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**IMFC Statement by Mukhisa Kituyi**
**Secretary-General**
**United Nations Conference on Trade and Development (UNCTAD)**

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World economic output is growing in 2015 at a rate slightly higher than in the three previous years. However, global demand remains subdued, mainly due to weak labour incomes and the persistently high inequality this entails. To avert the risk of 'secular stagnation', policy makers need to use the full range of expansionary measures, including fiscal, monetary and income policies. Excessive reliance on monetary policy will not bring about the desired growth path and is likely to exacerbate financial instability. A wider range of policy measures would address weaknesses on both supply- and demand-side, albeit with a short-term bias to correcting the shortage of aggregate demand. The abundance of cheap credit can be used to kick start public investment programmes in infrastructure and basic services. The developmental state has a key role to play in mobilizing domestic resources and channelling them to productive investment. Stronger multilateral cooperation can support this approach by tackling fiscal avoidance, obtaining foreign sources of concessional finance and establishing a mechanism to resolve sovereign debt crises.

**The global economy slightly accelerates, but remains fragile**

The world economy is growing in 2015 at rates slightly higher than during the three previous years. However, this improvement remains modest, unevenly distributed among different regions, and is vulnerable to financial shocks.

World output is expected to expand at around 2.7 per cent this year, compared to an annual rate of 2.4 per cent between 2012 and 2014.[1] This is the result mainly of a better economic performance in developed countries, which are expected to grow at around 2.0 per cent compared to 1.6 per cent in 2104; in particular, growth in Japan and the Euro Area is experiencing a moderate acceleration, although from very low rates. Developing countries as a whole will continue to expand at a rate of close to 4.5 per cent, thanks in particular to growth resilience in most of the Asian region and, to a lesser extent, in Sub Saharan Africa. However, other regions are experiencing a significant slowdown, due to lower commodity prices and capital outflows that, in some countries, have prompted tighter macroeconomic policies. Latin America, West Asia and the Transition economies are among the most affected; in the latter, recessionary conditions are already present.

The picture for international trade remains gloomy. In 2014, total merchandise trade grew almost at par with world gross product for the third consecutive year. In

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

developed economies, imports and exports of goods are still lacklustre and in many cases stand below their pre-crisis volume peaks. Among developed economies, the United States is bucking the trend, as its exports, and more recently also its imports, have gained traction. In developing and transition economies, imports of goods – despite remaining more than 30 per cent above their pre-crisis peaks – also showed some signs of deceleration, which reflects the slowdown of economic activity in some large emerging markets.

**Insufficient global demand and persistent pressures on labour income**

As of April 2015, the central problem of insufficient global demand that resulted from the global financial crisis has not yet been resolved. A lop-sided reliance on monetary policy in advanced economies has not only failed to correct this deficiency but has also added to global financial instability and heightened vulnerabilities in many developed and emerging economies. A more comprehensive and ambitious approach, using all the available instruments to support growth, is necessary to avert the risk of protracted slow growth and the occurrence of new financial crises.

When the global crisis erupted in 2008, the collapse of aggregate demand in systemically important economies was so sharp, that there was little room for an ambiguous policy response. Public spending sought to compensate for lower spending by households and firms, while monetary expansion addressed the tendency towards deflation, falling asset prices and balance sheet distress. However, there was no concerted attempt to adopt concrete measures to tackle the rise in income inequality, in particular the deterioration of the labour share in total income, which had been falling in a majority of economies since the early 1980s.

In the absence of widespread and sustained increases in labour income, neither consumption nor investment regained sufficient strength in most of the countries affected directly by the crisis. To make things worse, a general shift to fiscal austerity in developed countries squeezed domestic demand. Between 2010 and 2014, actual fiscal spending in Greece, Portugal and Spain was 4 percentage points of GDP below its long-term trend; that shortage of public expenditure amounted to more than 2 per cent of GDP in Ireland, The Netherlands and the United States, and about 1.5 per cent on average for other developed economies. As a result, in early 2015, most developed countries find themselves with private consumption levels below long-term projections, sluggish investment (which usually follows from sluggish consumer demand) and weak public sector demand.

