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Globalization and interdependence

Role of the United Nations in promoting development in the context of globalization and interdependence

Report of the Secretary-General*

I. Introduction

1. In the course of the past several months, and in particular in August and early September 2001, it became evident that the slowdown in the world economy was becoming much deeper than had been expected at the beginning of the year. Industrial production and business and consumer confidence were falling in many developed countries, and several commentators were forecasting major declines in high-profile indicators, such as equity prices and the flow of private foreign investment to developing countries.

2. Assessments now suggest a substantial decline in global growth. Practically every forecast made towards the first half of 2001 had to be modified in the third quarter of the year, including forecasts by the United Nations and, the International Monetary Fund. Whereas the *World Economic and Social Survey 2001*[1] forecast a growth for 2001 of 2.4 per cent for the world economy, this number is now being revised to 1.4 per cent, with forecasts for 2002 indicating perhaps a growth rate of 2 per cent.

3. These revised figures do not take into account the potential impact on the global economy of the terrorist attacks on the United States of America, on 11 September 2001. The precise impact will depend on how these will affect trade, business and consumer confidence, investments and the flow of capital among countries. Certain industries are, at least in the short term, experiencing a very direct impact, most notably the travel and tourism industries.[2] Events over the forthcoming few weeks will therefore be essential for assessing the direction in which the world economy is moving.

4. The present developments take on particular significance in the context of globalization and interdependence. Recent experiences, such as the Asian financial crisis of 1997-1998, its recovery phase, and the current slowdown in the global economy, show the macroeconomic dimension of globalization and its impact on reducing or amplifying the normal cycles of business activity in the industrialized world and in developing countries. As a result of these experiences, concerns about globalization are focusing increasingly on the structural, rather than cyclical, vulnerabilities of countries to globalization. Such vulnerabilities arise from various areas, including finance and investment, international trade, natural disasters, or from substantial changes in the nature of the economic system.[3] Growing attention is therefore being placed on the processes and capacities for managing the interaction of trade and finance. The forthcoming International Conference on Financing for

* The footnote requested by the General Assembly in resolution 54/248 was not included in the submission.

Development and its preparatory process provide a major opportunity for addressing these interrelated issues from a developmental perspective.

5. The present report is submitted in response to General Assembly resolution 55/212 of 20 December 2000, in which the Assembly requested the Secretary-General to prepare, in close collaboration with the United Nations Conference on Trade and Development (UNCTAD) and other relevant organizations, an analytical report on the effect of increasing linkages and interdependencies among trade, finance, knowledge, technology and investment on growth and development in the context of globalization, containing action-oriented recommendations, including on appropriate development strategies at both the national and international levels, and to submit it to the Assembly at its fifty-sixth session. Contributions from UNCTAD and a number of other United Nations organizations, in particular the Economic and Social Commission for Asia and the Pacific, were incorporated into the present report.[4]

6. The complex issue of globalization was addressed by the General Assembly at its earlier sessions, particularly since the holding of its first high-level dialogue, on the social and economic impact of globalization and interdependence and their policy implications during its fifty-third session. Subsequently, the Assembly decided, by resolution 53/169, to place the important issue of globalization on its agenda, and to address specifically the role of the Organization in promoting development in the context of globalization and interdependence, as well as the issue of promoting coherence, complementarity and coordination of economic and development issues at the global level in order to optimize the benefits and limit the negative consequences of globalization and interdependence. These issues were examined in the reports of the Secretary-General (A/54/358 and A/55/381), with the latter report focusing on information and communication technology (ICT).

7. At its present session, the Assembly addressed the theme, "Responding to globalization: facilitating the integration of developing countries into the world economy in the twenty-first century" within the framework of the second high-level dialogue, on strengthening international economic cooperation for development through partnership held on 20 and 21 September 2001. The dialogue focused on two of the most timely and relevant aspects of the issue, namely, promoting the integration of developing countries into the world economy and generating new public and private financing resources to complement development efforts; and enhancing the integration of developing countries into the emerging global information network by facilitating access to information and communication technology for developing countries.

8. Responding to the most recent mandate of the General Assembly in resolution 55/212, and taking into account that globalization and its various aspects have been extensively discussed within the United Nations system and elsewhere, section II of the present report seeks to analyse the increasing linkages and interdependencies among the major components of the process of globalization referred to by the Assembly in that resolution (i.e., trade, finance, knowledge, technology and investment) and to explore possible policy responses. Section III of the report, prepared by the secretariat of UNCTAD, focuses on coherence and consistency of policies for the prevention and management of financial crises. This section, as well as other parts of the report dealing with issues of finance, complement several recent United Nations documents, in particular the report of the Secretary-General on international financial architecture and development, including net transfer of resources between developing and developed countries (A/56/173) and its addenda (containing a note by the United Nations Development Programme (UNDP) on financial stability as a public good (A/56/173/Add.1) and information on work undertaken by UNCTAD in relation to long-term private flows (A/56/173/Add.2)), and should be read in conjunction with them. Also of direct relevance are the report submitted by the Secretary-General to the Preparatory Committee for the High-level Intergovernmental Event on Financing for Development at its second substantive session (A/AC.257/12) and the forthcoming report of the Preparatory Committee for the International Conference on Financing for Development. The detailed conclusions and recommendations made in these reports are not repeated herein. The recommendations contained in section IV below focus on enhancing the role of the United Nations in promoting the national and international development strategies that minimize the risks and take advantage of the opportunities emerging from globalization.

