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Chairman Carstens,
Chairman Padoa-Schioppa,
Excellencies,
Ladies and Gentlemen:

In my last address to the Development Committee and to the International Monetary and Financial Committee I noted that the short-term economic outlook in the developing world was relatively bright but also characterized by substantial underlying vulnerabilities. Addressing these vulnerabilities requires a renewed effort to strengthen multilateralism and to rethink the governance structure of the multilateral financial institutions.

Policy lessons from the recent financial turmoil

The most important economic event since the last meetings of the International Monetary and Financial Committee and the Development Committee has been the crisis of the sub-prime mortgage market in the United States of America and the associated financial turbulence in both Europe and the United States. While, so far, there have been no negative repercussions in the developing countries, the recent events bear several important lessons and I would like to focus the first part of my statement on these lessons.

Although massive provision of liquidity by several central banks has partially calmed down financial markets, it is still not clear whether the recent turmoil was a panic-driven liquidity crisis or a more fundamental solvency crisis. A sustained drop in housing prices could lead to a slowdown in consumption in the United States and could be part of the mechanism that, together with a fall of the dollar, kick-starts the unwinding of global imbalances. If this unwinding happens in a disorderly way, the consequences for the global economy may be dire.

The main transmission mechanisms would be a sudden drop in demand for developing countries' exports or a large *change* - in one direction of the other - in international investors' appetite for emerging market assets. Either a sudden drop or a sudden increase in the demand for emerging market assets could be problematic. A sudden stop episode could lead to a crisis similar to that which hit emerging market countries in 1998. By contrast, a sudden increase in capital flows to emerging market countries would have positive effects in the short run but could exert a large negative effect in the long run because of real exchange rate appreciation and a possible bubble in emerging market assets. This latter course would be consistent with the recent boom in the valuation of emerging market assets despite cautious credit markets elsewhere.

In thinking about policy recommendations, it is useful to distinguish between short-term and long-term measures. In the short term, policy-makers should stand ready to mitigate the effects of the crisis and prevent contagion. In the long term, policy-makers should think about measures for preventing recurrent crises and focus on the regulatory frameworks.

While I found the short-term policy response of the main central banks appropriate and timely, the vast liquidity injections conducted by the US Federal Reserve and by the European Central Bank have been the subject of severe criticism. Such criticism is based on at least four rationales: (i) Central banks should not bail out market participants who sought to earn large returns from engaging into risky activities; (ii) Banks that require emergency lending should face high interest rates; (iii) Central banks should not accept low-quality paper as collateral, even during crises; (iv) Low interest rates in the US at the beginning of the century were the main driver of the housing bubble and lowering interests rates now, may just generate another bubble and amplify the problems down the road.

Although these criticisms seem to be plausible at first glance, their fundamental thrust appears to be flawed. With respect to the first criticism, one should recall that providing liquidity to the markets to stabilize the target interest rate of the central bank does not necessarily imply a bail-out operation. Individual losses following imprudent lending will appear in the balance sheets even if the central bank tries to avoid collateral damage by injecting liquidity and avoid excessive volatility in the target interest rate. With respect to the second criticism, it is important to emphasize that a sudden increase in the short-term interest rate would penalize all participants on the money market and not only those who were involved in imprudent lending activities. In light of the previous two points, accepting a lower quality standard for refundable paper can be justified as another way to stabilize short-term rates. It is also worth noting that bailing out the depositors of a troubled bank does not automatically mean bailing out the owners and managers of the bank as the loss of trust in the bank will take its toll on the future activities of that bank. With respect to the last point, there is no clear evidence that monetary policy in the United States was too lax after the end of the dotcom bubble. Given the dogmatic and rather restrictive stance of European monetary policy at the time and the inability of the Japanese central bank to escape the zero interest rate trap of lasting deflation, the aggressive cuts of the Federal Reserve played a positive role in stabilizing the world economy.

While the immediate response to the recent financial turmoil has so far proven appropriate and proportionate, something fundamental is amiss with a financial system that cannot survive for more than three or four years without facing an emergency with global repercussions.

