Fifth L.K. Jha Memorial Lecture

Address by Mr. Rubens Ricupero, Secretary-General of UNCTAD Friday, 17 July 1998

"Globalisation, hot money and the search for profitable investments: Is the East Asian Crisis a global crisis ?

Mr. Governor, relatives of the late Mr. L.K. Jha, ladies and gentlemen :

Dangerous, often fatal, is the prophet's calling. Most are put to death. That was nearly UNCTAD's fate a couple of years ago. The few survivors of the lynch mob usually succumb to one of two evils. The first is the ugly sin of Schadenfreude, that is, rejoicing in other people's misfortune. The second is the loss of face they suffer when their predictions do not come true. Things have worsened so much, though, that nowadays prophets of boom run much more risk of being written off than prophets of doom.

The East Asian crisis, which is affecting growth prospects in most developing and developed countries throughout the world to varying degrees, has just had its first anniversary. On the 2nd of July, 1997, the Thai currency was devalued, setting off a fire-cracker of subsequent explosions. Several potential trouble spots for the global economy have been identified. But, as Mr. Michel Camdessus, Managing Director of the IMF, said at the UN in New York last week, the most worrying is the state of the Japanese economy. Aptly, he called it a `crisis within a crisis' Where this drama will end is hard to tell. I, for one, have no wish to play the role of a prophet. What is clear, though, is that the final chapter of this drama has not yet been written.

No one grasped the full implications of the Thai devaluation, when the baht was cut loose from its anchor. Typical of the international reaction at the time was the headline of an article in the Financial Times. `No More than a Blip' it read insouciantly. On the basis of the available evidence it was not an unreasonable thing to say, although I must admit that UNCTAD -- sometimes stereotyped, unfairly, as a perpetual prophet of gloom and doom û took a somewhat more sceptical view.

Over the last 12 months, however, divergence over the crisis has substantially increased û on two levels. At the level of the real economy, the East Asian crisis has, at least for the time being, called in question most of the best success stories of development - those very few cases of countries demonstrating the possibility of bridging the income gap separating them from industrial nations, the most solid evidence so far that globalisation has been capable of generating convergence in the world economy. The crisis has also had the perverse effect of hitting the poor particularly hard, in terms of sharp falls in commodities and in the export prices of some of their other goods. By the same token, the crisis has benefitted the wealthy, through the anti-inflationary impact of cheap imports.

On a different level, over the past year there has been significant evidence of a growing divergence of perceptions about globalisation. I need refer only to the `fast track' controversy in the United States, the anti-WTO demonstrations in Geneva last May, and the suspension of the Multilateral Agreement on Investments negotiations in the OECD, in Paris a few weeks earlier, to make my point.

In a statement I made on UNCTAD's behalf to the United nations' Economic and Social Council during its annual high-level session last year, I said that a backlash against certain aspects of globalisation was more likely to come in Lyon than in Libreville. The facts have proved us right; for those events I have just referred to all took place in developed countries. In one case, the

outcome was the expression of disagreements not only with non-governmental organisations or popular movements but between developed country governments themselves, and -in the case of Canada û even between provincial governments and the federal government.

At the same time, the crisis has forced all of us û in the banking community as well as the multilateral agencies û to come closer together in coping with the heightened danger. It may be wishful thinking, but I believe that there is now much more agreement than a year ago on the nature of the problems that we face. It is thus our duty to improve on this still imperfect intellectual agreement and to build consensus, not only regarding the causes of the disease, which risks pushing development back by several decades, but above all on finding and agreeing upon cures.

In pursuing this course over the coming weeks and months, we should be guided of course by reason and objectivity, but also by solidarity with developing countries. Contrary to the financial markets - cold and ruthless monsters, quick to panic and meagre in compassion - we should seek inspiration in the divine qualities: mercy, kindness and slowness to anger.

Mr. Governor:

The search for timely and appropriate policies to help developing countries attain sustainable economic development in an increasingly interdependent world has been the raison d`etre of UNCTAD for over thirty years. This period has seen many far-reaching changes in the world economy. Among the most encouraging until recently had been the success of the economies in East Asia in managing their integration into the global economy, mainly through foreign trade.

The crisis that we are now witnessing leaves this conclusion unshaken. For the severe damage that has been inflicted on these economies by volatile financial flows was not brought about by what had been done right: that is, the prudent and skilful way they managed trade liberalisation, the gradual and careful opening up of their markets, so as to maximize the benefits of globalisation. Rather, the crisis occurred because the governments concerned were not so successful in managing integration into the capital markets with the same talent as they had shown in other areas of the economy.