II. Linkages and interdependence

9. In recent years, it has become clear that processes of globalization have left few countries untouched. Economic, social, political and cultural transactions across national boundaries among citizens, enterprises and Governments have been progressively widening and deepening. Realizing that these processes were inexorable, many developing countries have sought to benefit from globalization and have thus based their development strategies on increasing integration into the global financial, trading and information exchange systems through liberalization of their economies.

10. The complexity of the phenomenon of globalization and, in particular, the linkages and interdependence of its components, present a daunting challenge to policy-making and implementation, both at the national and international levels. The various elements — trade, finance, investment, technology and development — tend to be under the purview of different ministries and agencies at the national level, and different organizations and intergovernmental bodies within the United Nations system. The challenge of bringing coherence to policy-making, at all levels, is thus among the first and foremost challenges posed by globalization. The consistency and focus with which the General Assembly has been addressing the issue of globalization in all its complexity in recent years testifies to its determination to advance the debate from a general understanding of the nature of globalization and its policy implications, through addressing its major individual components, such as ICT, to a comprehensive and integrated analysis aimed at producing action-oriented decisions and recommendations.

11. Globalization has made the task of pursuing development even more complex than before, primarily because of the increasing interaction among the various components that characterize it. For example, world trade is influenced in a major way by, in addition to existing international and national trade regimes, the results of investment decisions, by the availability of finance, by evolving technological infrastructures that facilitate trade, and by the rapidly growing role of knowledge as a production input and the enhanced ability to tap dispersed sources of knowledge and of knowledge-related activities. Similarly, investment is determined by, in addition to investment regimes and investment climate and risks, such factors as export prospects, the availability of tradable knowledge, greater diffusion of technological innovation and, again, evolving technological infrastructures. A policy approach that addresses just one or some of these factors is likely to be only partially effective, at best.

12. As stressed in the report of the Secretary-General to the Millennium Assembly (A/54/2000), the more integrated global context demands a new degree of policy coherence. The international financial architecture needs strengthening, as does the multilateral trade regime. Greater consistency must be achieved among macroeconomic, trade, aid, financial and environmental policies, so that all support the common aim of making globalization work for all.

13. With growing interdependence, Governments need to work together with all stakeholders to ensure that the gains from globalization are widely and equitably distributed and, in particular, reach developing countries. They also have to ensure that the gains are not quickly reversed and that countries are not pushed back into the quagmire of poverty. While States remain the key players in managing the globalization process, the role of civil society is becoming more important, since global problems can only be resolved through effective involvement and partnerships at all levels.

14. Despite such setbacks as the Asian crisis, experience has shown that countries that have successfully integrated their economies into the global economy and, as a result, attracted foreign investment and gained access to knowledge and global information networks, have achieved higher growth over time and made significant strides in alleviating poverty.

15. On the other hand, countries that have not benefited from the process of globalization tend to lack the structural and policy foundation necessary to take advantage of more open and integrated trade, investment and financial regimes. These countries, especially the least developed countries, by and large face a global trading environment that does not address their concerns in a transparent and equitable manner. In addition, developing countries have inadequate capacity to manage the globalization process, including lack of flexibility in economic and social structures and lack of adequate social protection mechanisms, which exacerbate their existing vulnerability, in particular of the poor, to exogenous shocks.

16. The following sections of the present report seek to outline some of the main factors that affect trade, finance, knowledge, technology and investment, with a view to identifying the linkages and interdependencies among them and their implications for growth and development.

A. Trade

17. The rapid growth of international trade in goods, services and finance, plus the prevalence of new technologies and innovative modalities for production and marketing in the global marketplace, are among the most visible features of the current patterns of globalization. Such cross-border interactions have contributed to the growth and recovery of the economies of many countries, including a number of developing countries, in particular in East and South-East Asia. The maintenance of an open liberalized domestic economy was decisive in explaining, for instance, East Asia's growth. It not only allowed for large inflows of foreign direct investment (FDI) but also for the rapid export growth generated to a large extent by foreign-invested companies. FDI inflows have been particularly high in those countries that also witnessed large export growth. Generally speaking, those countries that failed to open their economies and adopt an effective export promotion strategy also failed to reap the benefits of the globalization process.

18. Provided that appropriate policies are implemented, an institutional framework is established, and laws, rules and regulations are duly enforced, external trade is generally seen as a contributor to alleviating absolute poverty in most developing countries through a rapid expansion in output and employment in labour-intensive export industries and related activities. There are, as well, increases in real wages for labour, which is the primary asset that poor households possess.

