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Developing countries very vulnerable to global economic crisis, UN role is vital: South Centre speech at UN

The world economy is as fragile today as in 2009. Developing countries are very vulnerable to a slowdown caused by the Eurozone crisis. There has been no global reforms and the G20 is ineffective. Thus the role of the UN on global economic issues is vital. These are highlights of the speech by the South Centre's Chief Economist at the UN General Assembly High Level Thematic Debate on the State of the Global Economy in New York on 18 May.

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By Yilmaz Akyüz

Global economic conditions continue to have a strong bearing on production, trade and investment in developing economies (DEs). In this respect the current landscape is not very encouraging. After three years of recovery the world economy still remains highly fragile. The short-term outlook is for contraction in several advanced economies (AEs) in Europe. Growth in others, including the US, is weak and erratic. But more importantly, medium term prospects are bleak almost everywhere.

There is considerable uncertainty in global financial markets. Asset and commodity prices, risk spreads, capital flows and exchange rates are highly susceptible to sudden swings with devastating consequences for growth and employment. While growing public deficits and debt are an ongoing source of economic stress in several major AEs, currently the Achilles Heel of the international economy is the eurozone (EZ). Consequently, the way the EZ crisis is handled is a major concern for DEs.

At a first glance, the recent record looks very promising for DEs. The new millennium has witnessed a staggering rise of the South. During 2003-08, the average growth of DEs exceeded that of advanced economies (AEs) by some 5 percentage points, compared to around one point in the 1980s and 1990s. The difference widened during 2008-11 as most DEs proved resilient to the crisis while AEs collapsed.

This growth divergence has widely been interpreted as the South "decoupling" from the North. However, the evidence does not show the desynchronisation of cycles between DEs and AEs, and deviations of economic activity from underlying trends continue to be highly correlated. The more significant question is whether there has been a durable shift in the trend growth of the South relative to the North. A closer look suggests that the growth surge in DEs owes more to exceptionally favourable international economic conditions than improvements in their underlying fundamentals.

Until the financial crisis, the credit, consumption and property bubbles in AEs generated a highly favourable global economic environment for DEs in trade and investment, capital flows and commodity prices. At least one-third of pre-crisis growth in China was due to exports, mostly to AEs, and the ratio is even higher for smaller Asian export-led economies. China's accession to the WTO also gave a major impetus to outsourcing and exports to AEs by removing uncertainties surrounding its access to the US market.

From the early years of the 2000s, low interest rates and rapid expansion of liquidity in the US, Europe and Japan triggered a boom in capital flows to DEs. This was supplemented by a surge in workers' remittances, which exceeded 3 per cent of GDP in India and reached double-digit figures in some smaller DEs. Commodity prices rose strongly, largely thanks to rapid growth in China. On some estimates, Latin America would not have seen much growth had terms-of-trade, dollar interest rates and capital flows remained at the levels of the late 1990s.

With the financial crisis the global economic environment deteriorated in all areas that had previously supported expansion in DEs. AEs contracted, capital flows were reversed and commodity prices declined sharply. However, DEs showed resilience and were able to rebound quickly, particularly where a strong countercyclical response was made possible by favourable payments, reserves and fiscal positions built up during the preceding expansion. As a result, the growth impulse in some leading Southern economies has shifted to domestic demand, including in countries which had previously been export-led.

China has played a key role in the recovery of the South. It launched a massive stimulus package in infrastructure and property investment. Because of its high commodity intensity, this investment-led growth has given an even stronger boost to commodity prices than the pre-crisis export-led growth.

At the same time, short-term, speculative capital inflows surged with sharp cuts in interest rates and quantitative easing in AEs in response to the crisis. These have been more than sufficient to meet growing deficits in several major DEs including India, Brazil, Turkey and South Africa. But they have also widened deficits by leading to currency appreciations.

This rapid domestic demand-led growth has now come to an end. China cannot maintain investment-led growth indefinitely. But it also faces hurdles in shifting rapidly to consumption-led growth. Even a moderate slowdown in China, towards 7% per cent, could bring an end to the boom in a broad range of commodities. This can be aggravated by a rapid exit of investors and traders in commodity derivatives as happened in 2008 after the collapse of the Lehman Brothers.

DEs also face significant downside risks from AEs, including dampened export prospects and unstable capital flows. As noted by the IMF "even absent another European crisis, most advanced economies still face major breaks on growth. And the risk of another crisis is still very much present and could well affect both advanced and emerging economies."

There can be little doubt that the crisis has posed difficult policy challenges for AEs. But there have also been shortcomings in the policy response. First, there is a failure to maintain adequate demand by reconciling the need for short-term fiscal stimulus with a credible programme for long-term consolidation, leading to a return to self-defeating fiscal orthodoxy and austerity in the Eurozone (EZ), the UK and even the US.