Recent improvements in the economic activity in developed countries are due to a less stringent fiscal stance and some recovery in households' consumption, following a reduction in energy prices and, in some countries (including the United States, the United Kingdom and to a lesser extent Canada and Australia), a strong rebound of asset prices and related "real-balance effects".

Economic trends in developing economies followed a different pattern. In response to the initial shock in 2008-2009, many of them applied more ambitious counter-cyclical policies, including increased fiscal spending and income policies that were sustained for long enough to encourage a continuing rise of household expenditure and, by extension, of private investment. Some of these countries are scaling back or even reversing the policy stimulus as they face capital outflows or lower export prices; by contrast, for oil importers, the recent improvement in the terms of trade enlarges the room for manoeuvre.

**Shortcomings of monetary policy and export-led growth**

In a context of very weak private-sector demand, monetary expansion has not helped finance private capital formation. A large part of newly available credit has remained unused or was channelled towards speculative markets. In particular, the lop-sided policy response to inadequate demand in the advanced economies has made asset markets in developed and emerging economies the default destinations of international investors seeking higher yields. For some time, this encouraged credit expansion in developing countries, appreciated their currencies and propelled commodity prices above the levels justified by market fundamentals alone. But more recently, even the talk of a change of monetary stance in the United States adversely impacted capital movements to emerging economies putting downward pressure on exchange rates and domestic credit creation.

This follows a well-known pattern. Historically, developing and emerging economies have been subject to damaging boom-bust cycles of capital flows. Such flows did not, in many cases, respond to actual needs in developing countries; instead, they were driven by the changing monetary policies and the economic situation in developed economies.

In the present circumstances, extraordinary monetary measures have also generated significant exchange-rate movements between the main international currencies, with a significant appreciation of the US dollar, especially vis-à-vis the euro and the yen. There is therefore the risk that strong manufactures exporters such as Germany and Japan may seek to profit from their enhanced competitiveness and achieve higher growth rates by relying on an increase in exports, without a sizeable increase in domestic demand.

However, an export-led recovery does not offer a generalised solution to the shortage of global demand. Indeed, seeking export gains by cost-competitiveness has exacerbated the compression of labour income shares, damaging consumer and investment demand even in the countries where there were competitive gains. On aggregate, this contributed to deflationary pressures on global demand, which has since the end of 2014 negatively impacted global growth.

Meanwhile, commodity exporters are starting to experience severe price shocks and face restraints on financial conditions to the extent of forcing pro-cyclical adjustments on domestic spending.

**The spectre of secular stagnation**

The evolution of conditions of the world economy since 2010 has been characterized as a process of ‘secular stagnation’ by some observers, while others talk of a ‘new mediocre’. There is growing concern among policy makers about the urgent need for corrective policies to alter this state of affairs.

Two interpretations, with radically different policy prescriptions, have been offered. On some accounts, growth in the world economy is mostly determined by supply factors, namely fixed capital equipment, technology and skill levels. The underlying problem, from this perspective, is an exhaustion of productive capacity due to a prolonged period of low investment and protracted unemployment, leading to the erosion of skills and specialization that a normally active working population would achieve over time. Thus, labour in the aggregate has become less efficient and in some cases the potential workforce has shrunk thanks to labour dropping out. Likewise, as the total stock of productive capital has failed to match its historic pace, the diffusion of new technology, which is embodied in plant and equipment, has been adversely affected as well.

The policy implications are twofold. First, the principal course of action is 'structural reforms' understood as various supply-side measures to boost competitiveness. Second, maintaining tight demand-side policies to avoid inflationary pressures given that the world economy is actually functioning at or close to full capacity. In the event that such a 'supply-driven' interpretation of 'secular stagnation' turn out to be erroneous, these policy prescriptions based on tighter demand and labour cost-cutting measures would likely push the world economy from a mediocre growth performance to a new recession from which it would be even more difficult to exit than in 2009.