At UNCTAD, we believe that well-calibrated national policies can help manage such crises, limit their potential for lasting damage, and reestablish economic growth. But, when economic crises become a systemic problem, action is also needed at the global level. The East Asian crisis is only the latest in a string of financial crises that has disrupted the global economy since the breakdown of the Bretton Woods system. The reality, it is becoming apparent, is that the international community has still to learn how to manage such turmoil, let alone prevent it. At a time when the international trading system has been subjected to mutually agreed rules, backed up by an increasingly invoked dispute settlement system, the absence of even minimal agreed guidelines covering international financial flows is striking. A global mechanism that could monitor and regulate short-term flows, without discouraging long-term money, is badly needed.

The speed at which some of the most successful developing countries in East Asia have been derailed by adverse financial flows has taken us all by surprise. Countries that year after year enjoyed growth rates of between eight and ten per cent per annum, maintained full employment, and went a long distance towards eradicating poverty are now suffering a severe economic contraction. Almost every month, growth projections for the region are being revised downwards.

On some estimates, the decline of output is expected to exceed 15 per cent in Indonesia, and between six and eight per cent in the Republic of Korea and Thailand. Apart from China and its Taiwan Province, barely any country in the region is projected to register positive growth this

year. The extent of decline and hardship is unprecedented, surpassing even those experienced during the collapse of communism in Central and Eastern Europe.

Growth in South Asia also declined in 1997, falling to under five per cent, compared with 6.8 per cent the previous year. The crisis further east undoubtedly contributed to this more modest performance. But restrictions on capital account convertibility and more limited exposure to short-term foreign debt restricted the damage. The villain of the piece in South Asia was more that familiar culprit, adverse weather conditions. Although political instability and inadequate infrastructure will continue to act as brakes on growth in the region, in 1998 UNCTAD expects that both Pakistan and India will see a return to 1996 levels of growth. As South Asian growth last year exceeded that in South-East Asia for the first time this decade, the tortoise will have caught up with the hare.

But there is also a price to be paid for caution. While foreign direct investment in India has been growing steadily during this decade, the numbers remain modest by international standards. Notwithstanding extensive inducements, at under $ 4 billion FDI in India in 1997 was less than that in Chile. By comparison, China, a more comparable country to India, received 11 times as much. In fact, what these figures demonstrate is not the comparative lack of attraction of India for foreign investors û objectively speaking, that would be quite inaccurate - as the huge potential the country holds in this regard. Mr. Tarun Das, Director-General of the Confederation of Indian Industry, made this point in a speech two years ago. As he and other Indian industry leaders have argued, the potential gains are much more than for the balance of payments. FDI can bring with it a package of more intangible benefits which, in the long run, lead to an overall strengthening of the competitiveness of the economy.

Contrary to the views of some commentators, who look short-term at the league tables on FDI attraction that organisations such as UNCTAD publish, India's relatively late start in the FDI game may well turn out to be a real asset. The rise of major national groups with growing overseas connections provides an excellent platform for the type of network relationship that is becoming more the norm among transitional companies than traditional FDI. I could also add here that, as with China, which has benefitted enormously in recent years from overseas Chinese money û showing up in its national statistics as FDI û India has its own large pool of successful entrepreneurs living abroad whose latent interest in their original homeland remains to be fully tapped.

Mr. Governor :

There are no simple recipes for dealing with the situation in the most affected countries in South-East and East Asia. Since the crisis began, we at UNCTAD have suggested that policy advice should be offered with a certain degree of humility, mixed in with a healthy dose of pragmatism. However, it appears that we may all have failed to appreciate sufficiently the gravity of the situation.

Thus, in light of the persistent severity of the crisis, would it not be useful to conduct an honest reevaluation of the international policy response û without any preconceptions or prejudice û so as to assess its achievements and failures? The case of excessively high interest rates maintained artificially high for too long is one area worth reexamining. And, if the IMF is willing to be flexible over budget deficits, why not extend that same spirit to other areas of economic policy-making ? Justice would not be served if the living standards of ordinary people and the stability and prosperity of countries were to be sacrificed by a colossal failure of the global market and by measures to bail out international creditors and local financial institutions.

