not incompatible but whose differences are more a matter of emphasis and scope. The first essentially sees global governance in terms of delivering global public goods. Not only has the economy become more internationalized, but we have become more aware of interdependent threats and opportunities, such as climate change, trade and finance, whose governance structures are still strongly grounded at the national level. This view holds that governance structures at the international level therefore need to be strengthened to meet these new realities.

The second view argues that instead of trying to expand global governance structures, we should instead reclaim some of the areas enveloped by globalization so that the State has more control over the actions and prospects of its businesses and citizens. This view does not, however, simply promote national interests, but rather provides a

²For further discussion, see: Nayyar, D. (2002). *The Existing System and the Missing Institutions*. In Nayyar, D. *Governing Globalisation*. Oxford: Oxford University Press.

stronger political basis for the revival of multilateralism itself. We may also add yet a third view, which recognizes the increasing influence of regional initiatives in creating institutions and policy frameworks to govern regional economic relationships. Here, countries may benefit from regional public goods and at the same time pursue a governance agenda with regional partners that share a closer vision.

Using this framework, I would like first to show how the retreat of the State, and a fervent belief in the allocative efficiency of markets to price everything from exchange rates and risk to investment and comparative advantages has created uneven global economic growth. Second, I will argue that last year's economic crisis, and for that matter, previous and potential future crises, stem from poor governance and a structural inability in the world economy to correct various systemic imbalances. In doing so, I will highlight what UNCTAD has proposed, not just in the aftermath of what could be called an economic 'mega event' – last year's crisis – but as a forward-looking agenda for “sustainable growth and inclusive development”.

Allocative efficiency vs. productive capacities: the State's role in supporting growth and employment

Although I do not want to dwell on history, there are nevertheless some interesting lessons to be learnt

that can help us understand the policies and changes necessary for sustainable growth and development. Over the past 30 years, the economic policy agenda came to be dominated by a set of policy prescriptions focused on meeting short-term macroeconomic targets, such as a balanced budget and low inflation. Additionally, a number of reforms were advocated to make best use of the allocative efficiency of markets, including trade liberalization, the privatization of industry, and capital account liberalization. In the implementation of these reforms no attention was given to the specific needs of countries with weaker economies, and indeed no consideration was made of the fact that in all modern industrialized and emerging economies many forms of government intervention and protection were used to build competitive industrial sectors. Another way of putting this would be to say that in these countries, governments historically maintained their freedom to support and accelerate structural change in a socially desirable direction.

During the 1980s and 1990s, most developing countries undertook far-reaching market-oriented reforms. The international financial institutions played a dominant role in this context, both as lenders, imposing their policy conditionality on borrowing countries, and as setters of the international development agenda. The market-oriented reform agenda was based on the expectation that capital accumulation, technological progress and structural change would result from more efficient resource allocation following

improvements in the incentive structure and reduced State intervention. “Getting the prices right” was the catchphrase for this agenda.

However, from the very beginning, the orthodox reform agenda, which came to be known as the “Washington Consensus”, was viewed differently in South East Asia. Although some elements of the policy framework were regarded as useful and were applied fully, on the whole, the South East Asian economies followed a pragmatic approach to policy making with a focus on growth and sustained development. They also approached integration into the international economy, whether through trade or investment, in a more measured manner and used proactive macroeconomic policies. As I have argued in a forthcoming article³, in South East Asia, the concept of "market failure" was not defined in relation to the efficient allocation of resources, as the conventional wisdom dictated, but rather in relation to the ability of the market mechanism to achieve specific development goals set by the government. Unlike the experiences of many other developing countries that intervene extensively in the market often with devastating impacts on the private sector, government intervention in many South East Asian countries was not designed to constrain the business sector or replace private enterprise with centralized state control but to enhance it .

³Supachai Panitchpakdi, (2010). The role of UNCTAD and the development of the South East Asia region. Devawongse Varopakarn, Institute of Foreign Affairs, Bangkok, Thailand. (Forthcoming)

This, of course, does not mean that governments in this region got policies right all the time, nor did policy decisions always achieve the desired objectives. Far from it – in some cases it was a question of trial and error, learning from mistakes and trying again with different policies. Nevertheless, there were consistent efforts to design policies that promoted the interests of the business sector as a whole and in a manner consistent with a broader national interest. Industrial policy for example has been a hallmark of the kind of policy space that was pragmatically applied in South East Asia. Moreover, interventions by the state tended to be motivated by 'pragmatism' rather than based on doctrine. To illustrate my point further, let me refer to an UNCTAD study which compares the development experiences of East Asia and Latin America in the last decades of the 20th century⁴:

Between 1960 and 1973 Latin America and East Asia grew at much the same rate, and average per capita income in 1973 in the four first-tier NIEs was lower than that in the five largest countries in Latin America by \$850. Thereafter, performance started to diverge sharply, with East Asia growing at more than double the average rate in Latin America between 1974 and 2000. Furthermore, the slowdown in Latin America was accompanied by increasing instability: in most countries of the region, growth in the period 1980–2000 was slower and less stable than in the

⁴UNCTAD (2003). Trade and Development Report. United Nations publications, New York and Geneva.

previous two decades, except for Chile⁵. What is clear from this study is that one region overtakes and diverges quite dramatically from another, and continues to do so (as can be seen in figures 1 and 2).

