South Unity, South Progress.

Statement by
MR. MARTIN KHOR
EXECUTIVE DIRECTOR
TO THE MINISTERIAL MEETING OF THE GROUP OF 24
Washington DC, 10 April 2014

Weak and uncertain global economic conditions

Before the world economy has been able to fully recover from the crisis that began more than five years ago, there is a widespread fear that we may be poised for yet another crisis, this time in emerging economies. Once again, most specialists on international economic matters have been caught unawares. In fact, the signs of external financial fragility in several emerging economies have been visible since the beginning of the financial crisis in the US and Europe. The South Centre has constantly warned that the boom in capital flows that had started in the first half of the 2000s and continued even after the Lehman collapse is generating serious imbalances in the developing world along with the danger of a sudden stop and reversal.

Policy choices in advanced economies, notably in the US as the issuer of the main reserve currency, in response to the crisis are key to understanding what is going on. Reluctance to remove the debt overhang caused by the financial crisis through timely, orderly and comprehensive restructuring, and an abrupt turn to fiscal austerity after an initial expansion, has meant an excessive reliance on monetary means to fight the Great Recession, with central banks entering uncharted policy waters, including zero-bound policy interest rates and the acquisition of long-term public and private bonds (quantitative easing). This ultra-easy monetary policy has not been very effective in reducing the debt overhang or stimulating spending. It has, however, generated financial fragility, at home and abroad, notably in emerging economies.

The US itself is vulnerable because the Fed may not be able to exit from the ultra-easy monetary policy and normalize the size and structure of its balance sheet without market disruption and it cannot continue without creating bubbles. Tapering does not yet signal a return to monetary tightening and normalization of the Fed's balance sheet. It reduces not the level of long-term assets on the Fed's balance sheet but monthly additions. Besides, the policy rates are pledged to remain at historical lows for some time to come, even after unemployment rate falls below 6.5 per cent, if inflation remains low. Thus, ultra-easy money is still with us. But the markets have already started pricing-in the normalization of monetary policy and this is the main reason for the rise in long-term rates and the turbulence in emerging economies.

Responding effectively to the looming difficulties

In several emerging economies, policies pursued in recent years have no doubt made a significant contribution to the build-up of external vulnerability. Many commodity-dependent economies have failed to manage the twin booms in commodity prices and capital flows that started in the early years of the millennium and continued until recently, after a brief interruption in 2008-09. These countries, and several others, have stood passively by as their industries have been undermined by the foreign exchange bonanza, choosing, instead, to ride a consumption boom driven by short-term financial inflows and foreign borrowing by their private sectors and allowing their currencies to appreciate and external deficits to mount. Hastily erected walls against destabilizing inflows have been too little and too late – and neither wide enough nor high enough to prevent build-up of imbalances and fragility.

The IMF, the organization responsible for safeguarding international monetary and financial stability, has also failed to promote judicious policies not only in major advanced economies, but also in the South. It has been unable to correctly identify the forces driving expansion in emerging economics and joined, until its recent U-turns, the hype about the “Rise of the South”, arguing that major emerging economies are largely decoupled from the economic vagaries of the North and have become new engines of growth, thereby underestimating their vulnerability to shifts in policies and conditions in the North, notably the US. Even when it became clear that capital inflows posed a serious threat to macroeconomic and financial stability in these economies, its advice was to avoid capital controls to the extent possible and introduce them only as a last resort and on a temporary basis.

The policy response to a deepening of the financial turbulence in the South and tightened balance of payments should be similar in many respects to that recommended by the South Centre in the early days of the Great Recession. The principal objective should be to safeguard income and employment. Developing countries should not be denied the right to use legitimate trade measures to rationalize imports through selective restrictions in order to allocate scarce foreign exchange to areas most needed, particularly for the import of intermediate and investment goods and food.

Emerging economies should also avoid using their reserves to finance large and persistent capital outflows. Experience suggests that when global financial conditions are tightening, countries with large external debt and deficits find it extremely difficult to restore "confidence" and regain macroeconomic control simply by allowing their currencies to freely float and/or hiking interest rates. Nor should they rely on borrowing from official sources to maintain an open capital account and to remain current on their obligations to foreign creditors and investors. They should, instead, seek to involve private lenders and investors in the resolution of balance-of-payments and debt crises and this may call for, inter alia, exchange restrictions and temporary debt standstills. These measures should be supported by the IMF, where necessary, through lending into arrears.

The IMF currently lacks the resources to effectively address any sharp contraction in international liquidity resulting from a shift to monetary tightening in the US. A very large SDR allocation, to be made available to countries according to needs rather than quotas, would help. But a greater responsibility falls on central banks in advanced economies, notably the US Fed, which can and should – as the originators of destabilizing impulses that now threaten the South – act as a quasi-international lender of last resort to emerging economies facing severe liquidity problems through swaps or outright purchase of their sovereign bonds. The Fed could buy internationally issued bonds of these economies to shore up their prices and local bonds to provide liquidity; and there is no reason why other major central banks should not join this undertaking.

The way forward

The extent to which these tools – exchange restrictions and temporary debt standstills, IMF lending into arrears, a sizeable SDR allocation and provision of market support and liquidity by major central banks – should be used would no doubt depend on the specific circumstances of individual EEs. However, these unconventional mechanisms need to be included in the policy arsenal and deployed as and when necessary in order to break away from the muddle-through approach that characterised past interventions in currency and balance-of-payments crises in the South and to avoid unnecessary pains.

The world economy is facing bleak prospects largely because the systemic shortcomings in the global economic and financial architecture that gave rise to the most serious post-war crisis remain unabated. The Outcome Document of the 2009 UN Conference on the "World Financial Crisis and Economic Crisis and Its Impact on Development" had clearly recognized that "long standing systemic fragilities and imbalances" were among the principal causes of the crisis and proposed "to reform and strengthen international financial system and architecture" so as to reduce the likelihood of the occurrence of such crises. It pointed to many areas where systemic reforms are needed including regulation of "major financial centres, international capital flows, and financial markets", the international reserves system including the role of the SDR, the international approach to the debt problems of developing countries, and the mandates, policies and governance of international financial institutions. So far the international community has failed to address any of these issues in a significant way. They need to be put back on the agenda if recurrent financial crises with severe international repercussions are to be averted