Statement by the South Centre

Statement at the UN General Assembly Extraordinary Thematic Dialogue on The World Financial And Economic Crisis And Its Impact On Development

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1. The extraordinarily serious global economic crisis has its origins in the developed countries. Developing countries are not responsible, but they are severely affected, and in ways that are worse than the developed countries, as they also lack the means to counter the effects.

2. Developing countries are only in the past few months beginning to feel the effects of the crisis, due to the lag time in transmission. The crisis will certainly last longer than originally expected, and then it may take even more time before a full recovery.

3. There is thus growing anxiety in the developing world. When he met the British Prime Minister Mr. Gordon Brown, last week, as part of the preparation for the G20 Summit, the Ethiopian Prime Minister Mr. Meles Zenawi warned that African countries could face political chaos if the recession hits at full force. In developed countries such as Britain, the worst problem being faced in the downturn was unemployment. But in Africa, the recession means that "people who were getting some food would cease to get it and instead of beng unemployed they would die", said Mr. Zenawi, as quoted in the Financial Times.

4. The developing countries are being hit **through two transmission levels – trade and finance. The first transmission channel is through trade.** There has been a sudden and steep fall in manufacturing exports, the fall being 30 to 50% in many Asian countries. Then there is the fall in demand, prices and export earnings for commodities, affecting especially low-income commodity-dependent countries. On 17 March, The Economist's commodity-price dollar index for all items had fallen by 40% compared to a year ago (with declines of 29% for food, 44% for non-food agriculture products and 56% for metals). Earnings from services are also falling, for example in tourism (in the Caribbean tourist arrivals are expected to fall by one third this season) and migrant workers' remittances (a 6% drop is estimated by the World Bank for 2009)..

5. The **second transmission channel is through finance.** There is a rapid decline of bank loans to developing countries, whose companies may find it difficult to roll the many hundreds of billions of dollars of foreign loans due this year. There is a reversal of portfolio investment into developing countries, from large inflows in recent years to a sudden huge exit. Net capital flows to emerging markets fell from $929 billion in 2007 to $466 billion in 2008 and will fall further to $165 billion in 2009, according to the estimates by Institute of International Finance. Even FDI is rapidly slowing down because of difficulties in access to credit and economic contraction. If the past record is a guide, aid flows can also be seriously affected in the near future. Trade financing has also been affected by risk aversion, and is choking trade flows; a shortfall of $25 billion in trade financing was reported at a recent WTO meeting.

6. These trade and financial shocks are leading to stresses on the overall balance of payments, with a fall in foreign reserves, and a depreciation of the local currency in some countries. All these together threaten developing countries' ability to service their external debt and avoid a debt default situation. There are already 10 countries that have had to go to the IMF for emergency loans and many other countries are likely to be lining up in the near future.

7. All of the above are causing a stress on the real economy, with declines in GNP and industrial output, a reversal in poverty eradication and a slowdown in social development, as governments face reduced revenues and budgetary stress. Most developing countries are constrained from taking the fiscal expansion measures similar to those of developed countries.

8. There is a need for developing countries to examine the options for national policy on each aspect of the economic crisis and to seek the appropriate policies. However, only some policy measures can be taken at national level, especially if the country is too small to rely on the boosting of domestic-led growth. Regional-level measures are important. And most critical are the reforms, actions and cooperative measures required at the international level.

9. The South Centre views the two issues of reform international actions needed to counter the recession from the **perspective of the problems and interests of the developing countries**. What are the priority issues for the developing countries, on which action is urgently required?

10. Among the **priorities for the South** are (1) establishing an international system that fosters financial stability for developing countries; (2) having access to adequate and

stable financial resources, as private flows and exports decline; (3) avoidance of financial and debt crises and proper management of crises if they occur; (4) unimpaired access to markets for goods and services; (5) avoiding collateral damage from policies taken by developed countries in response to the crisis; (6) formulating policies for the short and long term for recovery and development, and being able to maintain and expand policy space to implement these policies.