Although financial services play a key role in allocating funds to high-return activities, the recurrence of such crises suggests that only well-regulated financial markets will yield the best possible outcome. This has important implications both in the advanced financial markets and in emerging market countries under pressure to increase financial openness and to promote deregulation.

Lack of transparency is a key feature of the recent crisis. Almost three months after the sub-prime crisis first emerged in force the full extent of risk and loss has yet to be revealed. This suggests that securitization deserves greater scrutiny than it has so far received. In a security-based system, banks generate loans but then sell these loans to investors that are better equipped to bear the risk. Such a system is supposedly superior to bank-based finance because, by slicing and dispersing risk, it increases the resilience of the financial system and isolates banks from costly defaults.

The recent events highlight that there may be several problems with securitization, which may increase herding and accentuate market swings as holders of structured instruments will all seek to sell assets during periods of market turmoil. First, it is not clear whether the system was successful in isolating banks from market turbulence. Second, most structured instruments are rarely traded and their valuations are not based on market prices, but on highly subjective and overly optimistic theoretical models. Third, in a bank-based system it is known who holds the risk, but in an opaque market-based system, it is not known where the risk resides. Fourth, banks are more careful in evaluating risk when they plan to keep a loan in their books whereas securitization may lead to laxer credit standards and to a deterioration of credit quality. Fifth, securitization severs the relationship between lenders and borrowers, which allows traditional banks to reschedule with borrowers that are unable to service their debt. Sixth, with traditional banking, lenders have privileged information about the quality of the loan, but with securitization, credit risk moves from bankers who know the value of the credit to institutions with limited knowledge of its origin.

Effective regulation can help to sustain finance and can permit innovative financial engineering while preventing excessive risk-taking. Prudential regulation, however, needs to be comprehensive and should not focus on just one segment of the financial system. Recently, prudential regulation focused on banking activities, and banks responded to regulation by hiding risk in lightly regulated, non-bank institutions. Long-term policies should thus aim at increasing the transparency of financial products. This is not an easy task because, by their very nature, structured products are complex instruments. There are, however, a few steps that should be considered at the multilateral level.

The first has to do with reassessing the role of credit rating agencies.[1] Credit-rating agencies, which should solve information problems and increase transparency, seem to have played the opposite role and made the market more opaque. Rating agencies play an ambiguous role as the current regulatory environment renders rating decisions important in establishing what assets can be held by certain types of financial intermediaries. Moreover, rating agencies are not fully subject to market discipline that would increase the accuracy of ratings. A reform of the role of credit rating agencies in evaluating complex financial instruments is an unavoidable step towards increasing transparency. Proponents of market-based discipline suggest that conflicts of interest could be eliminated by not requiring the use of credit ratings to determine the type of assets that can be held by regulated institutions. An alternative view favours the establishment of a regulatory agency which would supervise the

[1] The 2006 report of the UN Secretary-General on External Debt flagged several problems with the actions of credit rating agencies. The discussion in that report was based on a UNCTAD document titled "Rating the Credit Rating Agencies".

functioning of credit-rating agencies and certify that AAA assets have indeed minimal probability of default.

The second step relates to creating incentives for simpler financial instruments. The current regulatory stance creates a bias in favor of sophisticated and opaque financial products that, more often than not, are poorly understood by market participants and may be overly complex for many developing countries' financial markets. This should be modified by adopting regulations that favor simpler and more transparent financial products.

The third step should address maturity mismatches in non-bank financial institutions. The recent turmoil arose in part from maturity mismatches in non-bank agencies which enjoy liquidity guarantees from parent banks. Better regulation should limit involvement of banks with lightly regulated agencies which could transmit liquidity and solvency problems to the banking system.

The fourth step should focus on limiting credit deterioration linked to securitization: Banks that quickly sell their loans are less interested in monitoring the quality of the borrowers. This problem could be mitigated by forcing banks to keep on their books a part of the loans they extend.

