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**IMFC Statement by Mukhisa
Kituyi Secretary-General
UNCTAD**

Statement by Dr. Mukhisa Kituyi, Secretary-General of UNCTAD

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The world economy continues to grow at significantly lower rates than before the 2008-2009 crisis. In 2016, global output is expected to expand at only 2.3 per cent, compared with 2.5 per cent in 2015.¹ This reflects a growth rate of around 1.6 per cent in developed countries, 3.8 per cent in developing countries and 0 per cent in the transition economies; these rates are very close to, but slightly below our forecasts presented in April, earlier this year.

These figures confirm the ongoing difficulty of establishing a robust growth path in developed countries since 2008–2009. They also show that developing countries have not been able to decouple from developed countries' weak performance. Even East, South and South-East Asia, which are the best performing sub-regions, are set to grow almost three percentage points below their 2003-2007 average growth rate. This year, growth is slowing down markedly in Africa and West Asia to around 2 per cent, while Latin America and the Caribbean will probably record negative growth rates, due to economic contraction in a number of South American countries.

The current international economic framework does not provide enabling conditions for significant growth acceleration in developing countries. Indeed, in the absence of significant economic recovery in the developed economies, international trade is in the doldrums for the fifth straight year and the commodity cycle is in its second year of a sharp downturn. In addition, volatile international capital flows have negatively affected developing and emerging economies, and generated financial vulnerabilities that are already causing debt distress in some countries and could lead to a new debt crisis.

Weakening international trade: causes and consequences

In 2015, the value of global merchandise trade in dollar terms has contracted by almost 13 per cent (from \$19 to \$16.5 trillion), which contrasts with a two-digit expansion, on average, between 2003 and 2011. This contraction was essentially due to the evolution in nominal variables, in particular that of commodity prices: the fall in oil prices and, consequently, in fuels trade (from \$3.1 to \$1.9 trillion) explains half of total reduction in global trade at current dollars. The value of trade in manufactured goods also fell in

¹ Output is measured in 2005 US\$ at market prices.

dollar terms (-6.4 per cent in 2015), as the appreciation of the US currency reduced the value of trade contracted in other currencies, particularly in euros.

This reduction of international trade in value terms took place together with a strong deceleration in the volume of trade: from a growth rate around 7 per cent before the crisis, trade expansion slowed down to between 2 and 3 per cent in 2012-2014, and further decelerated to 1.5 per cent in 2015. Preliminary data for 2016 do not show any sign of recovery. UNCTAD has observed that the faltering dynamism of international trade mostly reflects the weakness of aggregate demand, which in turn has resulted from stagnant real wages and restrictive fiscal policies, particularly in developed economies. In those countries, large quantitative monetary expansion and very low (or even negative) interest rates have been insufficient for revamping aggregate demand, and have generated huge and unstable capital flows to developing economies.

In this context, some individual countries have replaced faltering domestic demand with increased net exports. However, this improvement in competitiveness can only be achieved at the expense of trade partners, since not all the countries can expand net exports simultaneously. In addition, it further reduces private and public expenditure (especially if it triggers a “run to the bottom” in labour and public revenues), and postpones global recovery.

Therefore, it would be illusory to expect that trade expansion can be the starter motor for global economic recovery: international trade can only accelerate again if consumption and investment (public and private) expand in a sufficient number of large economies. This does not mean, however, that policymakers should not seek to improve the conditions of international trade.

Improving trade benefits for developing countries

Despite the promises of the Doha Development Round, developing countries still face barriers and unfair competition to their exports of agriculture products, tariff escalation and non-tariff measures (NTMs) affecting their international trade.

The issue of NTMs requires a careful approach, since several of such measures that some characterize as “murky protectionism” actually have an important public policy purpose, not only for promoting financial stability and preventing drastic declines in employment, but also for building domestic productive capacity and protecting consumers. These include health and safety regulations, administrative measures, and many other policies that do not violate any current international agreements or other legal provisions. It is true, however, that some NTMs affect mostly developing countries, and in particular those that do not have the financial resources and technical capabilities needed to meet these complex and often opaque

rules. UNCTAD has estimated that exporters from the 48 least developed countries lose an estimated \$23 billion a year – that is 15% of their exports – because they are unable to comply with non-tariff measures, mostly set by developed economies. More transparency of existing regulations and a larger participation of developing countries in international standard-setting bodies are needed to reduce unjustified obstacles to those countries' trade.

