

**Yılmaz Akyüz**

# **Financial Crisis and Global Imbalances**



**A Development Perspective**

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 **SOUTH  
CENTRE**



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Yılmaz Akyüz



**Financial Crisis and Global Imbalances  
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is published by  
South Centre  
POB 228  
Chemin du Champ d'Anier 17  
1211 Geneva 19  
Switzerland

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Cover design: Lim Jee Yuan

Printed by  
Jutaprint  
2 Solok Sungai Pinang 3  
Sungei Pinang  
11600 Penang  
Malaysia

ISBN 978-92-9162-037-1

To  
B.K. and K.K.



# CONTENTS

INTRODUCTION	ix
<b>CHAPTER 1</b>	
<b>POLICY RESPONSE TO THE GLOBAL FINANCIAL CRISIS: KEY ISSUES FOR DEVELOPING COUNTRIES</b>	<b>1</b>
A. INTRODUCTION	1
B. POLICY RESPONSE IN DEEs: PAYMENTS CONSTRAINT AND INTERNATIONAL SUPPORT	3
C. REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE	12
D. SUMMARY OF POLICY CONCLUSIONS AND PROPOSALS	32
<b>CHAPTER 2</b>	
<b>GLOBAL ECONOMIC PROSPECTS: THE RECESSION MAY BE OVER BUT WHERE NEXT?</b>	<b>37</b>
A. ISSUES AT STAKE	37
B. BUBBLES, EXPANSION AND IMBALANCES	40
C. CRISIS, RECESSION AND RECOVERY	41
D. NO RETURN TO “BUSINESS AS USUAL” – NEED FOR US ADJUSTMENT	44

E. CHINA TOO NEEDS TO ADJUST, BUT IT CANNOT BE A GLOBAL LOCOMOTIVE	47
F. BRINGING IN THE BYSTANDERS: GERMANY AND JAPAN	52
G. EXCHANGE RATE ADJUSTMENTS	56
H. REMOVING THE DEFLATIONARY BIAS IN THE INTERNATIONAL FINANCIAL ARCHITECTURE	58
I. CONCLUSIONS	61

## CHAPTER 3

<b>EXPORT DEPENDENCE, SUSTAINABILITY OF GROWTH AND ADJUSTMENT IN CHINA</b>	63
A. INTRODUCTION	63
B. MEASUREMENT OF CONTRIBUTION OF EXPORTS TO ECONOMIC GROWTH	66
C. IMPORT CONTENT OF EXPORTS	69
D. TO WHAT EXTENT IS GROWTH IN CHINA EXPORT-LED?	75

## CHAPTER 4

<b>THE SUBPRIME BOOM-BUST CYCLE AND CAPITAL FLOWS TO DEVELOPING COUNTRIES</b>	87
A. INTRODUCTION	87
B. PREVIOUS POST-WAR BOOM-BUST CYCLES	92

C. CAPITAL FLOWS IN THE 2000s	95
D. THE CHANGING NATURE OF CAPITAL FLOWS	108
E. CHANGING VULNERABILITIES TO BOOM-BUST CYCLES	113
F. THE IMPACT OF RECENT CAPITAL FLOWS ON DEEs	115
G. WHAT IS NEXT?	121
H. MANAGING CAPITAL INFLOWS	126
I. CONCLUSIONS	131

## CHAPTER 5

<b>WHY THE IMF AND THE INTERNATIONAL MONETARY SYSTEM NEED MORE THAN COSMETIC REFORM</b>	<b>133</b>
A. INTRODUCTION	133
B. THE IMF'S FAILURES IN FINANCIAL ANALYSIS AND EARLY WARNING	138
C. IMF SURVEILLANCE AND MEMBERS' OBLIGATIONS	143
D. THE INTERNATIONAL RESERVES SYSTEM	154
E. CRISIS INTERVENTION AND LENDING	162
F. CONCLUSIONS	170
<b>REFERENCES</b>	<b>173</b>



## INTRODUCTION

This book is a collection of papers written for the South Centre during 2009-2011 on the global crisis triggered by speculative lending and investment in the United States and Europe – its actual and potential effects on developing and emerging economies (DEEs), the immediate international policy response needed in order to contain the damage and to restore stability and growth, and global systemic reforms that need to be introduced with a view to reducing the likelihood of such crises and managing them better if and when they occur.