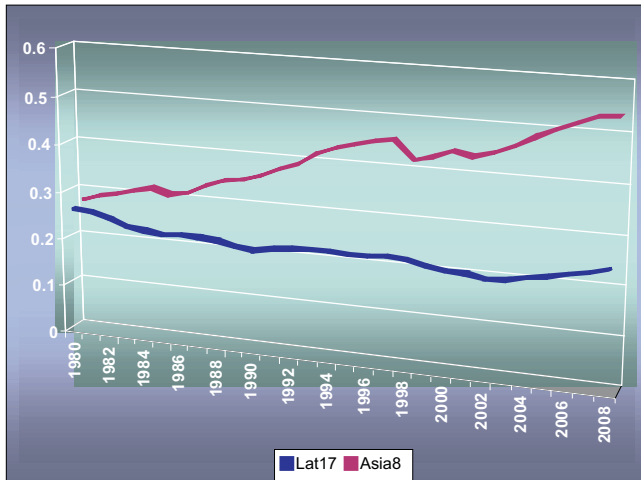
It is important to ask why growth rates differ between countries and regions – a question that has generated a myriad of explanations. Yet among the differing views on this question, there is general agreement that investment is a key variable and that growth cannot be sustained without it. This was highlighted long ago by the Austrian economist Joseph Schumpeter, who pointed to the importance of innovative investment for economic development⁶.

Investment plays a key role because it simultaneously generates income, expands productive capacity and carries strong complementarities with other factors in the growth process, such as technological progress, skills acquisition and institutional deepening. However, the occurrence of innovative investment is not automatic; it can encounter structural and

⁵Like most other Latin American countries, Chile also followed the policy framework proposed by Washington institutions and, in the 1980s, the monetarist policies advocated by the so-called "Chicago school". However, its sustained growth performance may be explained by Chile's political stability, especially after 1973, and its continuous efforts to build effective public institutions, improve the quality of regulations and control corruption. Following the privatization programme in mid-1970s, Chile pursued a private-sector-led growth strategy with active government support. In the 1980s, Chile also took advantage of rising copper prices to modernize its extractive sector and introduce social policies aimed at reducing poverty and improving social opportunity.

⁶Schumpeter, J. A. (1975 [1942]). Capitalism, Socialism and Democracy. New York: Harper.

Figure 1: Ratio between GDP in selected Latin American and Asian economies with respect to G7 (simple averages, period 1980-2008)



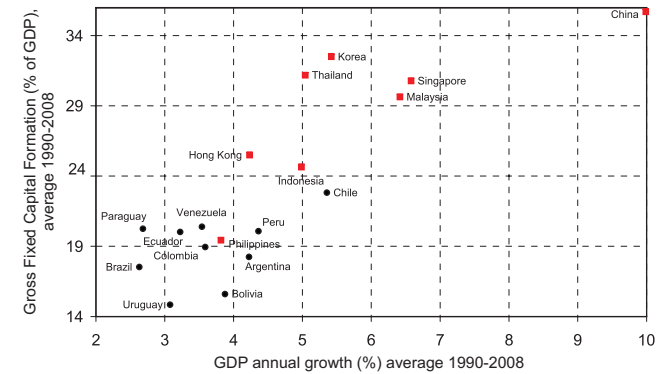
Source: UNCTAD secretariat calculations based on World Development Indicators database, World Bank

Note:

- a) GDP per capita refers to GDP adjusted by PPP based on constant 2005 international dollars.
- b) Lat 17 includes: Antigua and Barbuda, Argentina, Bolivia, Brazil, Chile, Colombia, Dominica, Ecuador, Guyana, Honduras, Nicaragua, Paraguay, Peru, St Vincent and the Grenadines, Suriname, Uruguay and Venezuela. Selected Asian economies includes: Indonesia, Malaysia, Philippines, Singapore, Thailand, Korea, Hong Kong and China. G7 includes: United States, Canada, France, Germany, Italy, United Kingdom and Japan.

institutional impediments. Moreover, the macroeconomic environment can be inappropriate for encouraging and supporting investors seeking to create or expand productive capacity and increase productivity.