19. Over the past decade, developing countries have indeed reduced the level and dispersion of tariffs, dismantled non-tariff trade barriers and increased reliance on market forces to allocate foreign exchange. Foreign participation is being allowed to improve the level of technology and efficiency and also to generate the financing for the required investments. These policies, associated with other market reforms, were associated with an acceleration of output and export growth. However, owing to continuing barriers to products of export interest to developing countries, developing countries remain at a competitive disadvantage in international trade and in the acquisition of the most recent production technologies and methods, which further exacerbate their marginalization from the emerging knowledge-based global economy.

20. This is particularly true for many commodity-exporting developing countries which, owing to weakening world demand, are confronted with declining prices for many primary commodities. These countries must deal with the problems of both a downward trend in commodity prices in the long term and high volatility in the short term. Many small, low-income economies confront not only the problem of mitigating the short-term volatility in international commodity markets but also the challenge of diversifying their economies in a period of increasingly specialized global production.

21. A graphic example of the problems that developing countries must deal with in trying to integrate into the emerging global knowledge-based and networking economy is participation in production networks. The growing production and service networks of multinational corporations across the world, coupled with the growing trend in mergers and acquisitions, have led to the emergence of complicated global and regional business networks that can have a positive or negative impact on the local economy. In addition, increased intra-firm trade and closer links between assemblers and component producers means that competition is now more between systems and networks than among individual firms. However, many developing countries are not part of these systems and networks. They are thus left out of the global systems of production and trade. Many exhibit low or negative growth rates in export earnings. Lessons could be learned from examples of successful development of small firms which are based either on their complementarity with large-scale firms or on the alliance of smaller firms in clusters. This is a key area in which growth can be enhanced by increasing the productivity and income of otherwise underemployed workers.

22. Trade flows, linked with finance, investment and technology, can induce rapidly spreading consequences, positive as well as negative, across borders. In the Asian experience, slower growth in high-tech exports played an important role in the build-

up of external fragility, and the impact of the subsequent financial shock was amplified through intraregional trade. On the other hand, the positive impact of trade flows is equally powerful, as exemplified in the Asian recovery, in which the import demand of the United States of America served as a driving force for the recovery of many countries hit by the 1997-1998 crises. In 2000, the growth of United States imports reached double-digit figures for the third consecutive year. The benefits to developing countries and economies in transition were particularly marked, their total export volumes being estimated to have risen by over 10 and 15 per cent, respectively.[5]

23. However, such interdependency can be a double-edged sword. Growth of United States import demand is slowing significantly in 2001 and thus many economies that have close trade connections to the United States, such as those in the Americas and South-East Asia, are experiencing a slowdown in the growth of their exports. Especially hard hit were exports of countries specializing in ICT products. Moreover, economic growth has also slowed or ceased in other large economies and this, too, has weakened global demand for the exports of developing countries. This is reflected, inter alia, in weak international commodity prices[6]. Other international linkages, such as stagnating private capital flows, rising risk premiums on external financing for some developing countries, softening commodity prices and inadequate access to global information infrastructure further inflict damage on fragile economies.

24. Globalization, together with interdependence, amplifies both upswings and downswings, thereby placing ever greater demand on policy formulation, coherence and coordination. In this regard, the issues related to the implementation of the commitments and provisions undertaken in the Uruguay Round of trade negotiations concerning products of interest to developing countries and the launching of a new trade round, currently being discussed at the World Trade Organization (WTO), are of crucial importance to the future of the world economy and to the growth and development of developing countries. In this regard, a productive, balanced and development-oriented outcome of the ministerial meeting of WTO in Qatar will be essential.

B. Finance

25. The globalization of financial markets has been spurred by ongoing deregulation of national financial markets, in particular of capital and exchange controls, and fuelled by rapid financial innovation that has facilitated foreign portfolio investments and other cross-border movements of capital. Although net international capital flows have not grown as explosively as have gross flows, the volume of international financial transactions has been extraordinary by any measure. For instance, the average daily turnover in the foreign exchange market has grown from about US$ 200 billion in the mid-1980s to around US$ 1.2 trillion in the mid-1990s, equivalent to about 85 per cent of all countries' foreign exchange reserves. Technological developments have further accelerated the integration of global financial markets, leading to paperless trading in fully computerized and automated stock exchanges across the world.

26. The globalization of financial and capital markets has facilitated access to capital, providing enterprises in developing countries increased access to the international bond and equity markets in addition to lending funds originating from international banks. At the same time, liberalization of capital markets has led to large inflows of foreign portfolio investments that provide foreign investors with a useful tool to hedge their operations and risk, but are short-term and volatile in nature. The Asian financial crisis painfully demonstrated the potentially destructive effects that such flows can have on national economic development. As a response to the crisis, some Governments tried to curb and control the inflows of such risk capital while continuing to encourage FDI.