There are also important implications for developing countries. Even though, so far the recent turmoil has not affected the developing world, events that originate in the developed countries often have severe repercussions in the developing world. This is problematic because developing countries have limited space, in terms of both fiscal and monetary policy, for countercyclical policy action. Hence, small shockwaves from the developed world can result in large oscillations in the developing economies. As the size of the regional repercussions depends on the linkages between the various developing regions and the developed world (especially the United States, Europe and Japan), developing countries could reduce their exposure to the vagaries of developed countries' economies by increasing the reliance on South-South trade and integration and thus increasing the diversification of the markets for their exports. Regional monetary and financial agreements could also help in limiting the impact on developing countries of external financial shocks. For instance, monetary cooperation across developing countries could enhance financial stability by limiting exchange rate misalignments and exchange rate volatility and also promote deeper and more stable local financial markets. All these issues are discussed in our latest *Trade and Development Report* on Regional Cooperation for Development.

Debt sustainability and commodity prices

Let me now touch on two issues that have important implications for developing countries. The first has to do with the framework for assessing debt sustainability and the second with the importance of developing international instruments to limit the effects of fluctuating commodity prices.

Over the last few years, the IMF and the World Bank have made great progress in developing a Debt Sustainability Framework (DSF) for Low Income Countries. While such a Framework can play a key role in helping low-income countries to maintain sustainable levels of debt which are compatible with

economic growth and poverty reduction, there are still several issues with the current structure of the Framework. The most important problem with the DSF has to do with its use of debt thresholds aimed at measuring a country's risk of debt distress and determining eligibility for grants from the International Development Agency. According to the Framework, debt sustainability is driven by a combination of the country's debt ratios and the quality of its policies (as measured by the Country Policy and Institutional Assessment index, CPIA). However, the thresholds are calculated by using an econometric exercise that does not predict the probability of debt distress very reliably, and the DSF classifications are blunt, grouping countries into general categories. This may lead to sub-optimal outcomes, as the borrowing capacity of those at the top of the group may be underestimated and those at the bottom may be overestimated. The current framework risks replacing the former 'one-size fits all' approach with a 'four or five-sizes fits all' approach.

Moreover, several concerns remain with respect to the use of the CPIA index. The concept of good governance and institutions is inherently subjective and there are concerns pertaining to the accuracy of the measure and the consistency with which it is measured across countries. Finally, the index may not offer the proper incentive and rewards for low performers and fragile states.

Although 81 commodity-exporting developing countries have benefited from increasing commodity prices and export earnings since 2002 due mostly to demand emanating from developing countries, a number of developing countries (including several African LDCs) are facing problems caused by high commodity and energy prices. Thus, the problem of commodity price instability is far from being solved. We must not forget that primary commodity markets are very sensitive to changes in global demand, so that a slowdown in the world economy can have severe repercussions on countries depending on exports of a small number of primary commodities. Unfortunately, there are no functioning mechanisms to either reduce price volatility or to compensate for resulting losses in export earnings of commodity-dependent developing countries, many of which are among the poorest. It is therefore important to revitalize international instruments that can help developing countries mitigate the impact of such price fluctuations on their import capacity and output growth.

The increasing importance of developing countries in international trade and investment

Developing countries are playing an increasingly important role in global trade and financial flows and this should grant them a greater role in the governance of the international financial architecture.

In the context of foreign direct investment (FDI), developing countries are attracting growing volumes of investment flows. UNCTAD's *World Investment Report 2007* documents that between 1990 and 2006, their share of all inward FDI doubled from 18 per cent to 36 per cent with total inflows reaching $379 billion in 2006 — the highest level ever. But perhaps even more interesting, some developing countries are emerging as significant sources of FDI. Between 1990 and 2006, outward FDI from the South as a share of global outward FDI tripled from 5 per cent to 15 per cent.

Large parts of these investments are channelled to other developing countries, thereby contributing to stronger South-South economic cooperation.

These and other trends reflect a fundamental shift in the global economy, with developing countries assuming a more prominent role in the financial system writ large as well as in the context of development finance. It is necessary to ensure that the voice and participation of these developing countries are adequately reflected in international institutions.