Figure 2: Correlation across gross fixed capital formation (as a percentage of GDP) and GDP annual growth (%), selected economies, average period 1990-2008



Source: UNCTAD secretariat calculations based on World Development Indicators database, World Bank

Note:

- a) GDP growth refers to GDP at constant 2000 US dollars.
- b) Data for Colombia refer to Gross Capital Formation share of GDP. For Peru, the average is for the period 1990-2003.

To return to the UNCTAD study I referred to earlier, in Latin America, overall productivity in manufacturing declined or generally remained stagnant and the level of wages fell in most countries during the 1990s. In some cases, there was an improvement in overall manufacturing productivity as a result of labour-shedding rather than investment and the expansion of employment. Even in strong exporters such as Mexico, the rise in manufacturing productivity was small and wages remained stagnant. This shows that, in reality, efficiency gains resulting from market-driven reforms are not always

translated into employment or higher wages. This has also been the case, for example, in Peru in the past 30 years, where exports have been increasing but wages falling.

The competitiveness of manufacturers in many countries in the region was further undermined by sharp currency appreciations, particularly in Argentina, Brazil and Peru. Where investment increased in the context of international production chains, the tendency was for an apparent increase in the technology content of exports without a similar increase in domestically generated value added. In sectors intensive in research, such as pharmaceuticals and ICT, the lag in productivity with those of technological leaders in developed countries widened considerably.

However, the strategy of macroeconomic targeting in Latin America can claim some success. Inflation was brought under control and a reasonable degree of monetary and fiscal discipline was established in the region. Nevertheless, the record in terms of growth, employment and poverty reduction fell short of expectations. The experience does not support the underlying logic of the prescribed policy approach, namely, that an import-substitution growth strategy could effectively be replaced by a market-driven, outward-oriented strategy simply by eliminating inflation, downsizing the public sector, and opening markets to foreign trade and capital. By overlooking more traditional macroeconomic fundamentals, such as aggregate demand, real

interest rates and real exchange rates, the policy choices and institutional reforms designed to remove State-induced distortions have, themselves, weakened long-term growth prospects. The policy orientation failed to produce an appropriate macroeconomic environment for investors and firms to encourage and support the creation, expansion and improvement of productive capacity, while at the same time unleashing the forces of global competition. That has begun to change in recent years thanks to some innovative policy initiatives, including a more strategic use of industrial policy as well as such social policies as the Bolsa Familia programme in Brazil.

In contrast, the East Asian economies developed a very different investment regime. The share of investment in GDP has grown steadily since the 1970s. By the early 1990s, the regional peak of 30% of investment in GDP was surpassed in a number of countries, in some cases by a considerable margin. Investment in machinery and equipment, along with expanding construction in physical infrastructure, were important features of East Asian investment⁷. In addition, these economies (as well as South Asia, India in particular) moved quickly into R&D, attracting substantial amounts of FDI in that area⁸.

⁷See UNCTAD (2008). World Investment Report. United Nations publications, New York and Geneva.

⁸See UNCTAD (2005). World Investment Report. United Nations publications, New York and Geneva. The report indicates that "While it is difficult to quantify R&D by type, among developing host economies the evidence points to the predominance of Asia in innovative R&D for international markets. R&D activities in selected Asian economies such as China, India and the Republic of Korea are becoming increasingly important within the global R&D network of TNCs". See page xxvii.

The East Asian economies also invested heavily in human capital to bring the labour force closer to international standards. This improvement in overall investment was in most cases associated with a stable or rising share of public investment, with strong crowding-in effects.

But perhaps more importantly, the State saw its central task as increasing the supply of investible resources and socializing long-term investment risks. One study of 30 developing countries in the late 1980s and 1990s⁹ found a strong correlation between a high savings rate, a large share of manufacturing output in GDP and a high profit share in manufacturing in the successful East Asian economies. This contrasts with Latin America, where savings rates are less than expected, given the share of profits in national income, and where a fall in the savings rate has been associated with a stagnant or falling share of manufacturing in GDP. UNCTAD research has shown that in addition to household saving, corporate profit has been an important source of project finance for enterprises in East Asian countries¹⁰. Retained profits often gave enterprises the freedom to expand and experiment with new lines of activities.

⁹Ros, J. (2001). *Development Theory & the Economics of Growth*. Ann Arbor: The University of Michigan Press.

¹⁰See UNCTAD (1997). *Trade and Development Report*. United Nations publications, New York and Geneva. See also, Akyüz, Y. and Gore, C. (1996). "The Investment-Profits Nexus in East Asian Industrialization", *World Development*, Vol. 24, No. 3, pp. 461-470.

Thus, the key to the development process is creating the necessary conditions for innovative investment. The most important condition is that firms have access to reliable, adequate and cost-effective sources for financing their investments. Obviously, this is least costly when corporate profits are the main source of investment financing. Indeed, if an investment-profit nexus can be ignited, profits from innovative investments simultaneously increase the incentive for firms to invest and their capacity to finance new investments. Another way of boosting this is for government to maintain high levels of public investment in productive capacities and infrastructure.