In East Asia today, decades of rising incomes have been reversed, and unemployment, underemployment and poverty are rising to alarming levels. Many of the lost jobs have been in

sectors of the economy that, in the past, reduced poverty by absorbing low-skilled workers of rural origin. This is particularly so in the small and medium-sized enterprise sectors û the backbone of a truly democratic and balanced market economy. More than the large conglomerates, it is these firms that are being decimated by the full impact of the credit crunch and the high level of interest rates. Sharply higher food prices and reduced social expenditures have further aggravated social conditions and contributed to the growth of poverty.

According to UNCTAD's estimates, the proportion of the Indonesian population living on incomes below the official poverty line in 1998 is expected to be 50 per cent greater than in 1996. Similarly, we expect absolute poverty in Thailand to increase by one third. Unfortunately, these predictions may turn out to be conservative.

As the crisis drags on, it will be increasingly difficult for the new poor to recover from deprivation and regain their previous occupations and living standards. Moreover, the social harm could persist long after economic recovery has been achieved. Judging by the preliminary evidence of growing child malnutrition and declining primary school enrolments in the affected region, particularly in Thailand, where the fire was lit, the human resource impact of the crisis could spill over into the next adult generation.

As a Latin American who lived through the debt crisis of the 1980s, I can tell you that the destructive effect of these disasters can prove extremely damaging, and can take long to reverse. In our case, the crisis had its genesis in a combination of imprudent borrowing and equally imprudent lending, together with the decision to raise interest rates sharply in the United States, regardless of the consequences for third parties. We were treated even more harshly than the East Asian countries are now. The net result is that, after a lost decade of sacrifice and readjustment, even though a recovery is underway, average growth in the region during the first half of this decade has oscillated between three and 3.5 percent. This is much less than the average growth rate of 5.5 percent recorded in the period from 1945 û 1980, and is well short of the six percent figure that the UN's regional commission for Latin America, ECLAC, reckons to be the minimum necessary for the continent, if it is to overcome its social and technological retardation.

In its recently published Social Panorama of Latin America, ECLAC shows that between 1990 and 1996 poverty in the region only declined from 41 to 39 percent of the population. More shockingly, poverty continues to stand at a much higher level than the 34 percent mark recorded before the debt crisis, in 1982.

Worse still is the situation of indigent families living in absolute poverty, defined as those households that cannot satisfy their nutritional needs even after spending all their income on food. The proportion of such households only declined by one point in the first half of the 1990s, from 18 to 17 percent, and remains two percentage points above the pre-crisis level. One in every six households in Latin America finds itself in this desperate situation.

Safety net measures can act as palliatives to cushion the impact of crises on poor and vulnerable groups. But they cannot be treated as lasting solution. Only the resumption of rapid and sustained growth can bring unemployment and poverty levels back down to pre-crisis levels. In consequence, it is now urgent to harmonize two complementary goals: to reform and strengthen local financial institutions in the affected countries and, simultaneously, to reflate domestic economies through an appropriate reduction of interest rates and a necessary expansion of liquidity and increase in public expenditures.

In the best text on development that I have read this year, Professor Joseph Stiglitz, Chief Economist of the World Bank, argues that, 'where currency turmoil is the consequence of a failing financial sector, the conventional policy response to increase interest rates may be

counterproductive.' He goes on to say that, 'empirical studies by IMF and World Bank economists have confirmed that interest rate rises tend to increase the probability of banking crises.'

As for the often heard argument that temporary increases are required to restore confidence and will do little damage, as long as the interest hikes are very short term, Professor Stiglitz indicates that, based on current experience, the evidence is not fully conclusive. In any case, Thailand and Indonesia have now been pursuing high interest rate policies for considerably longer than the average of four months usually considered to be the maximum reasonable duration for such measures. Indeed, it appears that when confidence depends on other factors, totally independent of interest rates, excessive reliance on this kind of measure will do much harm to the economy, without any guarantee of success for the ends to which it was intended. If we really want to break vicious circles that could otherwise lead to irreversible economic collapse, we need to give the highest priority to support for debtors and the unemployed.

Since the outbreak of the crisis, the downward revisions in GDP growth forecasts have been more substantial for developing than for developed countries. Economic growth in developing countries in 1998 is expected to be halved compared to 1997, falling to almost two per cent. Given the bleak prospects for recovery in East Asia, we expect the widening of the income gap between the North and the South - identified in last year's Trade and Development Report from UNCTAD - to continue. For the first time in many years, excluding China, growth in the developing world will fall below that of the developed world.

