SOUTH CENTRE

POLICY BRIEF

No. 47 June 2018

Renewed crises in emerging economies and the IMF – Muddling through again?

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It is now more than a decade and a half since the last severe currency crisis in a major emerging economy – that was in Argentina in 2001-2002 following a series of crises in Russia, Turkey and Brazil. It is now common knowledge that such crises generally occur when countries fail to manage surges in capital inflows so as to prevent build-up of fragility including currency appreciations, large and persistent current account deficits, increased leverage and currency and maturity mismatches in balance sheets. The absence of a major crisis in the Global South since the early years of the new millennium owes not so much to judicious management of the surge in capital inflows that had begun in the early 2000s and continued with full force after the global financial crisis, as to persistently benign global financial conditions resulting from exceptional monetary policies in the US, Europe and elsewhere in advanced economies and favourable global risk appetite.

Even though there has been no fundamental reversal of these policies, the arrival of the Minsky moment appears to be imminent with markets, in expectations of normalization of monetary policy in the US, getting nervous about the risks they have taken by investing heavily in emerging economies with poor economic fundamentals in search for yield in conditions of low global interest rates and ample supply of liquidity. The first serious signs have appeared in Argentina with the recently elected government of Macri knocking on the doors of the International Monetary Fund (IMF). But Argentina is perhaps only the tip of an iceberg. Several other emerging economies are equally and even more susceptible to sudden stops and reversals of capital flows and currency and balance of payments crises.

In typical IMF interventions in previous crises, liquidity support was provided mainly to keep debtor countries current on their payments to international creditors and to maintain the capital account open. As a result, obligations to private creditors were translated into debt to the IMF. Simultaneously, austerity was imposed on debtors by means of hikes in domestic interest rates, fiscal retrenchment, cuts in employment, wages and pensions in order to achieve a sharp turnaround in the current account, primarily through import compression, and to restore confidence among international creditors and investors.

This approach to crisis management was widely criticised on several grounds. A strong case was made that the combination of debtor austerity and creditor bailout would lead to inequality between debtors and creditors in the incidence of the burden of the crisis, create moral hazard by allowing creditors to avoid the full consequences of the risks they have taken and are paid for, and endanger the financial integrity of the Fund. Inequalities could also be created among creditors; in the event of a default and restructuring, those who exit first could escape without haircut, leaving the others to take the full brunt of debt write-offs. Profit opportunities are also created for vulture funds, at the expense of genuine creditors as well as the debtor, as seen in the case of Argentina.

Considerable scepticism was also expressed within the Fund about the wisdom of using public money to bail out private creditors and investors. During the earlier episodes of crises, the IMF Board recognized the need for involving the private sector in forestalling and resolving financial crises, but insisted on voluntary mechanisms, notably collective action clauses (CACs) and automatic rollover clauses in debt contracts and informal negotiations between debtors and creditors (IMF, 1999; 2000a). However, as these proved ineffective and some advanced economies started to oppose bailouts, the IMF Board agreed that in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally, and that since there could be a risk that this action would trigger capital outflows, a member would need to consider whether it might be necessary to resort to the introduction of more comprehensive exchange or capital controls. No protection against litigation was offered, but it was suggested that the Fund could signal its acceptance of a standstill imposed by a member by lending into arrears to private creditors (IMF, 2000b). The Fund staff went further and proposed a formal Sovereign Debt Restructuring Mechanism (SDRM) to facilitate sovereign bond workouts. However, this did not elicit adequate support and had to be abandoned. The issue was soon forgotten with a rapid recovery of capital inflows to emerging economies and bounce back of economic activity in crisis-hit countries.

However, private sector involvement in crisis resolution was back on the agenda again with the onset of the

Eurozone crisis. The Fund turned its attention to sovereign debt restructuring after misjudging the sustainability of the Greek debt, very much in the same way as it had done with Argentina about a decade earlier, pouring in money to bail out private creditors (IMF, 2013b). It restarted searching ways and means for involving the private sector in crisis resolution so as to "limit the risk that Fund resources will simply be used to bail out private creditors" and to ensure that private creditors made some concessions and took some losses on their holdings as a condition for Fund lending (IMF, 2013a). Subsequently it was suggested that the sovereign approaching the Fund for assistance were to be asked to find ways of rolling over all bonds and commercial loans falling due within the life of the Fund programme (IMF, 2014). This would be necessary whether external payments difficulties are perceived to be as one of liquidity or solvency which is often difficult to identify with a reasonable degree of precision *ex ante*. This so-called "reprofiling" was again to be market-based and voluntary. However, no statutory mechanism was proposed for bailing in the private creditors in the event of failure of a voluntary agreement. In such an event, as long as the IMF stood firm in refusing lending without private sector involvement, the debtor would have had no option but to impose unilateral standstills on its obligations to private creditors, but without any statutory protection against litigation. Although various proposals were made outside the Fund to address the holdout problem and protect debtors against litigation, the matter was once again put aside without being resolved.