Chapter 1, originally published in May 2009, provides an overview of the key issues regarding the policy response to the crisis from the point of view of DEEs. It discusses both the immediate countercyclical measures that need to be undertaken at the national and international levels and the reform of the international financial architecture. While recognizing that many DEEs had considerable policy space to counter destabilizing and deflationary impulses from the crisis, it is argued that several poorer countries faced resource constraints. Even though they could use trade and financial policies to ease the tightened payments constraint resulting from reduced private capital flows and exports, in most cases effective policy response depended crucially on the provision of adequate international liquidity on appropriate terms and conditions through multilateral financial institutions. The paper then goes on

to make an assessment of the international liquidity support agreed on or already provided and makes proposals for alternative and additional mechanisms that could be used in the event of such crises.

Regarding the reform of the international financial architecture, on crisis prevention the chapter emphasizes the need to significantly improve the effectiveness, evenhandedness and the quality of International Monetary Fund (IMF) surveillance over macroeconomic, financial and exchange rate policies of systemically important countries; the reform of the existing international reserves system centred on the dollar, advocating a much greater role for the Special Drawing Right; and the regulation of international financial markets and systemically important financial institutions, without, however, imposing a one-size-fits-all model on DEEs and narrowing their policy space in regulating their domestic financial system and international capital flows and determining access to their markets in financial services.

On crisis intervention and resolution, the chapter argues against structural and deflationary macroeconomic conditionality in the provision of international liquidity to countries facing contagion. It also argues against bailouts of international lenders and investors in countries facing rapid exit of capital and proposes that ways and means should be found to involve international private creditors and investors in the resolution of balance-of-payments and debt crises in emerging economies, drawing on the principles of national insolvency laws. Several of the above measures needed for reducing the likelihood of financial crises with global repercussions and ensuring better crisis intervention and management call for fundamental changes in the IMF – an issue taken up in much greater detail in the last chapter on the reform of the international monetary system, written 18 months later, in November 2010, taking into account various initiatives and proposals in the UN, G20 and IMF in the interim.

Chapter 2, written at a time when recovery was under way in the major advanced economies, moves beyond the crisis and looks to medium-term prospects for the world economy. It is argued that the global economy suffers from a demand gap in large part because of sustained declines in the share of labour income in most major economies, including the US, Europe, Japan and China. Until the outbreak of the subprime debacle, the deflationary threat posed by underconsumption was averted and the global economy enjoyed a rapid growth thanks to debt-driven consumption and property bubbles in the US and several European economies. This, however, resulted in growing global

trade imbalances and financial fragility which eventually culminated in a global crisis.

A return to the pre-crisis pattern of growth can prove to be more damaging. A global rebalancing between major surplus and deficit countries would be necessary. This cannot be done through nominal currency adjustments. These cannot address the problem of underconsumption associated with sluggish wages and create additional demand for the world economy as a whole, but simply serve to redistribute demand impulses across countries. A nominal appreciation of the Chinese yuan against the dollar will not solve Chinese underconsumption or US overspending. China should move to consumption-led growth through faster growth of wages. This would appreciate the real exchange rate of the yuan and reduce net exports, but it would at the same time provide a domestic offset by expanding domestic consumption, and hence allow it to maintain strong growth. The US should move to export-led growth not through wage cuts but through increased productivity through investment in infrastructure and education.

However, a US-China rebalancing would not be sufficient to restore an acceptable pace of growth in the world economy. The two major mature surplus economies, Japan and Germany, which have been siphoning global demand without adding to global growth, would also need to reduce their reliance on exports and add to global demand. Germany has been relying on exports for growth even more than China, primarily by wage suppression and competitive disinflation, which gave it a competitive advantage (that is, a real depreciation of the euro for Germany) vis-à-vis other eurozone countries, notably in the periphery where wages have been keeping pace with and even ahead of productivity growth. Until the outbreak of the subprime crisis, the resulting trade deficits in the periphery were financed with large capital inflows from the core eurozone countries, notably from German and French banks, encouraged by the changed risk perceptions and convergence of interest rates after the move to the Economic and Monetary Union. These unsustainable intra-eurozone imbalances and debt accumulation were laid bare with the global crisis. The crisis in the eurozone now constitutes the single most important threat to stability and growth in the world economy, in particular in DEEs.