On the other hand, when enterprises are heavily dependent on borrowing to meet their needs for fixed investment and working capital, as is the case for new enterprises, the stance of domestic monetary policy is of crucial importance, because high real interest rates tend to increase financing costs and may eventually become prohibitive to new productive investment. An overly restrictive monetary policy may bias investment decisions in favour of financial assets.

To return to the question I posed earlier, about why growth rates differ between countries, it can be seen that investment, and in particular the cultivation of domestic sources of capital formation, is critical to sustainable growth and development. Moreover, the strategic creation of productive capacities has been

more successful when directed by strong government intervention and policy than by market-based reforms. Whilst these reforms are also helpful in the long-term development of international competitiveness, the pursuit of efficiency gains as a strategic objective on their own did not succeed in bringing about growth and development. The governance of economic policy, and those institutions that guide national governments, should therefore opt for a more pragmatic approach, which promotes innovative investment and prioritizes the creation of productive capacities over allocative efficiency.

Global imbalances and exchange-rate movements: governance and coordination at the international level

In an interdependent world, however, it is wrong to regard a strong profit-investment nexus as a sufficient condition for sustained economic growth. There must also be markets available to absorb the potential expansion in output that this implies. Building robust domestic markets is of course key to long-term growth and development, but exporting is also an essential feature of any balanced economy – although just how significant it is can vary from country to country. Certainly, successful exporting is contingent on favourable investment dynamics, a supportive macroeconomic environment, large domestic firms, etc., and hence, a wide range of

conditions must come together for firms that are competitive domestically to become successful exporters in the global markets¹¹. It is also the case that the international environment must be supportive of efforts to forge a dynamic profit-investment-export nexus in developing countries.

At the international level, rarely in the history of global economic governance have there been concerted efforts to imagine the long-term development of the global economy or to manage it. The creation of the Bretton Woods institutions was certainly one such moment, and its architects gave to it a strongly Keynesian design covering monetary and fiscal concerns, governance issues and trade flows. The emergence of a series of UN development bodies, including my own, in the early 1960s¹² was another such moment, and perhaps the establishment of the WTO in 1995 was the last.

UNCTAD has long advocated a multilateral approach to international finance. The principle that well-defined multilateral rules, with a transparent and fair arbitration process to adjudicate on the infringement of those rules by all players, underpins an open and stable economic system and is orthodoxy in the WTO. Yet the same thinking is somehow regarded as anathema when applied to the

¹¹UNCTAD (2006). Trade and Development Report. United Nations publications, New York and Geneva.

¹²UNCTAD (2004). Beyond conventional wisdom in development policy - an intellectual history of UNCTAD (1964-2004). United Nations publications, New York and Geneva.

financial system. Beggar-thy-neighbour policies on currency depreciation are tantamount to protectionism, and indeed can have a far more distorting effect than tariffs. At worst, they could also incite a cycle of retaliation either through competitive exchange-rate adjustments or through other protective measures.

Obviously, there are important differences between the impact of exchange-rate changes and tariffs on trade, the most important being that tariffs are product-specific, while exchange-rate changes affect the relative prices of all traded goods and services. Another important difference is that tariff changes are predictable, while exchange-rate movements are not. The latter are frequently unrelated to economic fundamentals and strongly influenced by the changing moods of financial market participants. But tariffs and exchange-rate changes both affect the competitive positions of domestic vis-à-vis foreign participants in goods markets, and thus both affect the geographical pattern of trade flows. Financial markets are much more integrated and interdependent internationally than goods markets. As a result, adverse spillovers from exchange-rate and financial policies have much stronger repercussions on global stability and prosperity than trade policy. Therefore, it is even more imperative to ensure that any future reform of the international economic governance system envisages closer and more effective monetary cooperation within a strengthened framework of

multilaterally agreed rules and regulations. This should involve macroeconomic surveillance of, and advisory functions for all countries by an international body, similar to the framework of the multilateral trading system.

Since experience has shown that under a regime of open capital accounts neither completely fixed nor fully flexible exchange rates can ensure financial stability, the solution must lie with intermediate regimes of managed floating. Exchange-rate changes are necessary to compensate for the price and cost developments between a high-inflation and a low-inflation country. However, exchange-rate changes, and in particular, real exchange-rate changes that determine the competitiveness of the whole economy, cannot be left to the market. Stabilizing rates within certain limits will require significant foreign exchange market interventions. On the other hand, it has to be acknowledged that attempts by many countries to keep their currencies at an undervalued rate may result in a race to the bottom or in competitive devaluations that would be as harmful for the world economy as in the 1930s. Indeed, avoiding competitive devaluations was a central idea behind the foundation of the IMF. But the existing global economic governance system lacks institutional arrangements that could exercise multilateral discipline on exchange rates.