27. Developing countries and economies in transition have been highly vulnerable to financial volatility, where there is rapid expansion and diversification of financial flows, often followed by abrupt reversals. This pattern has been aggravated, in some cases, by premature liberalization of the capital account, fragile domestic financial structures, and weak financial regulation and supervision. Extended financial booms build up strong pressures on aggregate domestic demand, and that makes macroeconomic imbalances unsustainable during the ensuing financial contraction. They also tend to weaken financial structures, since increasing risks are often underestimated. Under these

conditions, a downswing may result in a domestic financial crisis which consumes large amounts of the scarce resources that could otherwise be available for development and which severely affects economic activity and investment for several years. The impact of financial crises on the real economy in developing countries and economies in transition is thus far larger than in developed market economies.

28. The financial crises have clearly shown that abrupt or premature liberalization of the capital account is inappropriate for developing countries and economies in transition. Strong domestic financial systems, regulation and supervision are essential elements in guaranteeing appropriate liberalization. However, even with strong fundamentals in these areas, it has proved quite difficult for the developing countries and economies in transition that liberalize the capital account to adapt to the conditions generated by volatile international capital flows, which may in fact weaken or destroy those fundamentals.

29. As the liberalization of financial markets facilitates access to international capital, the need for a strong and viable financial sector becomes more crucial than ever for effectively intermediating the global financial flows, in particular volatile short-term transactions. The 1997 crisis demonstrated the enormous impact of the financial sector on the development process, including the perils arising from contagion. It highlighted the interdependence of financial markets and prompted the discussion on the need to reform the global financial architecture, including the creation of an early warning system for impending financial crises.

30. Such reform should encompass a number of interrelated aspects, including international liquidity management, global consistency of macroeconomic policies and financial regulation, and prevention and management of financial crises, as well as finance for development and resolution of outstanding debt issues. With regard to prevention and management of financial crises, reforms in this area must be addressed with a sense of urgency in six key areas: (a) improved consistency of macroeconomic policies at the global level; (b) reform of IMF aimed at providing adequate international liquidity in times of crisis; (c) adoption of codes of conduct, improved information, and financial supervision and regulation at national and international levels; (d) preservation of the autonomy of developing and transition economies with regard to capital account issues; (e) incorporation of internationally sanctioned standstill provisions into international lending; and (f) design of a network of regional and subregional organizations to support the management of monetary and financial issues.[7]

31. A central element of a new international financial architecture is the development of regulatory and supervisory mechanisms that will better correspond to the current globalized private capital and credit markets. Such mechanisms should be global in the sense of including all countries (and particularly source countries), as well as different financial institutions and markets, so as to avoid regulatory gaps and asymmetries. However, due account should be taken of different national financial structures and traditions as regards financial regulation and supervision.

32. Stronger regional and subregional institutions can play a significant role in terms of the stability of the world financial system. The experience of Western Europe suggests that regional financial organizations and arrangements can play an essential stabilizing role. More limited experience at a regional level, including that of regional and subregional development banks and a few reserve funds, indicates that they can also play an important role in a new international financial architecture, both in crisis management and in finance for development. The swap arrangements of the Association of South-East Asian Nations with China, Japan and the Republic of Korea provide one example of a subregional support system to deal with emergency liquidity problems. Strong regional reserve funds would at least partially deter would-be speculators from attacking the currencies of individual countries and thus, among other dire effects, from threatening regional trade and financial relations. They could also supplement IMF funds in times of difficulty. Thus, on both the demand and the supply sides, they could reduce the need for IMF support. Moreover, regional institutions and peer review could also play a central role in surveillance, both of macroeconomic policies and of domestic financial regulation and supervision. Indeed, such surveillance and peer review could be more acceptable to countries than that of a single, powerful international institution. It would contribute towards a more balanced globalization.

C. Investment

33. Foreign direct investment has contributed to the globalization of financial markets as leading corporations set up networks of businesses, which are often quoted on the various stock exchanges in the world. FDI has also contributed to the growth of world trade, as well as to the increase in the volume and diversification of global financial flows due to intra-firm shipments and concomitant capital flows among countries. At the same time, the surge in FDI flows would have been impossible without the liberalization of trade and investment regimes and rapid developments in ICT that have facilitated the expansion, through FDI, of production and marketing operations of business enterprises across national borders.

34. Flows of FDI now far surpass exports. Sales of foreign affiliates have grown faster than world exports of goods and services, and the ratio of the volume of world FDI stocks to world gross domestic product (GDP) has grown twice as fast as the ratio of world imports and exports to world GDP, which suggests that the expansion of international production has deepened the interdependence of the world economy beyond that achieved by international trade alone. FDI has become a major part of global private capital flows to developing countries and has exceeded official flows, such as official development assistance. However, FDI continues to be concentrated among developed countries and less than a dozen of the largest developing countries economies.

35. In addition to providing a source of finance and capital, FDI also serves as a conduit of knowledge and technology. Through their considerable research and development efforts, their links to the network of research laboratories and their ability to negotiate the labyrinth of the international patent system, the multinational corporations have not only been the drivers of FDI but have also pushed technological developments.