Under the alternative view, to which UNCTAD adheres, protracted stagnation reflects downward pressure on aggregate demand, income and employment, combined with systemic financial instability. Raising aggregate demand is a policy priority for the short and longer run. From this perspective, the policy prescriptions can be grouped along three fronts.

First, immediate efforts to boost effective demand require an expansionary and well-calibrated fiscal policy, along with public programmes to strengthen skill levels. If maintained for a sufficiently long period and calibrated towards expenditures with greater multiplicative impact, the effect on rising consumer and investment demand will be significant and self-sustained. In the process, government revenues will rise and the pace of public spending could be eased as private spending resumes. Credit expansion should be channelled towards sustaining real investment and responding to short-term consumer needs.

Second, it will be essential to put in place consistent policies to contribute to a rise of labour incomes so that households can sustain higher consumption without adding to household debt. Under current global demand conditions, the fear of inflation is unfounded. Any (unlikely) resurgence of inflation expectations can be mitigated with consistent and coordinated policy messaging.

This brings us to the third front. International coordination is needed in order to enable a pattern of growth that is consistent with current conditions, in which surplus countries have the capacity to inject more to global demand without stretching financial conditions, and that is also consistent with a more balanced growth of the world economy that can help minimizing the risks of financial crises which tend to unwind when external imbalances grow out of proportion.

**Financing economic recovery**

Recognizing that the main obstacle to sustained growth presently lies on the demand side should not lead to a disregard of the need for expanding and modernizing production. More generally, supply-side "structural" policies should not be opposed to demand-side "short-term" measures. Some policies aimed at enhancing demand are structural in nature: for instance, strengthening the social security system, creating minimum income schemes, introducing more progressive taxation rules, improving labour rights and establishing wage negotiations procedures. Moreover, they favour real investment because they provide firms with a long-term perspective of expanding demand, without which they would not have the incentive to invest. Conversely, some supply-side policies aimed at expanding the profitability of firms and consequently their investment (e.g. wage compression) have negative impacts on demand and, therefore, on investment decisions. Ignoring the linkages between supply and demand policies may therefore lead to self-defeating outcomes.

Preventing such outcomes requires an actor that would be willing to increase its debt and investment expenditure without necessarily generating profits in the short-term: that actor is the state. Just as they did in the aftermaths of the 2008 crisis, governments can be the borrowers of last resort. From the lenders' point of view, financing the state is low risk, since it received the explicit or implicit guarantee of their national or regional Central Banks. From the governments' point of view, abundant and cheap credit can help finance much needed infrastructure investment. For the private sector, such expenditure would generate strong multiplicative effects by creating employment, strengthening domestic purchasing power and providing better infrastructure and public goods for enterprises. All this would improve the conditions for private investment, without any significant negative effect. No inflationary pressure should arise, since idle productive capacity can meet the initial increase in demand, and extended production capacity can respond to the rising demand trend. Neither should public deficits be an obstacle, because higher economic activity would also generate rising public revenues. Rigid rules forbidding any fiscal deficit above a given level may need to be softened, for instance by excluding public investment in priority areas from the calculation of fiscal balances.

A similar approach can be applied to the financing of development goals. The main obstacle is not the availability in general of financing capacity. The question is putting that capacity into the hands of agents wishing to finance long-term investment projects that generate large positive externalities and therefore encourage induced investment. In this respect, a central role in financing development should be assigned to the developmental state.

**Empowering the developmental state**

Development-oriented public expenditure needs to be properly financed. The most important source are government revenues. Governments need to generate the necessary fiscal space to allow them to cover current expenditure and investment needs on a sustainable basis. This requires enhancing fiscal capabilities within developing countries. It also needs multilateral coordination and cooperation for reducing tax competition among countries and tackling tax avoidance mechanisms actively used by transnational corporations. On-going initiatives promoted in the G-20 and OECD to check the "base erosion and profit shifting" towards low-tax jurisdictions should be reinforced and extended to developing countries.