The global ramifications of the crisis have not been felt so acutely in the industrial world, since the benefits of declining commodity prices and improving terms of trade appear, so far, to outweigh the loss of incomes and jobs due to reductions in exports to the region. However, developing countries in most other parts of the world have already started to feel the adverse consequences of the crisis. Because of the risk of contagion, many emerging markets elsewhere have undertaken preemptive monetary and fiscal restrictions in order to maintain market confidence and reduce their vulnerability to a reversal of capital flows. In consequence, they have choked off domestic demand and lowered overall growth.

Moreover, developing countries are expected to be affected more than the developed countries by negative trends in the volume and export prices of their goods. From Chile, Cuba, Ecuador and Peru in Latin America to Angola, Congo, Tanzania and Zambia in Africa, and to Kazakhstan, Russia and Romania, developing countries in all regions have depended on East Asia for an important part of their export earnings. The collapse of growth in East Asia has been the single most important factor in the recent declines in the prices of many commodities, including oil, agricultural raw materials and metals. For some of these countries, up to a quarter of export earnings may be lost.

Unfortunately, far from subsiding, the crisis seems to be deepening, as can be seen in this rapid overview of recent developments:

economic growth and exports are slowing down in China, alongside a decline in prices for the seventh consecutive month;

in Hong Kong, the first quarter of 1998 recorded a two per cent drop in GDP;

as a result of recession and the continuous depreciation of the yen in Japan, Pakistan has devalued for the second time in nine months;

the Australian dollar has fallen, and Australian commodity exports will probably fall for the first time in 20 years, leading to a current account deficit expected to exceed 6.5 per cent of GDP;

the New Zealand Government has warned that the economy is 'halfway down the road to recession,' as GDP declined by 0.9 per cent in the first quarter;

in the same period, Taiwan recorded its first quarterly trade deficit in 17 years.

The improvements so far in the current account of the countries at the centre of turmoil are due essentially to sharp import compression rather than to an expansion of exports. Besides the inter-regional dynamics and higher prices of imported inputs, a major factor contributing to this situation is the credit crunch affecting companies in those countries.

The financial picture continues to be sombre. Last year, the East Asian region suffered a net loss in capital flows of US $ 109 billion, equivalent to 11 per cent of regional GDP. There were also precipitous decline in private flows to Africa and the Middle East. On top of this, the spreads required for any financing in developing countries are increasing, as well as the risk premium on government bonds in the Eurobond market for nations in Latin America and Africa.

More problems could yet unfold if a new cycle of competitive devaluation starts, with the increased danger that a process of competitive devaluation could trigger a protectionist backlash in major markets in North America and Europe.

Mr. Governor,

For many years, UNCTAD has argued that the global economy needs to grow at a rate of at least three per cent, year in and year out, in order to start making a dent in unemployment in industrialized countries and poverty in developing countries. In recent times, this figure was attained only in 1996-97. Even then, it was extremely unevenly distributed. Nevertheless, many people started to believe that the world economy was at a turning point, poised to reap the fruits of increased liberalization, deeper integration and faster globalization.

In our Trade and Development Report last year we drew particular attention to the asymmetry between labour and capital, and pointed out that the exit option that capital enjoyed in comparison with labour was a major source of global instability and inequality. In our view, the 'discipline' that financial markets undoubtedly exert on policy makers does not favour the unemployed and underprivileged, but rather holders of existing wealth. I imagine that this point will have particular reverberation in India, where issues of social justice are matters of daily political debate.

Today, given the close integration of financial markets and speed with which financial capital moves across borders, almost every major financial crisis is a global one. When a crisis occurs, defaults are inevitable unless massive bail-out operations take place. But bail-outs are becoming increasingly problematic. Since they are designed to prevent default, they protect creditors from bearing the full costs of poor lending decisions, thereby putting the burden entirely on debtors. And in doing so they can create moral hazard for international lenders, encouraging imprudent lending practices. But, above all, the scale of funds required for bail-outs has been growing in step with the size of financial markets - and may be reaching the limits of political acceptability.

Professor Kenneth Galbraith once said that in blaming anything and anybody except the real culprits for what are essentially market failures, some people create the impression that markets are not only infallible but also sacred. In addressing an audience composed heavily of persons from the financial milieu, I may risk unpopularity in saying this, but I believe that the late L.K. Jha would have agreed with the spirit of my remarks. For he would have appreciated that these devotee of the cult of the market are overlooking the obvious fact that financial markets are inherently unstable and volatile, for they rely more than other markets on speculation and risk. This is particularly true in an era of hedging, derivatives and futures trading.