However, even if the access to developed countries markets can and should be improved, this will not solve the problem of subdued demand from those economies. Developing countries cannot excessively rely on those markets, and need to seek instead a more balanced approach by strengthening both domestic and regional markets. In several regions, strengthening regional integration can be an important instrument for production upgrading and diversification.

This is particularly true in Africa: while the continent exports mostly unprocessed commodities to the world (around 57 per cent of total exports), two thirds of intraregional exports consist of manufactures and processed commodities (43 per cent and 22 per cent, respectively, in 2014). Hence, intraregional trade has the potential to support industrialization and diversification in Africa. In this perspective, the planned Continental Free Trade Agreement (CFTA) has the potential to reinvigorate Africa's development. UNCTAD estimates that implementing the CFTA will roughly double the share of intra-African trade (currently below 20 per cent) by early next decade. Manufacturing export sectors will be the biggest beneficiaries. Agriculture will also get a boost through the creation of a more viable African marketplace for food. Enhanced trade in agriculture products will also increase prospects for agro-processing, creating dynamic linkages with manufacturing. However, to deliver sustainable development, CFTA will need to be accompanied by a massive scaling up of private and public efforts to invest in cross-border infrastructure in the continent.

Capital flows and increasing debt in developing countries

During the recent period of finance-led globalization, international capital movements have been driven by “push” factors (i.e. economic conditions in world financial centres) rather than “pull” factors stemming from developing countries' need for external financing. After the crisis, developing economies first received huge amounts of foreign capital – especially between mid 2009 and 2013 – as the result of economic policies in developed countries, which implemented very expansionary monetary policies but at the same time constrained government and private expenditure. Hence, instead of contributing to a stable growth of productive investment in developed countries, financial capacities have leaned towards short-term financial investment or to the faster growing developing world.

There have been growing concerns about financial fragility in developing and emerging economies due to large financial flows and cheap credit since 2009. Alarm bells have been ringing over the exploding corporate debt incurred by emerging market economies. According to the Bank for International Settlements, the debt of non-financial corporations in these economies increased from around \$9 trillion at the end of 2008 to just over \$25 trillion by the end of 2015, and doubled as a percentage of gross domestic product (GDP) – from 57 per cent to 104 per cent – over the same period

Until recently, increasing external debt did not appear in the usual debt-risk indicators in terms of gross domestic product (GDP) and export revenues. Though external debt stocks rose more than three-fold from 2000 to 2015, strong and sustained GDP growth rates in current dollars coupled with dynamic exports led to a decrease in the ratio of total debt stocks to GDP from 36 per cent in 2000 to 22 per cent in 2008, while the ratio of debt services to exports fell from 22 per cent in 2000 to around 9 per cent in 2008. However, since 2009 and particularly in 2014 and 2015 both ratios increased, with total debt to GDP reaching 25.5 per cent in 2015, and debt service to exports increasing to 11.5 per cent.

This change in the external debt profiles of developing countries is also observed in other indicators that experienced marked improvements in the 2000s, even though current indebtedness levels do not reach the peaks observed at the beginning of the millennium, when assessed in terms of GDP, exports or foreign reserves. International reserves have registered two consecutive years of decrease, though even when evaluated in terms of short-term debt, these are, on average, still well above the 2000 figure, though there is variation across economies.

Some developments that have occurred since 2000 have strengthened the resilience capabilities of developing countries to eventual shocks, but other factors point towards potential vulnerabilities. Domestic debt securities increased as a share of total debt securities from around 56 per cent in 2000 to 87 per cent in 2015. At the same time, there is a larger presence of foreign investors in domestic markets. While borrowing in domestic currency allows governments to shift the currency risk to investors, the larger proportion of locally-issued public debt held by non-residents externally exposes the refinancing of public debt to the conditions in the economies of foreign investors. The risk is increased by the fact that local-currency denominated debt is usually of shorter maturity.