36. In the economies of many developing countries, FDI has made a significant contribution to economic growth, employment generation, training new skills and acquiring expertise. It can also facilitate the transfer of technology to developing countries and increase their access to international markets. However, the concentration of FDI in a few of the largest developing economies means that many of the least developed countries are not able to benefit fully from the transfer of technology and access to export markets. The least developed countries remain heavily dependent on official development assistance, which has declined over the years. FDI flows are also subject to the vagaries of the market. In the current economic climate, there has been a significant drop in the levels of FDI to the emerging markets and developing countries, especially the least developed countries.

37. Attracting FDI needs a commitment on the part of the host country to create the conditions that are conducive to such flows, including good governance and transparency, sound macroeconomic conditions, and tax and fiscal policies. It also entails the development of appropriate national and/or regional institutions. For example, the establishment of national and regional investment guarantee agencies, co-insuring with the Multilateral Investment Guarantee Agency or working independently, should be encouraged to provide insurance against non-commercial risks on attractive terms. Such agencies can be set up as joint ventures with the private banking and insurance sector. Working alongside one-stop investment promotion agencies, such agencies can be effective tools in lowering the information and entry costs for investors and raising expected returns on investment, thereby increasing the potential volume and duration of investment flows.

38. Equity is a major concern in the spread of FDI. There is a widely shared need for global action to spread more widely the flows of FDI and to make such flows development-oriented. These concerns could be addressed through a multi-stakeholder alliance that could propose practical steps towards the realization of these twin goals.

D. Technology and knowledge

39. The pace of technological change, especially in the ICT sector in recent years, has led to revolutionary changes in the processing and dissemination of data and to the emergence of an information society, with a profound effect on production, services, organization of labour and the environment. ICT has increased the information available and improved the quality of information for the purposes of sound decision-making by individuals, firms and Governments. Knowledge has become a source of competitive advantage and is increasingly embedded in the production process.

40. Information and communication technology has allowed greater mobility and flexibility in the movement of goods and services, has made production processes more flexible, and has allowed more efficient utilization of resources and thus contributed to higher productivity and economic growth. The importance of ICT to the process of globalization, and especially the linkages among trade, finance, investment and development, cannot be overemphasized.

41. Owing, in no small measure, to rapid increases in telecommunications and computer-based technologies and products, cross-border financial flows have expanded at a remarkable pace. Changes in ICT, together with new financial instruments and risk-management techniques, have enabled a wide range of financial and non-financial firms to manage their financial risks more effectively. Complex financial instruments such as derivatives would not have flourished without the technological advances of the past decade. Without high-powered data-processing and communication capabilities, derivatives could not be priced properly, the markets that they involve could not be arbitraged properly, and the risks that they give rise to could not be managed at all.

42. The rapid expansion in cross-border banking and finance should not be surprising, given the extent to which low-cost information processing and communication technology has improved the ability of customers in one part of the world to avail themselves of the borrowing, depositing or risk-management opportunities offered anywhere in the world on a real-time basis. These developments enhance the process whereby an excess of saving over investment in one country finds an appropriate outlet in another. In short, they facilitate the drive to equate risk-adjusted rates of return on investments throughout the world. They thereby improve the worldwide allocation of scarce capital and, in the process, engender a huge increase in risk dispersion and hedging opportunities.

43. Information and communication technology has enabled the acceleration of global integration of production processes, which has increasingly contributed to the growth of world trade. Through the use of ICT, companies have been able to set up global production and service networks and, in the process, link numerous small and medium-sized enterprises, including in the developing countries and in economies in transition, to the global marketplace. Further advances in the access of developing countries to ICT and, in particular, electronic commerce, have the potential of significantly enhancing their participation in the global trade in goods and services. Expansion of the Internet and increased access to markets will lead to greater competition in both production and services geared to local or to foreign markets. Access to ICT will increasingly become a determinant of investment by foreign enterprises seeking opportunities in developing countries.

44. Participation in the competitive knowledge-based global economy will increasingly require a certain level of electronic readiness (i.e., a business environment that is conducive to Internet-based commercial activity) as one of the factors of production. However the picture is very bleak for many developing countries which are far from being "e-ready", although they may be in the process of liberalizing telecommunication markets. This digital divide reflects an economic divide at the national and global levels that, in the absence of adequate levels of investment, resource and technology transfer, as well as appropriate policies and regulatory environments, will continue to increase to the detriment of the poor, especially in developing countries.

45. The Governments of developing countries are confronted by huge challenges in bringing their countries into the information age. The enormous investments required in the necessary human, physical and institutional infrastructure is beyond the capacity of most countries. They require the technical and financial assistance of the developed countries and the international donor community, and the active participation of the private sector. Policies appropriate to national economic structures, production bases and social needs should be implemented urgently in order to address structural deficiencies that hinder the ability of these countries to participate in the knowledge-based global economy.

46. In order to prevent further marginalization and the exacerbation of the digital divide, it is vital to ensure developing countries effective and affordable access to information and knowledge. In this context, there is a need to identify ways and means of providing and improving effective access to and transfer of knowledge and technology for such countries.