The stakes are now getting higher because of massive amounts of external liabilities that emerging economies built up in the past ten years. These are not only in debt contracted in reserve currencies, notably by private corporations, but also unprecedented amounts of foreign holdings in local deposit, bond and equity markets. Furthermore, most emerging economies have eliminated or significantly reduced restrictions over capital outflows by residents. Consequently, exit of non-residents from local markets and capital flights by residents now constitute bigger sources of potential drain on reserves of emerging economies than external debt contracted in reserve currencies.

Emerging economies are widely commended for large amounts of international reserves they have accumulated in the new millennium. However, in the large majority of cases these came from capital inflows rather than current account surpluses. Cumulatively, all Group of Twenty (G20) emerging economies except China and Russia have registered current account deficits since the beginning of the millennium, at a total amount of some $2 trillion while their external labilities have increased by over $4 trillion. Reserves accumulated is less than a quarter of the increase in total liabilities while the rest of capital inflows (new liabilities) has been used for financing current account deficits or private acquisition of assets abroad – assets that would not necessarily return at times of interruption and reversal of non-resident capital inflows. As of end 2016, on average, the reserves of deficit G20 emerging economies were less than one-third of their total non-foreign direct investment (FDI) external liabilities including debt issued internationally and non-resident holdings in local deposits, bonds and equities. In many cases these holdings plus short-term forex debt reach or exceed international reserves. In most cases reserves would be totally inadequate to provide a reliable buffer against a generalized exit of non-residents and a widespread capital flight by residents.

Given the dismal record of the IMF in crisis intervention and management, many emerging economies are loath to go back to the IMF in the event of a severe currency and liquidity crisis, except those such as Argentina whose neo-liberal policies are strongly supported by the IMF. In any case at some $800 billion, the lending capacity of the IMF would be too small to take on the task. The level of liquidity that may be needed by many emerging economies in the event of capital reversals exceed by a large margin what the IMF could provide under exceptional financing.

Most emerging economies would also be highly reluctant to resort to unilateral debt standstills and exchange controls in view of their exposure to creditor litigation and chronic dependence on international lenders and investors. On the other hand, not much relief could be expected from South–South multilateral arrangements for liquidity provision, notably the Chiang-Mai Initiative Multilateralization (CMIM) of East Asian countries and the Contingent Reserve Arrangement (CRA) of Brazil, Russia, India, China and South Africa (BRICS). These are not only small in size but also have design problems. The CMIM has never been called upon, even during the global crisis. It does not include a common fund but a series of promises to provide liquidity, with each country reserving the right not to contribute to the specific request by a member. Its size is $240 billion and access beyond 30 per cent of quotas is tied to an IMF program. The CRA is also designed to complement rather than substitute the existing IMF facilities. Its size is even smaller, $100 billion, and access beyond 30 per cent is also tied to the conclusion of an IMF programme. Thus, these regional arrangements do not provide escape from IMF conditionality and surveillance.

That leaves bilateral swaps among central banks and bilateral lending by governments of reserve-currency countries, notably the US, and surplus emerging economies with ample international reserves such as China. A very large part of bilateral swaps established by the US Federal Reserve is with other advanced economies (Council of Foreign Relations, 2015). Those with emerging economies (Brazil and Mexico) are too small to provide much relief. In the words of the former chair of the US Federal Reserve, Janet Yellen, expanding the swap lines to serve as a safety net for countries encountering balance of payments pressures is not within the Fed's mandate and therefore is a complete non-starter (quoted in Triggs, 2018, p. 8). China has swaps with over 30 countries. But these are mostly with advanced economies and designed to support trade and investment and to promote the international use of renminbi rather than boost reserves.

To sum, as recognised by the IMF (2016), the global financial safety net including international reserves, Fund resources, bilateral swap arrangements, regional financing arrangements is "fragmented with uneven coverage" and "too costly, unreliable and conducive to moral hazard". Given the aversion of emerging economies to the IMF and unilateral debt standstills and exchange controls, the next crisis is likely to be even messier than the previous ones. Some countries may seek and succeed in getting bilateral support from China or some reserve-currency countries according to their political stance and affiliation. For instance, one of the most vulnerable emerging economies, Turkey, is likely to approach China, Russia or some Gulf states with strong reserve positions rather than the IMF if its currency goes into a free fall. In such cases, crisis intervention would become even more politicised than in the past and a lot less reliant on multilateral arrangements. By failing to establish an orderly and equitable system of crisis resolution, the IMF may very well find its role significantly diminished in the management of the next bout of crises in emerging economies. In other words, multilateralism, however imperfect, could face another blow in the sphere of finance after trade.

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