Official development assistance (ODA) is another essential source of funds to be used in long-term investment, especially in low-income countries (LDCs). Unfortunately, recent ODA statistics show a declining trend in aid to LDCs. This needs to be reversed. Donor countries should comply with the commitment of 0.7 per cent of Gross National Income target. Efforts should also be directed to relinking aid to strengthen the productive economy. However, the current focus in the Financing for Development debate on the potential use of ODA to "leverage private finance" should be approached with caution: there is a risk that this is a way of privatizing benefits and socializing risks. An alternative channel could be through concessional long-term financing using development banks.

Banking credit is another major instrument to finance investment. However, structural transformation requires large-scale projects of long maturation periods, which involves risks that private banks are unwilling to undertake. By contrast, development banks are by design appropriate institutions to provide long-term finance and to address market failures. They have a clear mandate to support developmentally oriented projects and a funding base whose liabilities are predominately long term and thus aligned with their mandates. Their equity is, for the most part, owned by highly rated sovereigns which permits the banks to borrow long term in the international financial markets at relatively low costs. Their efforts can be complemented by active credit policy conducted by Central Banks, which can support maturity transformation in the banking system and encourage, or oblige, banks to provide more lending for the financing of productive investment.

**A multilateral approach to sovereign debt resolution**

The international financial system has recurrently generated debt crises since the early 1980s. International financial organizations have been unable to prevent these crises, or mitigate the significant economic and social costs endured by affected countries. In an international context in which many countries are affected by slow growth and deteriorating terms of trade, and remain vulnerable to new financial shocks, it is urgent to design a debt resolution mechanism that preserves the general interest.

The existing processes to deal with sovereign debt crises and resolution are fragmented, slow, and often result in unfair burden sharing and high economic costs for the sovereign debtor. Debt restructuring, in particular, has often been "too little and too late", as insolvency situations were mistakenly treated as liquidity problems. Credit from official sources was then used to pay private creditors instead of supporting the indebted economy – which, on the contrary, had to implement adjustment programmes. This has introduced a recessionary bias to the debt-resolution system.

Under the current fragmented processes, a debtor has to negotiate separately with different types of creditors for different types of debt contracts. The absence of a global forum dealing with the resolution of debt has led to decisions being made at the local level in a wide range of institutional contexts at the expense of global coherence.

In addition, the legal fragmentation problem means different courts have different interpretations of the same contractual clause and can impose a wide array of rulings.

Another problem with the current system relates to creditors' coordination and incentives to holdout from debt renegotiation. Debt reduction requires a coordination mechanism that forces all creditors to accept some nominal losses. In the absence of such a coordination mechanism, some individual creditors will prefer to hold out while other creditors cancel part of their claims. Free-riding and coordination problems are exacerbated by the presence of vulture creditors who buy debt at deep discount on the secondary market, with the explicit intention of litigating after the majority of creditors has reached a settlement with the defaulting country. Based on the recent unprecedented interpretation of the usual "*pari passu*" clause, vulture funds can even block the payments on restructured debt and undermine the international payment mechanism in very different jurisdictions.

It is possible to introduce some changes to the current contractual approach, by introducing a more clear wording to the "*pari passu*" clause and generalizing Collective Action Clauses (CACs). However, this would not provide a sufficiently strong coordinating mechanism, would not necessarily reduce the delay in taking action, and would not guarantee that the resulting restructuring will actually solve the solvency problem. Moreover, it cannot apply to the existing stock of debt.

UNCTAD has been a long-standing advocate of orderly debt workout procedures, an idea that was also considered by the IMF secretariat in 2001, when it prepared a proposal for Sovereign Debt Restructuring Mechanism (SDRM). The necessity to create a more equitable and efficient international debt workout mechanism was reaffirmed in the United Nations General Assembly resolution (A/RES/68/304) "Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes". This resolution has placed the question of sovereign debt restructuring in the United Nations to discuss these issues in a universal and democratic forum, based on the one country one vote principle. Moving towards a sovereign debt workout process at the international level would address the fragmented nature of the existing debt landscape. It would also provide the means to avoid costly delays in handling debt problems, better distribute the burden of debt restructuration and give countries a fresh start to grow their way out of a debt overhang.