47. There is a clear sense that the new technologies, and the financial instruments and techniques that they have made possible, have strengthened

interdependencies between markets and market participants, both within and across national boundaries. As a result, a disturbance in one market segment or one country is likely to be transmitted far more rapidly throughout the world economy than in previous eras.

48. It is crucial, in particular in the light of the global economic slowdown, that the international trading system continue its difficult evolution towards fairness and openness. The issues relating to the implementation of the Uruguay Round provisions relating to products of export interest to developing countries need to be addressed. In this regard, the productive, balanced and development-oriented outcome of the ministerial meeting of WTO in Qatar would be crucial.

III. Coherence and consistency of policies for the prevention and management of financial crises

49. The accelerating pace of economic interdependence over the past two decades means that the impact of economic policies and performance in one part of the world economy can now be felt far more quickly and spread far more widely than was the case when the international system was taking shape after the Second World War. Accordingly, pursuing domestic policy goals with due regard for the cross-border effects of the actions taken in pursuit of them remains a key to overall global economic stability. With a growing and more diverse group of countries actively participating in the international economy, the chance for possible policy conflicts has increased and the threat of destabilizing shocks has heightened. However, the policy decisions of a small number of industrialized economies still have a disproportionate bearing on the overall economic prospects of the international system.

50. Trade provides one channel for transmitting shocks across countries. This channel has widened considerably with the reduction of legal, geographical and political barriers to trade. Policy makers in developed countries, where the bulk of world trade is concentrated, continue to worry about the negative impact of external shocks, such as higher oil prices. However, the general trend in terms of trade has in recent years been to their advantage, and the limited trade links across the main industrial blocs means that shocks from this source are easier to contain than in the past. With an increasing number of developing countries turning to export-oriented development strategies, however, the health of markets in major industrialized countries has become more important for their macroeconomic stability and growth prospects. Slow growth in these markets and continued restrictions on products for which developing countries have competitive advantages, together with increased competition among developing countries themselves, means that many developing countries continue to be very vulnerable to external shocks, in particular to those resulting from abrupt policy changes in the major industrialized economies.

51. The shape of the current global trading system reflects a long and steady evolution over the past 50 years. Global financial markets, by contrast, began their explosive global expansion only after the collapse of the Bretton Woods system in the 1970s. Although private capital flows have been greatest among the advanced industrial economies, the size, composition and distribution of flows to developing countries have also been transformed during the past three decades. Bank credit was initially the most important form of private capital flow to developing countries but, since the debt crisis of the early 1980s in particular, rapid liberalization and privatization has encouraged sizeable equity and FDI flows, albeit concentrated on a small number of so-called emerging markets. In theory, economic fundamentals are expected to be the overriding influence on private capital flows. In reality, short-term profit opportunities, speculative pressures and herd behaviour have also exerted a powerful influence, bringing considerable instability to these flows.

52. Experience suggests that developing countries are particularly vulnerable to reversals of external capital flows and that the scale of the damage can be particularly large. This is partly owing to their high level of net external indebtedness and the higher share of that debt denominated in foreign currencies. It also reflects the small size and institutional fragility of financial markets in many developing countries, so that the entry and exit of even medium-sized investors from industrialized countries is capable of causing considerable price fluctuation.

53. The fact that recent crises in emerging markets have been provoked by a reversal of capital inflows

greatly complicates the adjustment process in these countries. This process often starts not with unsustainable policies, but with the introduction of policies designed to maintain macroeconomic stability and to be integrated more quickly into the global economy. In the absence of effective controls over capital flows, macroeconomic signals, which are taken as success indicators when capital is flowing into a country, can quickly be transformed into warning signs when market sentiment shifts; currency appreciation, rising asset prices and an extension of bank lending which accompany, and further encourage, large capital inflows, can be followed by a vicious spiral of depreciation, price collapse and a crisis in banking when capital flows out.

54. Such crises in emerging markets can be triggered by external shocks; indeed, they have often been connected with major shifts in exchange and interest rates in the major industrialized countries. This was true not only for the debt crisis of the 1980s, but also for more recent boom-and-bust cycles in capital flows to Latin America, East Asia and Eastern Europe. However, given the global reach of markets, contagion has become more pervasive. Emerging markets have many more trade and financial ties with each other than they had in the past. The Asian financial crisis was compounded by regional trade and currency links which helped to spread and intensify a vicious spiral of declining asset prices and output losses to neighbouring countries, including those with strong records of macroeconomic responsibility. In addition, financial links have opened up channels of contagion back to creditor countries; concerns about the exposure of banks and other financial institutions in advanced industrialized economies accompany each outbreak of crisis in an emerging market. In the Russian bond crisis, those concerns were great enough to trigger a swift response from the Federal Reserve in the United States.