11. There is need to review and reform the international financial and economic systems to ensure the problems that led to the crisis are not repeated and that the international system does not prevent but positively encourages developing countries to have the adequate policy space to deal with the crisis nationally.

12. There are dangers that some **crisis measures taken by developed countries may have adverse effects on the South,** and thus a need to prevent or offset these actions. For example, developed countries' agriculture subsidies used to be the main distortion in world trade but these are now accompanied by huge subsidies to financial institutions and emerging subsidies to manufacturing (the auto industry). Developing countries lack funds to match these subsidies; they should be allowed to take measures to prevent subsidised service providers like banks and subsidised goods from overwhelming their domestic markets. In the area of tariffs, developing countries should be allowed to exercise their right to use the policy space to raise their applied tariff if it is below the bound tariff. A moratorium against raising applied tariffs would be imbalanced because there is little difference between the applied and bound rates in developed countries, unlike the developing countries.

13. Private investors and public agencies in some developing countries invested in or lent to private and public institutions in developed countries. Developed countries' governments should **assure that the assets of developing countries are protected.** Pressures from interest groups that exclude developing countries' assets or loans from bailout plans (for example the suggestion that AIG should only honour claims from nationally-owned institutions) should be resisted.

14. **New forms of trade protection** that affect developing countries should not be introduced. The fiscal stimulus programmes should not exclude goods and services from developing countries, as has happened with the Buy American clause in the recent US stimulus package. Developed countries are mainly exempted from the clause due to their membership of the WTO plurilateral procurement agreement, of which most developing countries are not members. There is also need to guard against a new trade protectionist element being proposed in the climate policies and legislation of some developed

countries; if this is introduced, it could have a further adverse effect on developing countries' exports and add more stress in this crisis period.

15. A high priority for developing countries is to **establish international measures to foster financial stability and avoid activities driven by speculation.** The crisis originated from banking deregulation and excessive liquidity creation, causing speculation to be rife in capital and currency markets. Developing countries have been hit by these speculative activities leading to violent fluctuations in capital flows. But because of highly costly self-insurance taken in large stock of reserves, these swings have not created the kind of dislocations seen in 1997 in Asia. An important part of the solution is to reinstall firewalls and regulations to avoid speculative capital flows unrelated to real economic activities (trade and investment) and to establish a system of currency exchange where currency rates reflect underlying fundamentals. This should be a major priority in the reform of the international financial architecture.

16. In the absence of reform and an international system regulating these flows, developing countries must have the policy space and be allowed to undertake **national policy measures to regulate capital flows** and to defend themselves from speculation. However the required policy space to take the required measures is hindered by (1) IMF-World Bank conditionality that mandates an open capital account; (2) Many North-South free trade agreements that (a) mandate the free and unregulated inflow and outflow of funds; (b) liberalisation of financial services, including the entry of foreign institutions for "new financial instruments"; (c) liberalisation and deregulation of investments. These barriers (the loan conditionality and the FTA provisions) to the required regulation should be reviewed. Existing FTAs should be reviewed to consider amending clauses that prevent the required regulation. Current negotiations on FTAs such as the EPAs between the EU and the African and Pacific countries should fully take this into account.

17. A major plank of the new financial architecture is the **reform of the IMF.** Its policy conditionalities have previously not been appropriate in assisting developing countries deal with crises. These include: (1) the policy of an open capital account system, that deregulates capital flows (increasing financial vulnerability) and discourages or prevents capital controls over inflows and outflows; (2) pro-cyclical monetary and fiscal policies that have magnified contractionary conditions; (3) trade policy linked to extreme liberalisation of imports and industrial policy based on non-state intervention, which have damaged domestic agriculture and industry in many developing countries. A preliminary review of recent crisis loans to 10 countries (including some developing countries) by the IMF show that contractionary financial and fiscal policies (such as a

significant increase in interest rates, and a reduction of government spending) are still maintained as part of the loan conditions.