German adjustment cannot be based on a nominal appreciation of the euro. This would not generate higher wages and faster growth of private consumption in Germany, but would hurt other eurozone countries. Indeed, it could simply give rise to further wage restraint through competitive disinflation.

By contrast, higher wage settlements in Germany would increase domestic consumption while producing a real appreciation of the euro for Germany, without leading to a corresponding appreciation for the periphery. In other words, higher German inflation holds a key not only to global rebalancing, but also to rebalancing within the eurozone.

Chapter 3 takes a closer look at China, now the number two economy in the world, whose policies are widely seen as the main source of global trade imbalances and currency instability. It is estimated that, despite a high import content ranging between 40 and 50 per cent, about one-third of Chinese growth before the global crisis was due to exports because of their phenomenal growth of some 25 per cent per annum. This figure goes up to 50 per cent if spillovers to consumption and investment are accounted for. The main reason for excessive dependence on foreign markets is underconsumption. This is due not so much to a high share of household savings in GDP as to a low share of household incomes and a high share of profits. It is argued that China can no longer maintain such high growth rates for its exports given the need for global rebalancing and prospects of slow and erratic growth in major advanced economies. It thus needs to turn to consumption-led growth by expanding the share of wages and household income in GDP and accelerating public spending in social infrastructure.

However, during 2008-09 China responded to the slowdown in exports with a massive investment programme, creating considerable excess capacity not only in property and infrastructure but also in some industries such as steel, financed by rapid credit expansion and debt accumulation by local governments. While investment filled the demand gap, consumption lagged behind income. As the effects of this package started to fade out in the course of 2011, another investment boom appears to have got under way, with fixed investment growing by almost 26 per cent and property investment by 33 per cent year-on-year in the first half of the year. Unless accompanied by rapid export and/or consumption growth, such debt-driven investment booms can eventually threaten stability and growth no less than did the debt-driven consumption and property bubbles in the US. Efforts to keep filling the demand gap with investment may postpone the underconsumption crisis, but only for it to come back with greater force.

In the coming years – possibly by the middle of the decade – Chinese growth can be expected to come down considerably compared to pre-crisis levels, particularly if the EU and/or the US experience a second dip. Given

the problems of inflation, overinvestment and fragility of many of its lending institutions, China has limited policy space in responding to the demand gap in the same way as it did in the last three years. A sharp drop in Chinese growth could mark the end of not only the asset and credit bubbles there, but also the boom in commodity markets and capital inflows to DEEs.

If strong growth in China sustained through rapid credit expansion and investment is one factor making a major contribution to growth in several DEEs, notably commodity-rich ones, another factor is the surge in capital inflows from advanced economies. This issue is taken up in Chapter 4, which examines the capital flows to DEEs during the subprime boom-bust cycle in a historical context. It is noted that while advanced economies continue to encounter debt deflation, financial stringency and insolvency, many DEEs have been facing rapid credit expansion and asset inflation and the risk of overheating and hard landing. Except for a brief interruption in 2008 after the collapse of Lehman Brothers, they have been getting large capital inflows as major advanced economies have responded to the crisis caused by excessive liquidity and debt by creating still larger amounts of liquidity to bail out troubled banks, lift asset prices and lower interest rates. Quantitative easing and close-to-zero interest rates have been generating a surge in capital flows into countries with higher interest rates and better growth prospects.

This is the fourth post-war boom in capital flows to DEEs. The previous booms were also associated with a rapid expansion of global liquidity and exceptionally low interest rates in the US, and all ended with busts under tightened global financial conditions, including higher US interest rates and a stronger dollar. The first one ended with a debt crisis in the 1980s when US monetary policy was tightened, and the second one with a sudden shift in the willingness of lenders to maintain exposure in East Asia. The third boom developed alongside the subprime bubble and ended with the collapse of Lehman Brothers and flight to safety in late 2008. Unlike previous episodes, the Lehman reversal did not cause serious dislocations in DEEs because of generally strong payments and reserve positions, reduced mismatches in balance sheets and, above all, the short duration of the downturn and rapid recovery of capital inflows in 2009.

The renewed surge in capital inflows has created different imbalances and fragilities in different DEEs according to their degree of openness to various forms of capital and policy response. Major economies such as Brazil, India, South Africa and Turkey have been relying increasingly on foreign

capital to meet their growing external shortfalls and many of them have been experiencing currency appreciations faster than surplus DEEs in East Asia. By contrast, most East Asian countries have been successful in maintaining strong payments positions, but they have also been facing credit and asset bubbles. In other words, all major recipients are now exposed to the risk of a sudden stop and reversal, though in different ways, even to a greater extent than that experienced after the Lehman collapse.