Second, public interventions have failed to alleviate the debt overhang and deleveraging and retrenchment at the expense of employment and growth. The US TARP has rescued big banks without preventing foreclosures or increasing lending to support employment. In the EZ long-term refinancing operations have provided little relief to debtors. Banks remain highly fragile. Last summer the EC resisted mandatory capitalisation despite calls from the IMF, but it is now finding them undercapitalized. They are shrinking their balance sheets by selling assets and cutting credit, impairing the access of DEs to trade financing.

Third, deep cuts in interest rates and quantitative easing have not been very effective in addressing over-indebtedness and reversing spending cuts, but have led to "currency tsunami" and problems for DEs in macroeconomic and exchange rate management. The surge in short-term capital flows have shifted exchange rates and trade not only between the North and the South but also among DEs, creating tensions in the trading system. The matter has been taken to the WTO by one of the most affected DEs for discussion in a seminar held at the end of March. Questions have been raised on the coherence between international trading and financial systems, the impact of exchange rates on trade concessions and the rationale and scope to deploy WTO disciplines, reaffirming once again the urgent need to reform the international monetary system in order to avoid beggar-my-neighbour policies and protectionism.

The IMF lacks effective surveillance to bring discipline and elicit responsible behaviour on the part of reserve-issuing countries. With the surge in destabilizing capital flows, it has abandoned willy-nilly its orthodoxy and has offered a framework to DEs for managing inflows, including capital controls as a last resort and temporary measure. This is rightly rejected by DEs, in an effort to retain their policy autonomy in managing capital flows and avoid new obligations. The Fund has paid no attention to policies in source countries, including measures to stem speculative outflows of the kind that the US used in the 1960s when it suited them.

The risk-return configuration that has sustained short-term capital flows to DEs cannot last indefinitely. They are subject to sudden stops and reversals and they have already shown a high degree of volatility since last summer. The immediate threat is not a hike in interest rates in AEs, but the deepening of the EZ crisis, triggering a flight to safety, very much like the collapse of Lehman Brothers.

Default by Greece has been averted for the moment, but now Italy and Spain are facing similar pressures. Bailouts for these would require much larger funds and their austerity would create a much bigger impact. Spain is the epicentre. Its problems have little to do with fiscal irresponsibility, but excessive private debt built during the housing bubble, financed by core banks. Wrong diagnosis and recipes by the EC and ECB are now worrying even the IMF. With unemployment at 25%, foreclosures rising and economy shrinking, Spain is not expected to succeed in meeting deficit targets and financial obligations.

This is the main reason for the recent initiative to double IMF resources. This makes the Fund highly leveraged, particularly because of the failure to review quotas in time. The 2009 UN Conference on the World Financial and Economic Crisis and its Impact on Development agreed that the next quota review should "be completed no later than January 2011". An agreement was reached in the IMF in 2010 to shift votes and two seats to DEs and double the quotas, to become effective by October 2012. Less than half of G20 members have ratified it so far. The US, Germany and its current chair, Mexico, are not among them. The package is unlikely to be ratified on time by the required percentage of votes and members.

In any case there is no justification for the EZ to draw on the IMF. Unlike DEs the EZ can issue unlimited international liquidity. The moral hazard argument used against intra-EZ bailouts also applies to IMF bailouts. More importantly, the financial integrity of the IMF may be put at risk by large scale lending. In the event of a default by its borrowers, the IMF has no de jure preferential creditor status. By lending to the IMF to lend to the EZ periphery rather than lending to the periphery directly, the EZ is effectively shifting the default risk to IMF shareholders, including its poor members. Thus, the IMF should lend to the EZ periphery subject to significantly increased efforts by the EZ to bail in private creditors and to supplement and use its own rescue fund.

Finally, despite recurrent sovereign debt difficulties, the international community has not been able to introduce orderly debt workout mechanisms. The attempt made at the IMF in the early years of the 2000s to establish a Sovereign Debt Restructuring Mechanism was blocked by some major AEs. The UN Conference agreed "to explore the need and feasibility of a more structured framework" for debt workouts. It has since then gained further importance with the EZ crisis. The Financial Stability Board has included bail-in as one of the key attributes of effective resolution regimes and the EC has formulated a bail-in proposal, but the issue is not placed squarely on the IMF agenda.

In conclusion, the world economy is no less fragile today than it was on the eve of the 2009 Conference. And DEs are just as exposed to downside risks from AEs as they were then, but their policy space has narrowed in the interim. There can be little doubt that there is a lot DEs could do to strengthen their own fundamentals and reduce dependence on foreign markets, capital and commodities to gain greater autonomy. But they cannot be expected to put their house in order when AEs falter and the global financial architecture continues to suffer from systemic shortcomings.

These difficulties continue unabated despite agreements reached at the 2009 Conference on the crisis on "decisive and coordinated action to address its causes, mitigate its impact", to "avoid possible adverse impacts" of stimulus measures on DEs, and to "reform and strengthen international financial system and architecture". The task remains unfinished. The UN is often said to have no competence in these matters. However, the International Financial Institutions and the Groupings such as G7, G8 or G20 have proved to be totally ineffective in resolving these matters. Thus, they need to be pursued with greater determination and commitment in the UN and linked to a process of assessment and monitoring.

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