Most of the financial crises in the post-Bretton Woods era of floating exchange rates have been

characterized by nominal interest rate differentials that have triggered large short-term capital flows. As a rule, the quantity of inflows is big enough to increase the short-term attractiveness of the high-inflation country's currency, resulting in appreciation, which further raises the return on investment.

In what is a clear systemic failure, an appreciation of the currency of the higher-inflation country fundamentally undermines the normal functioning of the “exchange-rate mechanism” in the short term. The high-inflation country's higher prices on the world market are not offset by a nominal depreciation, and the appreciation adds to the loss of competitiveness of that country and worsens the current account situation rapidly.

If exchange rates do not follow the purchasing power rule in the short term and destabilize the external accounts, the introduction of this rule as a political target is the only way out. The presence of the carry trade brings into question the widespread acceptance of floating as the only feasible solution to the problem of the external balance¹³. Brazil's competitiveness, for example, is not helped by inflows of hot money that seek to exploit the high interest differential between Brazil and other countries. Such inflows contribute to appreciating

¹³See, for example, UNCTAD (2007). Trade and Development Report. United Nations publications, New York and Geneva. And, UNCTAD (2009). Trade and Development Report. United Nations publications, New York and Geneva.

the exchange rate and to any inflationary pressures that exist in the economy. Conversely, the pressure on China to float its currency could actually end up encouraging carry trade and, with a depreciation of the renminbi, a further increase China's competitiveness. Such an outcome would accentuate global imbalances.

In the same way as intended by multilateral trade rules, a well-designed global financial system has to create equal conditions for all parties involved and help to avoid unfair competition. Avoiding competitive depreciations and other monetary distortions that have negative effects on the functioning of the international trading system is more important in today's highly interdependent world than at any other time in history.

Instability in international currency and financial markets is the result of unregulated international financial activities and clearly cannot be remedied by national policies alone. Therefore, apart from strengthening national and international frameworks of financial regulation, it is also imperative to provide for an institutional framework for better international coordination of financial regulation and supervision. Equally important is to reshape international monetary arrangements that help avoid the build-up of large current-account imbalances and their counterpart, large unbalanced asset positions across countries. Such an agreement would hopefully address the current potential for regulatory

arbitrage, which under a system of loosely coordinated national policies, makes a mockery of efforts at financial system reform.

Speculative capital flows and the need for controls

The realization that in a globalized world “shocks” emanating from one segment of the financial sector of one country can be transmitted rapidly to other parts of the interconnected system, including those countries with only weakly developed financial sectors, raises some fundamental questions about the wisdom of global financial integration of developing countries in general. The experience with the current financial crisis calls into question or debunks the conventional wisdom that dismantling all obstacles to cross-border private capital flows is the best recipe for countries to advance their economic development. This has been part of mainstream economic advice since the 1980s. While it is agreed that global finance has caused the current crisis, there is still a good deal of resistance to reforming the global financial architecture. Debates about reform focus primarily on improving national prudential regulation and supervision of financial players of systemic importance. These are important issues. But the experience of this financial crisis also supports the case for a more fundamental rethinking of global financial governance with a view to stabilizing trade and financial relations by reducing the potential for gains from speculative capital flows.

Promoting proactive capital-account management may be one element in a revised governance structure that could give countries sufficient flexibility to manage their domestic macroeconomic policies and improve their prospects for economic stability. Effective capital-account management not only helps prevent volatile private capital flows from causing exchange-rate volatility and misalignment, and thereby destabilizing the domestic financial system; it also helps improve the reliability of price signals in domestic markets and the conditions for efficient resource allocation and dynamic investment.

Assertions that capital controls are ineffective or harmful have been disproved by the actual experiences of emerging-market economies. This is a point that now appears to be accepted by senior IMF economists¹⁴, who acknowledge that they can be useful under certain conditions, such as economic crisis and indebtedness. These experiences show that different types of capital flows can be targeted and limited effectively by a variety of instruments¹⁵. These instruments range from outright bans or minimum-stay requirements to tax-based instruments like mandatory reserve requirements or taxes on foreign loans that are designed to offset interest rate differentials, as introduced by Brazil last October. Thus, in pursuing its surveillance function,

¹⁴Ostry, J.D. et al. (2010). Capital Inflows: The Role of Controls. IMF Staff Position Note, available at:

<http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf>.

¹⁵See, for example, UNCTAD (1994 and 2008). Trade and Development Report. United Nations publications, New York and Geneva.

the IMF should more actively encourage countries to use, whenever necessary, the introduction of capital controls, as provided for in its Articles of Agreement.