A major feature of international finance in the last fifteen years is the marked increase in the indebtedness of non-financial corporations in developing economies. The Bank for International Settlements estimated the overseas United States dollar credit to reach \$9 trillion in 2014. With the exception of China, corporate debt of developing countries firms has been mostly issued in international financial markets, and denominated in foreign currencies. The proceeds from this indebtedness have been only partially used

to finance the building of productive capacity. Instead, UNCTAD has highlighted the rise in the ratio of financial assets to total assets and to total debt in the last twenty years. These developments have been influenced by the excess liquidity in international financial markets and the continued deregulation of developing country financial systems. While governments have taken advantage of this excess liquidity to change the currency denomination of public debt, firms have borrowed in foreign currency at low cost, using this funding to invest in financial markets domestically, profiting from interest rate spreads. Abrupt changes in exchange rates, which might be triggered by capital outflows, can lead to large corporate bankruptcies, transferring unsustainable corporate debts into public balance sheets.

Rising financial risks and the need of a debt-management mechanism

Huge net capital inflows do not last forever, and changes (or anticipated changes) in the monetary conditions or in the risk perception in developed countries can lead to “sudden stops” of capital flows to (or capital reversal from) developing countries. The end of the Federal Reserve’s asset purchasing programme in 2014 had an impact on the reversal of flows, but the most relevant factors were the protracted slowdown in developed-country growth, combined with steep falls in commodity prices, both of which adversely affected developing country exports and growth prospects. Changing prospects reinforced capital outflows, as “carry trade” positions began to make losses and were rapidly unwound.

The pronounced decline in net inflows since mid-2014 and in particular throughout 2015 drove aggregate net capital flows to developing countries into negative territory, for the first time since the Latin American debt crisis in the second half of the 1980s. In the aggregate, overall capital net flows were negative by about \$656 billion in 2015, about 2.7 per cent of the total GDP of these countries.

The reversal in net capital flows was most pronounced in Asia, especially in China (which has accounted for the bulk of the negative net capital flows since 2014), but also hit some other emerging economies. By contrast, Latin America and countries such as India and South Africa continued to receive positive net capital flows. China’s net capital flow deficit in 2015 amounted to around 4.5 per cent of GDP, driven by external debt repayments from non-financial corporates, the unwinding of carry trade operations, a decline in offshore convertible renminbi deposits, and outward FDI that increased to 1.8 per cent of GDP, approaching the level of inward FDI flows (2.4 per cent of GDP). The gradual recovery in net inflows to developing economies observed in the first quarter of 2016 continued to be offset by outflows from residents, which maintained net capital flows in negative territory.

The many downsides of excessive financial and capital account liberalization may well mean that the international community should prepare for managing debt workouts in a faster, fairer and more orderly

manner than is currently the case. Already, several countries have turned to multilateral lending institutions, such as the IMF and the World Bank, in order to obtain financial assistance. The emergence of debt and financial vulnerabilities in developing countries may force them in to economic adjustments based on fiscal austerity and labour market flexibilization. These policies would not only jeopardize the macroeconomic conditions for recovery and development, but would also exert a negative influence in global demand and financial stability. Building an international framework in which debt problems can be managed without aggravating economic and social distress is an urgent task for the international community. The Basic Principles for Sovereign Debt Restructuring Processes stated in the United Nations Resolution of the General Assembly A/RES/69/319 can provide a useful starting point.

The bumpy path to economic convergence

Considered in a long-term perspective, most developing countries outside some Asian sub-regions have failed to significantly reduce the income gap with developed economies. The big investment push in developing regions remains one of the unfulfilled promises of the more open global economy set in place in the 1980s and 1990s; and after general growth acceleration at the beginning of the century, convergence is now losing steam with a more challenging international environment.