International trade is making important contributions to economic growth in developing countries, and has the potential to make an even bigger impact. Between 1990 and 2006, developing countries' share in world trade increased from 24 percent (USD 848 billion) to 36 percent (USD 4.3 trillion) for trade in goods, and from 19 percent to 23 percent for trade in services. Tectonic changes are taking place in the trading system. The emergence of many developing countries as regional or global locomotives of trade in manufacturing, agriculture and services exports, along with unprecedented expansion of developing countries as major import markets and the increase of intra and inter-regional South-South trade, is shaping what we in UNCTAD refer to as a "new geography of international trade".

South–South merchandise trade is estimated to have expanded from $577 billion in 1995 to $1.7 trillion in 2005. In the second half of 2006, for the first time China's merchandise exports exceeded those of the United States. But China is not the only Southern locomotive of growth and international trade. In the past two decades, a number of other emerging economies have significantly increased their share in international merchandise and services trade. In particular, the "Emerging Seven" (Brazil, India, China, Mexico, the Russian Federation, South Africa and the Republic of Korea) have contributed immensely to this trend. The E7 accounted for around 27 per cent of world exports of goods and services in 2005.

These global trends, however, conceal many disparities within and among countries. In many countries, poverty remains endemic; they face infrastructure deficits and their participation in international trade a weak link. The share of LDCs in global trade remains below 1%. These trends points to more systematic efforts at development solidarity, global coherence and governance through national, regional and international policies and measures aimed at maximizing development gains and minimizing attendant costs from trade and investment driven globalization. This shift in global trade dynamics and the importance of South-South trade, as a complement to existing North-South trade and investment linkages, calls for a reassessment and adjustment of global economic governance. This shift is already evident in the WTO negotiations, where developing countries are organizing themselves to pursue a development agenda.

No wonder that development has had to be at the heart of current negotiations and it has to be delivered. Hence, the international community is facing a moment of truth in the Doha negotiations under the WTO. We need to ensure that all concerned, especially the major trading countries, make the down payments and compromises necessary towards a timely, balanced and successful conclusion of this Doha Development Round. In this regard, five key deliverables need to be ensured as the touchstone of development.

Firstly, the Doha round must result in real, enhanced and additional market access for developing countries exports of commodities, manufactures and services; remove tariff escalation and tariff peaks they face in major markets; and effectively deal with NTBs. Secondly, it must provide developing countries with sufficient policy flexibility to take proactive and enabling measures to develop productive capacity, take care of food security, energy security; rural development and livelihoods. Such special and differential treatment should also reduce the potential cost of implementation and adjustment. Thirdly, the outcome of the Doha round must increase substantially the fairness quotient of the trading system by effectively reducing and eliminating trade distorting agricultural subsidies, and disciplining anti-dumping measures and fisheries subsidies, harmonization and simplification of rules of origin, trade facilitation, and rules issues on services and RTAs etc.

Fourthly, Aid for trade and aid for trade-related infrastructure in the form of aid for development must not be conditional on the Doha outcome. Aid for trade must be significant, additional, non-debt-creating, predictable, needs-based and demand-driven. All developing countries in need should be covered to enable them to take advantage of trade liberalization and achieve and sustain a virtuous circle between productive capacity, competitiveness and market access and entry. Multilateral agencies like UNCTAD should be enabled to reinforce their TRTA and global public goods delivery which has unique value along with bilateral aid. The establishment and resource pledging for the EIF (Enhanced Integrated Framework) is a positive start and UNCTAD will contribute to its operationalization, along with other partner agencies, as well as to the larger AFT initiative and the UN system's response and contribution to it.

Lastly, care needs to be taken to ensure coherence between the multilateral trading system and RTAs, especially in terms of the development dimension and developing countries' rights and obligations (as noted by our TDR 2007). In cases such as the new generation agreements, like the EPAs being negotiated between the EU and ACP countries, a balanced, development-positive and sustainable market access and rules package must be arrived at, accompanied by a credible technical assistance package that is focused on trade needs and additional to other development assistance.

Beyond the Doha mandate, several other opportunities can be further explored to promote trade and the beneficial integration of developing countries in the international trading system. In doing so, one important avenue is to sustain the dynamism of the new growth poles of the South and deepen and widen the development and poverty reduction impact on other countries. Equally important is the promotion of technology and innovation in developing countries to enable them to strengthen their participation in higher value-added production, especially in new and dynamic sectors of world trade, and attain international competitiveness.