Reform of the global reserve currency and voting rights

One problem that has received renewed attention is dependence on the United States dollar as the main international reserve asset. An international reserve system that uses one or even a small number of national currencies as a reserve asset and as a means of international payments also has the disadvantage of being dependent on monetary policy decisions by the central banks issuing those currencies. However, their decisions are not taken in response to the needs of the international payments system and the world economy, but to national policy needs and preferences. Moreover, an economy whose currency is used as a reserve currency is not under the same obligation as others to make the necessary macroeconomic or exchange-rate adjustments for avoiding continuing current-account deficits. In the current international reserve system, the burden of adjusting imbalances is greater for deficit countries (whose currencies do not serve as reserve currencies) than for surplus countries. Central banks can easily counter pressure for currency appreciation by buying foreign currency against their own currency, but they are less able to withstand pressure for currency depreciation, because their foreign exchange reserves are often limited. Since

adjustment would imply a reduction of imports by the deficit country, there is a deflationary bias in the system, which makes it more difficult to achieve and maintain high employment.

Against this background, a proposal first discussed in the late 1970s has recently resurfaced. It argues for facilitating reserve diversification away from dollars without the risk of a major dollar crisis by giving central banks the possibility to deposit dollar reserves in a special “substitution account” at the IMF, denominated in SDRs¹⁶. These SDRs could also be used to settle international payments. Indeed, in response to the increased needs for international liquidity in the current financial and economic crisis, the G20 at its London Summit in April 2009 announced its support for a new general SDR allocation, which would inject \$250 billion into the world economy and increase global liquidity. This proposal was endorsed by the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System¹⁷.

However, the new SDRs would be distributed according to member countries' quotas in the Fund. This would mean that the G7 countries, which have

¹⁶See Chapter 5, United Nations (2009). Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System. United Nations publications, New York and Geneva.

¹⁷United Nations (2009). Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System. United Nations publications, New York and Geneva.

no real need for SDRs because they themselves issue reserve currencies or have easy access to international capital markets, would receive more than 45% of the newly allocated SDRs. Less than 40% would be allocated to developing countries and less than 8% to low-income countries. Thus the countries most in need of international liquidity from official sources would receive the smallest shares. This raises the more general issue of the geographical and time dimensions of SDR allocation¹⁸. Additionally, it is perhaps ironic that the European Union recently announced its intention to create a European Monetary Fund partly in response to the sovereign debt crisis in Greece. After the Asian financial crisis of 1997/1998, the EU was sceptical and was opposed to the idea of Asian countries creating a regional monetary fund under the auspices of the Chiang Mai Initiative. In the aftermath of the crisis, some Asian countries felt that such regional mechanisms would provide a more flexible alternative to the IMF, as they are likely to have greater regional knowledge and could be quicker to respond; additionally, they increase 'competition' in global economic governance, which could also lead to more responsive multilateral institutions. These arguments are still valid and the possibility of establishing a regional monetary fund in developing regions should be given serious consideration.

From the standpoint of criteria for geographical distribution of SDRs, it has been suggested that in

¹⁸UNCTAD (2009). The global economic crisis: systemic failures and multilateral remedies. United Nations publications, New York and Geneva.

order for the SDR to become the main form of international liquidity and means of reserve holding, it should be distributed in response to the needs of countries. Appropriate criteria for determining those needs would have to be worked out, but there can be no doubt that an allocation according to the current structure of IMF quotas is entirely out of line with needs. One approach would be to allow all countries unconditional access to IMF resources by an amount necessary to stabilize their exchange rates at a multilaterally agreed level. Another approach could be to link the issuance of SDRs with the needs of developing economies for development finance by allowing the IMF to invest some of the funds made available through the issuance of SDRs in the bonds of multilateral development banks. Such a proposal was made by an UNCTAD panel of experts in the 1960s, before international liberalization of financial markets began, and when access to capital market financing by developing-country borrowers was very limited¹⁹.

Whatever form an enhanced scheme of SDR allocation takes, it will only be acceptable to all countries of the system if the terms on which SDRs can be used as international liquidity are absolutely clear-cut. The Bretton Woods system and the European Monetary System provide precedents for what could be an appropriate solution. In these

¹⁹UNCTAD (2009). The global economic crisis: systemic failures and multilateral remedies. United Nations publications, New York and Geneva.

systems the implicit rule was that the exchange rate between a national currency and the international currency was determined by the purchasing power of that currency expressed in all other currencies. This rule may be difficult to introduce at the time the system starts, because of the problem of determining the initial purchasing power parities of each currency, but it would be straightforward and simple once the system was on track.