Comparing country performance in terms of relative distance from the United States (measured in terms of GDP per capita), developing countries' chances of catching-up have become worse and not better. The *Trade and Development Report 2016* shows that the chance of a middle-income country rising to high-income has fallen by more than half over the last six decades. Countries are classified into three groups according to their income relative to the United States, where 'low' income groups have income below 15 per cent of the United States, 'middle income' countries have an income between 15 and 50 per cent of the United States and 'high income' had above 50 per cent. For the period 1950-1980, middle income group countries had 18 per cent probability of moving up to high income status, but by the years 1981-2010, this probability had fallen to just 8 per cent. Analogously the probability of moving up from the low income group to the middle one fell from 15 per cent to 7 per cent. Second, and perhaps more strikingly, the probability of falling behind has significantly increased over recent decades. In short, middle income countries in the more recent period had a one in five chance of falling backwards, and less than one in ten chance of rising.

The key role of industrialization

If the gap between developing and developed economies has been hard to reduce – and in some cases is increasing – this has, in particular, reflected shortcomings in the industrialization process. This year's

Trade and Development Report draws attention to three important factors. The first is that the virtuous cycles of structural transformation associated with *catch-up industrialization* with robust production, investment, knowledge and income linkages have been achieved in only a small number of East Asian newly industrialized economies. More typical among developing countries have been cases of *stalled industrialization* where shares of industrial income and employment find a ceiling too low (and too soon) to generate the structural transformation and the production and knowledge linkages needed for upgrading and productivity increases across the whole economy. A more extreme trajectory is that of *premature deindustrialization* in which the shares of manufacturing value added and employment started to decline at levels of per capita income much lower than those at which developed countries started to move more towards high-productivity services and deindustrialize. This is accompanied by a sharp fall in relative productivity levels, as the employment tends to migrate from formal and relatively skilled manufacturing activities to low-productivity informal services. This has been especially observed in Latin America, since the debt crisis of the 1980s.

Such trends matter because manufacturing and industrialization has such an important role to play in the process of structural transformation. The expansion of manufacturing activities creates employment, incomes and demand on the one hand, and accelerates productivity increases on the other, in turn boosting incomes and growth. But as important as expanding the share of manufacturing in total employment and value added is to strengthen its production and knowledge linkages to the rest of the economy, particularly the primary sector and modern services. Continuous upgrading of productive capacities in manufacturing leads to productivity gains in the entire economy, with the application of more advanced technologies, the creation of linkages relating to knowledge, the production of more sophisticated goods and the insertion into international or regional value chains at rising levels of skill. The fact that, with the exception of East Asia, there has been a general reduction in the share of manufacturing in total employment and value-added is therefore a major brake holding back the development path of many countries.

Structural transformation needs high levels of investment, and reinvested earnings are the most important source of investment finance. Dynamic interactions between profits and investment used to be an important stimulus for industrialization and catch-up, because profits are simultaneously an incentive, a source and an outcome of investment. However, the profit-investment nexus has weakened in recent times. With the 'shareholder primacy' in corporates' strategies and their increasing focus in short-term profits, corporations (especially in developed countries) have been increasingly using profits to pay dividends and to repurchase shares instead of reinvesting them in new plant and equipment, research and skill acquisition. Also in large developing economies the investment-to-profits ratio in leading firms has

declined, as profits are increasingly reoriented to financial investment or sent abroad by transnational corporations.

The case for industrial policies

No countries have made the long and arduous journey from rural poverty to industrial and post-industrial prosperity without the use of targeted and selective government policies to shift the production structure towards activities and sectors with higher productivity, better paid jobs and greater technological potential. Industrial policy measures – or what could more correctly be termed “structural transformation policies” – are needed UNCTAD argues that it is time to replace sterile debates about whether governments can “pick winners” with a discussion on building linkages that shift the production structure, through the use of “active” policies that target changes in corporate structure and behaviour – not simply “passive” policies that accept the existing endowments and structures.

Doing this successfully requires an integrated policy approach where macro, financial and other policies support industrial policies. The crucial step is how to deal with the rents that are created, and governments need to ensure that they remain potentially beneficial and not growth reducing. Achieving this rests upon the establishment of a set of institutions that can ensure government is close enough to business to hear its needs, but not so close as to be under its influence, and can link support with performance. Failure is an inevitable possibility in any policy activities, especially when the reach is ambitious (just as in business), but obviously regular monitoring is essential and failure to perform should mean that support is withdrawn.