Add to these new financial instruments, the enormous sums of money at the disposal of fund managers who often have difficulty in distinguishing between Dhaka and Dakkar and the dangers are frightening. Better quality, more timely information for market makers and borrowers alike is essential. But how can the pension funds of tens of millions of ordinary Americans and Europeans be put to good use, in search of a profitable return, without killing the golden goose that laid the egg? At a time when the distinction between portfolio investment and FDI is becoming blurred, the problem facing policymakers wishing to entice the latter while controlling the former is increasingly awkward.

However much we regret or dislike it, we have to deal with an unpleasant and often dangerous reality. Let us take the example of volatile short terms flows. I do not need to teach any lessons to the Reserve Bank of India, but it may be useful to hear my own experience from Brazil to reinforce the point about the dilemma policymakers often face. Four years ago, I was Finance Minister of Brazil when we introduced the new currency on the 1st of July 1994. It was, and continues to be, a huge success, bringing inflation down from a staggering 55 per cent a month - almost two per cent a day - to something close to three per cent a year. In the process, it freed 11 million people from a situation of extreme poverty.

But all of us in government knew quite well at that time that, for political reasons, some of the economic fundamentals necessary to underpin a lasting stabilization were not in place and would not be for some time. We were also aware that, under those unfavourable conditions, we would probably have to run a trade and current account deficit that could only be balanced by international financial flows, hopefully much of it as foreign direct investment but some of it short-term funds.

Faced with such circumstances, should we have given up fighting the scourge that was devastating our society, multiplying the number of the poor and waited for more favourable times? We chose to go ahead. The same policy dilemma has faced all countries, particularly in the developing world, that have been unable to sustain rapid growth rates without a deterioration in their current account. Of course, we did not foresee the East Asian crisis and the increased volatility in the financial markets. But I am still persuaded that we made the right choice.

Regrettably, textbook solutions are not what the policymaker usually finds in his path. If I can abuse your tolerance, I will say that, for me, short- term flows are like the miraculous new male potency pill, Viagra. In really desperate cases, or if you can not help it, then it may become unavoidable. But you had better manage it very carefully, or else it will create so much excitement that it will prove too much for weak hearts. In an ideal world, it would be better to avoid it altogether. As that latter course is not necessarily a practical option, one should bear in mind the Roman saying 'dosis facit vaenenum' in other words, it is the dose that makes the poison.

For all these reasons, because short-term flows are inherently volatile, and because financial markets are not the same as potato markets, it is much more difficult to manage integration into international capital markets than it is to successfully insert oneself into the international trading system. This is why the Asian countries, including Korea, a recent entry to OECD status, succeed in the latter, but managed less well in the former.

This is also why one should avoid pushing or pressuring developing countries into premature financial liberalization, thus denying them the option to protect their economies from international financial instability, and volatile and speculative capital flows. The cautious approach taken by India to financial integration and liberalization has stood it in good stead during the crisis. Nor should it be seen as necessarily out of step with the rest of the world. After all, mature capitalist countries in Europe like France and Italy took a very long time until they adopted full convertibility of the capital account of the balance of payments. Some waited until as late as 1990 to do so.

Until appropriate global checks and balances are in place, we should assist and guide the developing countries in recognizing the need for reforms, but these should be introduced thoughtfully and progressively. Strong domestic capital markets and a transparent banking system are, of course, prerequisites. Cleaning up bad debt in line with BIS guidelines and recapitalizing the banking systems of the worst affected countries of East Asia are vital steps. Meanwhile, for the less badly hurt, in South Asia for example, it may be worth considering another look at the regulatory system, to avoid nasty surprises when controls on external borrowing are eased further.

The same wise combination of realism and determination has to be applied to reforms at the international level. The adoption of much-improved and effective controls and regulations that go beyond conventional prudential measures are badly needed, if we want to prevent future crises. Such results can not be achieved in a once- for -all conference, a new Bretton Woods conference, as some have called for, but will require a long and patient process of consensus-building on a shared and balanced agenda. Mr. Governor:

The prudent approach India has adopted to integration into the world economic system, moving at its own pace and following its own compass, is being vindicated. And the investments it has made in education and in science and technology, creating a world - class cadre of scientists, software designers and so on, will prove to be money well spent. The wheel turns full circle; and the country that produced the ancient wisdom of the Vedas and other great works of Sanskrit culture is now a world leader in a modern language, that of computer software. This will be your spearhead into the outside world, as India takes its rightful place among the leaders of the twenty first century.

Thank you for your attention.