Universal access to essential services is one clear way in which international trade could also contribute to poverty reduction. But here, the experience of the last decade suggests that, apart from trade liberalization, public investment, donor support and public-private partnerships are also critical ingredients for a successful national development strategy.

UNCTAD is also trying to assist developing countries in exploiting the window of opportunity in the current commodity price booms to sustain the growth trend and to make it a source of development and poverty reduction, particularly in the commodity-dependent developing countries.

High and unstable oil prices pose serious trade and development challenges for both oil importers and oil exporters. Crude oil prices jumped this week to an all-time high above $86 a barrel. An early winter cold snap or serious geopolitical problems in oil producing regions could drive prices even to $100 a barrel in the near future. Therefore UNCTAD is promoting energy security and sustainable energy mixes suited to each country's situation in energy-importing countries and ensuring that windfall gains from current energy price booms are ploughed back in development activities for future generations.

Oil exporters risk seeing the increased export revenues lead to real exchange rate appreciation and loss of competitiveness. The more deleterious impact, however, will hit oil-importing countries in which rising import bills can trigger knock-on effects that touch every sector of the economy - from falls in household income at the micro-level, to fuel shortages and cost increases that hamper the operations of business (particularly transportation) and undermine export competitiveness, to macro-level increases in inflation, unemployment and external debt. In both groups of countries, the impact of higher oil prices may be particularly serious for the poorer segments of the population.

Another global issue that needs our attention is the trade, investment and development aspects of climate change. Climate change will significantly affect the way in which trade and production processes are organized around the world. We therefore need to find the best ways to address climate-change-related mitigation and adaptation measures including energy efficiency requirements, while at the same time promoting trade and sustainable development of developing countries.

Overall, UNCTAD is committed to upholding the UN Millennium Declaration and its commitment to achieving an open, equitable, non-discriminatory and predictable multilateral trading and financial system. UNCTAD's mission is to promote trade as an effective instrument for the effective and qualitative integration of developing countries into the international trading system. UNCTAD has historically made a positive mark in the trade and development discourse and practice. It is determined to ensure that it now makes an even greater, practical impact in this, most challenging and promising of times. Thus its Twelfth Conference, which will take place in Accra, Ghana, from 20-25 April 2008, will address the opportunities and challenges of globalization for development in the years ahead.

The need to reform the governance of the international financial institutions

Let me conclude with some remarks on the issue of the voice and participation of developing countries in the main international financial institutions. So far, the discussion has focused on the International Monetary Fund and thus I will concentrate on this institution, but it is worth mentioning that similar lines of argument should also apply to the governance of the World Bank Group. Even though, following the

2006 meetings in Singapore, there have been some marginal changes in the ownership of the IMF, several emerging markets and developing economies are inadequately represented in the collective decision-making of the international financial institutions.

In principle, the Fund's voting system allows for adequate participation of the smaller countries through the institution of basic votes. But since these votes have not been increased since 1944, their significance has been greatly reduced, going from the 11.3 per cent of total votes to the current to 2.1 per cent. Even with the quota adjustments agreed in Singapore, and a doubling of the basic vote, the current system is skewed heavily in favour of the developed countries.

The voting reform should be based on a mechanism that allows for adjustments in the medium to long-term and reflects structural changes in the world economy. The Group of 24 has been very active in discussing and elaborating proposals aimed at increasing the voice and participation of developing countries. These proposals, especially the ones aimed at reassessing the role of openness and volatility and the proposal to increase the weight of PPP-adjusted GDP in the GDP blend used to assess the relative size of economies to at least 50 percent, deserve serious consideration.

It is also crucial to mention that reforming the IMF voting structure is important not only for fairness reasons but also to guarantee the long-term viability and relevance of the institution, as more and more developing countries that feel underrepresented are opting out of the system either by accumulating large international reserves and thus self-insuring or by promoting the creation of new institutions.

Thank you very much.