18. A reform of the IMF is thus crucial. Without the reform, it is premature to expand its resources. The IMF should not impose or promote an open capital account or prevent regulation of capital flows. It should not deal with trade and industrial policies and other development-related policies. The reform process should lead to its creditor role being confined to providing short-term loans to countries to deal with temporary balance of payments difficulties. In that area, its policies should be counter-cyclical and not pro-cyclical. Countries should not be requested to provide loans to the IMF to augment its resources because this would compromise the ability of the IMF to carry out its surveillance function and to discipline the policies of countries that provide the loans. It can obtain resources from the market or from the issuance of SDRs, instead of obtaining loans from governments. The imbalances in the system of governance, with its present serious imbalance in voting rights and decision-making, should also be addressed.[1]

19. One major source of financial instability is that the **international reserve currency** is the currency of a single country (the United States). This causes instability as availability of reserves for the world economy depends on the reserve currency country (the US) having growing current account deficits. This problem is worsened under the present crisis because of : (a) the absence of multilateral discipline over exchange rate and macroeconomic policies of the US; (b) developing countries' increased vulnerability to fluctuations in capital flows and exchange rates; (c) pro-cyclical behaviour of financial markets; (d) developing countries holding large stocks of foreign reserves at very high costs. As an alternative, an international reserves system based on the SDRs could be established. The IMF could distribute SDRs to itself to make it available to members, and there should be greater automaticity in access to it.[2]

20. The new financial architecture should include establishment of **a multilateral fund or funds**. This could be similar to the two oil facilities set up in the 1970s to assist countries cope with the oil price increases and to prevent a global recession. The fund can assist developing countries counter the recession and to offset the multiple losses of

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[1] Several of these points are in Yilmaz Akyuz, "Key issues in the reform of the international financial architecture"; and "The IMF is back in business – as usual?"

[2] The points in this paragraph are from Yilmaz Akyuz, "Key issues in the reform of he international financial architecture."

financing caused by reduced exports, migrant remittances, service payments, loans, investments, trade financing, etc. The shortfall facing developing countries may total many hundreds of billions of dollars a year. The fund should thus be of a major amount. The channels of funding and its multiple uses should be determined together by the international community.

21. Developing countries should also be encouraged to explore and expand regional financial cooperation. Examples of this are the Chiang Mai Initiative and its extension in Asia, and the Bank of the South in Latin America.

22. The new financial architecture should also **deal with the threat of new debt crises facing developing countries**. The current account and overall balance of payments of many developing countries and their foreign reserves are or will be coming under increasing stress, due to a crisis that was not of their doing. The reform process should as a priority establish **an international system of debt standstill and debt workout** for countries that face debt servicing difficulties. Proposals on this (which originated at UNCTAD) had been rather extensively discussed, including at the IMF, but did not lead to any conclusions. Given the present crisis, this should again be a priority proposal. A new round of debt elimination and debt relief should also be looked at now.

23. For many of the poorer countries, dependence on commodities has revived as a serious problem because the positive conditions and high prices of the past several years have vanished. The stabilisation of commodity prices and fair remuneration to producing countries has thus become a priority crisis issue for developing countries. **International cooperation on resolving commodity issues** should thus be on the reform agenda.

24. The crisis provides an opportunity to address the deficits and imbalances in the governance of global finance and economic issues. The United Nations used to play a central role in policy formulation and in reaching and implementing agreements. However in recent years, too much faith and power had been given instead to the markets and to international financial institutions which supported the drive towards "marketisation" and "financialisation." At the national level, in developed countries in the centre of the storm, the pendulum has swung, with the leadership and interventionist role of the state being emphasised. The international counterpart of this national-level development should be the strengthening of the role of the United Nations, including its General Assembly and its economic arms, particularly ECOSOC. Greater authority provided to a **strengthened and more effective UN** should be a crucial element of the new global economic architecture.

25. The UN General Assembly high-level conference in June is an important opportunity for discussion and follow-up actions on the wide range of issues of the crisis and how it affects development, and the remedies required. The South Centre is willing to contribute to the success of this very important event.