55. The increasing frequency of financial crises is itself a major concern for policy makers but, in addition, the intertwining of trade and financial flows means that the consequences of shocks are becoming much more difficult to predict and manage. Not only was the ferocity of the East Asian crisis in terms of lost output and social damage much greater than was expected, but the benefits derived by advanced countries through movements in favourable terms of trade and capital reflux in search of less risky investments were also unforeseen.

56. The promise that floating among the major reserve currencies would bring stability, orderly balance-of-payment adjustments and greater policy autonomy has not been realized. Instead, currency misalignments have fed into growing macroeconomic imbalances among the big industrial blocs, greatly complicating economic management. For developing countries, in which there is a structural tendency for deficits to rise quickly as growth accelerates, the liberalization of trade and capital flows has meant that the choice of exchange-rate regime has become a politically charged issue. Moreover, with the major currencies experiencing large swings, neither floating nor fixing holds out much hope of a stable solution for developing countries.

57. A more interdependent world economy has become a much more volatile one. Indeed, according to IMF, trends in the 1990s point to a global economy in which there is a potential for excesses to develop in asset markets and the private sector, and therefore for recurrent macroeconomic instability even when macroeconomic policies are reasonably well disciplined.[8]

58. Against this setting of growing global interdependence and instability, the search for greater policy coherence takes on added importance. The exposure of developing countries to sudden shifts in trade or financial flows is made all the more worrisome given their diminishing policy autonomy. Multilateral action could provide an alternative means of support. However, multilateral surveillance has become increasingly asymmetric as industrialized countries have dropped any financial reliance on the Bretton Woods institutions. An original concern with facilitating timely economic adjustments for all members through a shared set of rules has shifted to the promotion of policy instruments for developing countries, based on a universal set of economic principles that provide the basis for identifying and admonishing governmental errors and restoring market confidence.

59. Despite its much more intrusive presence in developing countries, the success of multilateral surveillance in preventing financial crises has been limited. This reflects the continuing limitations of multilateral institutions in handling the problems posed

by large private capital flows. To date, faith in financial liberalization has meant insufficient attention to the sustainability of private capital flows and to the harmful effects on recipients of their instability. However, it is also closely related to inadequate surveillance of policy actions by the larger industrialized economies, which are the major creditor countries.

60. This is in partial contrast with developments in the trading system. Here, the steady move towards a more liberal system has also been marked by persistent biases against developing countries. However, a degree of multilateral surveillance has evolved which, in theory at least, allows for even-handed treatment among countries regardless of their economic and political status and, in some areas, recognizes the value of special treatment for poorer countries. With no comparable structure for global finance even being discussed, let alone put in place, the political and economic weight of creditor countries continues to dictate the current workings of the multilateral financial institutions.

61. A more stable system of exchange rates and payments positions calls for a minimum degree of coherence among the macroeconomic policies of the major industrialized countries. However, the existing modalities of multilateral surveillance do not include ways of attaining such coherence or dealing with unidirectional impulses resulting from changes in the monetary and exchange rate policies of the United States and other major industrialized countries. What is needed is a more balanced system, one which can identify global fault lines, wherever their source or location. This requires closer scrutiny of the policy choices of the major industrialized countries. It also requires more careful attention in IMF surveillance to the build-up of financial fragility and external vulnerability linked to private capital flows. Here, surveillance will need to pay greater attention to the sustainability of capital flows, and the Fund's recommendations should include, where needed, control over such inflows.

62. With the extension of IMF surveillance to include issues in the financial sector, international codes and standards covering financial activities and in related areas, such as data dissemination and fiscal transparency, are taking on greater importance in the search for global financial stability. However, they also carry dangers, particularly where consensus and voluntary enforcement are compromised. Already, implementation of standards has been linked to conditions of eligibility for access to multilateral lending facilities. Smooth progress in global initiatives on standards requires even-handedness regarding the various aspects of their application among all of the parties involved, including both debtors and creditors. In particular, developing countries will need to be given a much stronger voice in the relevant multilateral institutions and standard-setting bodies so as to ensure that their concerns are fully taken on board and that a meaningful level of participation is achieved.

IV. Conclusions and recommendations

63. The conclusions and recommendations below should be seen in the context of the preparatory processes for at least two other events which will provide much greater depth and detail than can be achieved in the present report. Both the negotiations under way in preparation for the ministerial meeting of WTO at Doha, Qatar, from 9 to 13 November 2001, as well as the preparatory process for the International Conference on Financing for Development, scheduled to be held at Monterrey, Mexico, from 18 to 22 March 2002, provide major opportunities for the international community to address most if not all of the core issues that arise from the dynamic interaction of trade, finance, technology and investment and that shape globalization and interdependence.

64. The key challenge that must be met in these and other international policy forums is to place development at the centre in considering how globalization is managed, and not to view it as a by-product of globalization. Development goals should shape the framework of globalization rather than allowing the blind forces of globalization to define development outcome. This implies not only ensuring greater policy coherence at the global and national levels, but also making the international trade, finance and technology regimes much more responsive to development.