Financial speculation and oversight

It is regrettable that enthusiasm for a reform of the international monetary and financial system appears to be diminishing now that many observers and policymakers believe the worst of the financial crisis is over. I would argue that rethinking the international reserve system and regulation of speculative capital flows are as urgent as ever, especially as speculation affects many areas of the global economy. For example, from 2006 to 2008, commodities increasingly became a target for speculative activity. Whilst market fundamentals (growing demand from emerging markets, the rundown of stocks, drought, decline in refining capacity, and so on) initiated price increases in many agricultural and non-agricultural commodities, clearly the link between supply and demand was distorted beyond all recognition by the impact of speculation. The simultaneous movement of commodities markets with other assets appears to

demonstrate the influence of speculation²⁰. Major commodity exchanges around the world witnessed record trading volumes: in 2007, agricultural futures and options trading grew by 32%, energy by 28.6% and industrial metals by 29.7%. In addition, according to statistics of the Bank for International Settlements, outstanding amounts of over-the-counter commodity derivatives increased by close to 160% between June 2005 and June 2007. The number of futures and options contracts outstanding on commodity exchanges worldwide rose more than threefold between 2002 and mid-2008. During the same period, the notional value of commodity-related contracts traded over-the-counter increased more than 14-fold, to \$13 trillion. Commodity derivatives exerted a significant influence on spot prices and arguably distorted prices, which had punishing effects for consumers but could also have a negative impact on the future production plans of producers.

In general, the financial sector's lack of transparency and disclosure created a "shadow banking system", with off-balance-sheet assets worth 30% more than those on balance sheets (\$16 trillion : \$12 trillion).²¹ Furthermore, and as I do not need to tell an audience

²⁰As a recent UNCTAD study on the financial crisis shows, "The strongest evidence is found in the high correlation between commodity prices and the prices on other markets that are clearly dominated by speculative activity". See, UNCTAD (2009). The global economic crisis: systemic failures and multilateral remedies. United Nations publications, New York and Geneva. Page.38

²¹UNCTAD (2009). The global economic crisis: systemic failures and multilateral remedies. United Nations publications, New York and Geneva

of bankers, opaque innovation in financial products such as collateralized debt obligations and special purpose vehicles for off-balance-sheet assets, increased the systemic risk – just the opposite of what they purported to achieve. Taken together with the huge leveraged debt binge in areas from swaps to real estate, the financial markets became completely detached from the real economy and ultimately created a systemic crisis in the banking sector, which spread to the global economy. Needless to say, stronger monitoring, regulation and disclosure are required for limiting excessive speculation, especially in staple food commodities in the light of the 2008 food crisis. We at UNCTAD support the ongoing discussions in Europe and elsewhere on the restriction of certain instruments, such as credit default swaps after last year's financial crisis, and the role of CDSs in exacerbating the recent sovereign debt crisis in Greece.

Additionally, the time has come to seriously rethink governance reform at the IMF, so that it can focus most properly on what it does best: macroeconomic surveillance and management. If it is to have a strengthened role in reserve currency management, it should remove itself from other areas, such as development finance and poverty reduction, which serve only to clutter and confuse its mandate. The IMF should also strengthen its oversight and surveillance functions so that it is in a better position to warn of crises such as the one we are currently experiencing. In any reform of the international

financial institutions, or any institutions governing economic activity for that matter, it is imperative that the composition of committees and supervisory boards reflects a diversity of economic views. One of the criticisms levelled at both the IMF and the Financial Stability Forum (now Board) was that the similarity of intellectual backgrounds of members led to a convergence and even reinforcement of opinion, which failed to foresee the coming crisis. Instead of voices pulling in different directions to test views and policy recommendations, a kind of flocking emerged which proved nearly fatal for the global economy. It should, however, be said that there were several voices that did raise concern about the crisis and how it could be avoided, not least in UNCTAD, which has been analysing global imbalances since as early as 2004.²²

Conclusion

In the past year, mainstream economic thinking has been turned on its head by events in the real world. As the economist J.K. Galbraith once wrote, “[ideas] yield not to the attack of other ideas, but [...] to the massive onslaught of circumstance[s] with which they cannot contend”. Ultimately, reconstructing economic governance may be the outcome of a more pragmatic policy stance against what was the biggest onslaught of economic events since the 1930s.

²²See, for example, UNCTAD (2006, 2007 and 2008). Trade and Development Report. United Nations publications, New York and Geneva.

Economic governance should work primarily to achieve the goals of prosperity, security and stability, which are the prerequisites for sustainable poverty alleviation. This was the original intention of Keynes and the other architects of the Bretton Woods institutions, who looked to the 1930s and saw unemployment as essentially a waste of resources, and undervalued exchange-rate movements as a weapon for exporting unemployment. For those pioneers, a regulated financial system was essential for an open and stable trading system. As developing countries, from the early 1960s, forced their own concerns on to the international economic agenda, international cooperation was extended to address the problem of weak or insufficient productive capacity through concessional development finance and support for sectoral and industrial policies; macroeconomic targets, such as maintaining low inflation or a balanced budget, were seen as policy tools, a means to serve the goal of rapid economic growth and industrial development – not the goal itself. In recent years, it could be thought that selected macroeconomic targeting has become governments' primary objective, and trust in the efficient factor allocation of the market has replaced government policy: growth and employment will result if the 'prices are right'.