65. At the international level, the United Nations, given its universality and broad mandate, has an important role to play in promoting policy coherence with the explicit goal of placing development and poverty eradication at the centre of policies and processes related to global integration. Also, coordination needs to be strengthened so as to ensure

the most efficient and effective use is made of international assistance, both financial and technical. Improved coordination of and cooperation among donors and international organizations is a necessity at the national, regional and international levels.

66. Given its system-wide coordination functions and its growing role as a central global forum, the Economic and Social Council could be encouraged to deepen its dialogue with the Bretton Woods institutions and WTO. The Council could encourage the United Nations system to develop integrated policy responses and a set of mutually reinforcing actions to address globalization, with a view to strengthening efforts to achieve the outcome of the major United Nations conferences and the goals set during the Millennium Assembly. The high-level meetings of the Economic and Social Council with the Bretton Woods institutions should continue to be used as an important opportunity for policy makers to address the task of ensuring coherence in policies for financial, macroeconomic and development cooperation and for the airing of new ideas and initiatives.

67. In this context, the Economic and Social Council could be encouraged to explore the feasibility of spearheading the work of several organizations of the United Nations system and WTO in the Integrated Framework for Trade-related Technical Assistance for the least developed countries, created to increase the effectiveness and efficiency of such assistance in part by strengthening coordination among participating agencies. The Council could also be invited to explore ways of broadening this assistance by raising awareness and sharing experience as regards interlinkages with other issues, such as knowledge, technology, finance and investment.

68. To build the capacity in developing countries and economies in transition to deal with the challenges of globalization calls for additional efforts by the international community in terms of financial resources and technical assistance. Support should be given to national efforts to strengthen programmes and projects for education, institutional capacity-building and development of human resources. Financial support provided through official development assistance should be concentrated on key areas, such as physical infrastructure, development of human resources and institutional and managerial capacity-building.

69. Governments need to foster an environment that enables the private sector of developing countries and economies in transition to be integrated more effectively into the globalization of economic activities. To this end, the key impediments in many developing countries need to be addressed, such as insufficient physical and legal infrastructure, an inadequate human resource base, weak financial systems and lack of access to technology. In this regard, the provision of technical and financial assistance by the international community and the active participation of the private sector are crucial in addressing structural deficiencies that hinder the ability of the developing countries to participate in the knowledge-based global economy.

70. The globalization of production by multinational corporations, the globalization of international finance, the globalization of information and the large-scale movements of people have not been matched by a corresponding reshaping of relevant institutions. The challenge we face is that institutional arrangements for economic governance have fallen far behind the realities of the growth and interdependence that are known as globalization. Global institutional structures could be usefully adapted and evolved in the functioning of financial markets, international capital flows, intellectual property and patent regimes, competition policy and bankruptcy law, taxation and trade policies, and regulation and supervision of banks and financial institutions. In each of these policies, an improvement in institutions would require better coordination and cooperation among global, regional, bilateral and national governance structures.

71. Given the nature of linkages and interdependence in the driving forces of globalization and its cumulative impact on growth and development, Governments need to cooperate in establishing fair and equitable trade, investment, technology and knowledge regimes. In this regard, ensuring greater participation of developing countries in the decision-making processes and institutions should be a key goal.

72. As coordination and cooperation is strengthened at the global level, it should be borne in mind that development strategies must be tailored to domestic and local conditions. Domestic resources and institutions must be strengthened and mobilized so as to ensure that a development strategy serves to advance the objectives and priorities of the national

development agenda and to enable a country-specific response to global trends and impacts.

73. There is an urgent need for a partnership encompassing the Governments of both developing and developed countries, international organizations, civil society and the private sector in order to ensure the adequate flow of resources, knowledge and technology to developing countries so that they can effectively address the underlying causes which stand as obstacles to sustainable development and poverty eradication. To enhance the design and implementation of development programmes and investment projects, lessons could be drawn from the experiences of regional partnerships among Governments, business communities and non-governmental organizations.

Notes

[1] United Nations publication, Sales No. E.01.II.C.1.

[2] See, for example, “The impact of the attacks in the United States on international tourism: an initial analysis”, World Tourism Organization, 18 September 2001 (http://www.world-tourism.org/market_research/impact_attacks).

[3] See *World Economic and Social Survey 2001* (United Nations publication, Sales No. E.01.II.C.7), part two.

[4] In addition to contributions from a number of United Nations organizations and specialized agencies, their publications were extensively used in preparation of the present report (e.g., various issues of United Nations, *World Economic and Social Survey*; United Nations Conference on Trade and Development, *World Investment Report* and *Trade and Development Report*; and World Bank, *Global Economic Prospects* and *Global Development Finance*).

[5] UNCTAD, *Trade and Development Report 2001* (United Nations publication, Sales No. E.00.II.D.10).

[6] For more details, see *World Economic and Social Survey 2001*...

[7] Further details are discussed in the report of the Task Force of the Executive Committee on Economic and Social Affairs of the United Nations, entitled “Towards a new international financial architecture”.

[8] IMF, *World Economic Outlook, October 2000*, chap I.