From the perspective of 2010, as growth rates have tumbled and growing unemployment has hit both the North and the South, it should be obvious that these policies have not worked. The crisis was largely the

result of a giant market failure: a mega-event in the cyclical pattern of contemporary economic growth. As I mentioned before, even the IMF now acknowledges that some of the policies it prescribed to governments were based on false assumptions.

UNCTAD has been warning for many years about the dangers of uncontrolled global imbalances and their implications for the world economy. These conditions have produced uneven and unstable growth and mixed results for development. To ensure the long-term sustainability and stability of countries' economic development, we need to adopt new measures at the national and international levels: we need a new agenda, which, incidentally, may draw on some old ideas.

For one thing, the new agenda should be based on improved regulation of financial markets, which should be based on a careful evaluation of the social costs and benefits of financial innovation. Financial sophistication with no social returns must be weeded out, and regulatory arbitrage avoided. Incentive structures in the financial industry must be overhauled to put an end to excessive risk-taking. For another, developing countries must increase their resilience to external shocks by maintaining a competitive exchange rate and limiting currency and maturity mismatches in private and public balance sheets. As I have already explained above, the world also badly needs international coordination.

Regulators based in different countries should share information, aim at setting similar standards, and avoid races to the bottom in financial regulation.

Special attention must also be paid to the plight of the poor economies, which means increasing development aid is yet another imperative. UNCTAD research has found that past financial crises were followed by a substantial decline in foreign aid, ranging from 10% to 60%. And if Overseas Development Assistance (ODA) takes as long to recover from today's turmoil as it did previously – say, in three to four years' time, just when world markets are starting to pick up again – the poor countries could be caught short, lacking the resources needed to get back into exporting. Not only should current ODA pledges be kept, but they should be increased, substantially.

As to the international financial system, I believe that we need to rely more on a multilateral approach and the same rules and regulatory discipline that apply to international trade should also apply to international finance. In this respect, a set of multilaterally agreed rules on exchanges rates, and a mechanism to correct long-term misalignment in exchange rates are long overdue. For rising economic welfare to be sustainable, it has to be shared without altering the relative competitive positions of countries.

In the 1920s, when the “market juggernaut” was rolling at full steam, John Maynard Keynes called for a “new wisdom for a new age” with “new policies and new instruments to adapt and control the workings of economic forces, so that they do not intolerably interfere with contemporary ideas as to what is fit and proper in the interests of social stability and social justice”.²³ Open-minded, tolerant and pragmatic approaches to the development challenge, consistent with today's increasingly interdependent world, are urgently needed to place economic policy and governance once again at the service of financial stability and economic prosperity for all.

²³Quoted in UNCTAD (2003). Trade and Development Report. United Nations publications, New York and Geneva. Page i.

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EXIM 6 (S)



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Supachai Panitchpakdi is Secretary-General of the United Nations Conference on Trade and Development (UNCTAD). Dr. Supachai began his second four-year term as Secretary-General of UNCTAD on September 1, 2009, following his unanimous confirmation by the UN General Assembly.

Dr. Supachai received his Master's Degree in Econometrics, Development Planning and his Ph.D. in Economic Planning and Development at the Netherlands School of Economics (now known as Erasmus University) in Rotterdam. In 1973, he completed his doctoral dissertation on Human Resource Planning and Developing under the supervision of Prof. Jan Tinbergen, the first Nobel laureate in economics.

Dr. Supachai began his professional career at the Bank of Thailand in 1974. In 1986, Dr. Supachai was elected to the Thai Parliament and appointed Deputy Minister of Finance. In 1988, he was appointed Director and Adviser and subsequently President, of the Thai Military Bank.

In 1992, Dr. Supachai was appointed Senator and that same year he became Deputy Prime Minister, entrusted with oversight of the country's economic and trade policy-making. In this role, he was actively involved in international trade policy and represented Thailand at the signing ceremony in Marrakech of the Uruguay Round Agreement in 1994. He was also active in shaping regional agreements, including Asia Pacific Economic Cooperation (APEC), the Association of Southeast Asian Nations (ASEAN) and the Asia Europe Meeting (ASEM).

In 2001, Dr. Supachai was appointed Visiting Professor at the International Institute for Management Development in Lausanne. He has published a number of books, including *Globalization and Trade in the New Millennium* (2001), and *China and WTO: Changing China, Changing World Trade* (2002, co-authored with Mark Clifford).

Prior to his appointment with UNCTAD, Dr. Supachai served as Director-General of the World Trade Organization from September 2002 to August 2005.