The risk-return profile and growth differentials that now favour DEEs in the eyes of international lenders and investors cannot be expected to last indefinitely. Still, experience shows that it is almost impossible to predict the timing of stops and reversals and the events that can trigger them even when the conditions that drive the surge in capital flows can be diagnosed to be unsustainable with a reasonable degree of confidence. Various scenarios are explored in Chapter 4 regarding possible events that could end the boom with a sudden stop and even reversal, including a sharp increase in interest rates in the US resulting from increased inflationary pressures associated with the commodity boom or pressures from bond markets, a sharp slowdown in China, a payments crisis in a major emerging economy with growing current account deficits and international contagion thereof, and widening and deepening of the debt crisis in the eurozone and a consequent double dip in the US and EU. Indeed, growing risks in many of these areas are now making international investors highly nervous, creating a tendency to flight to safety and sizeable capital outflows from some emerging economies and sharp drops in asset and currency markets.

For the DEEs, the greatest threat comes from the European periphery – now the Achilles' heel of global finance. As long as the European Commission and the European Central Bank fail to diagnose the origin of the problems correctly and to put in place viable solutions, the region will remain susceptible to extreme instability and messy defaults, with attendant consequences for growth and stability in DEEs.

In all likelihood, the end of the current boom in capital flows can be expected to be disorderly and to coincide with a reversal of the upswing in commodity prices. The countries which have been enjoying the twin benefits of global liquidity expansion – that is, the boom in commodity prices and capital flows – as well as those running growing deficits are particularly vulnerable. Asian economies with strong current account and reserves positions are unlikely to face serious payments and currency instability even in the event

of sharp and sustained declines in capital inflows. However, their financial markets are highly exposed to destabilizing impulses from abroad because of increased foreign presence and their closer integration into the international financial system. The consequent damage could be more severe and longer-lasting than that experienced during the Lehman collapse, given the significantly reduced policy space in responding to renewed instability, at both the global and national levels.

The world economy is now facing renewed risks of instability and downturn before fully recovering from the so-called Great Recession, and the chances of averting such an outcome are becoming quite slim. This is in part because the imbalances and fragilities built up over several years in the past as a result of misguided policies in the US and Europe cannot be easily undone, regardless of the policy pursued today. However, there have also been serious shortcomings in the policy response to the crisis in major mature and emerging economies in both countering the deflationary and destabilizing impulses and addressing the underlying structural and systemic problems.

After a good start in London in early 2009 with a coordinated policy response, disagreements emerged both within and across major members of the G20 group of leading economies regarding how to proceed. Fiscal response in the US has fallen too short to meet the challenge and focused on private consumption rather than investment as called for by a shift to export-led growth. The EU has been too quick in tightening monetary policy to fight a non-existent inflation and in getting into fiscal consolidation which could well prove to be self-defeating. Governments in advanced economies have been unwilling to devise mechanisms to write off unpayable private debt, in some cases making such debt even less payable by imposing austerity on debtors. The US has been engaged in a beggar-my-neighbour monetary expansion, exploiting its “exorbitant privilege” and flooding the world with dollars, effectively seeking competitive devaluation vis-à-vis its trading partners. No matter of importance has been resolved regarding the reform of the international financial architecture, to address shortcomings in crisis prevention, management and resolution; to secure symmetrical adjustment between deficit and surplus countries; to move away from an inherently unstable international reserve system centred on the dollar; and to establish orderly and equitable sovereign debt workout mechanisms – areas that are particularly important for DEEs.

The latter economies have no doubt incurred a relatively heavy burden due to fallouts from a crisis they could not be held responsible for. But it

is also true that they benefited from the global locomotive role played by the US based on debt-driven property and consumption bubbles, through capital inflows, the boom in commodity prices and rapid expansion of exports. But their growing dependence on foreign markets and/or capital inflows has made them particularly vulnerable to shocks from mature economies. They have been generally unwilling to impose effective restrictions on capital inflows, even when they were not needed (that is, in countries with strong payments and reserve positions), allowing them to create credit and asset bubbles and link their economies more closely to mature markets, hence increasing their exposure to external financial shocks.

While many major emerging economies responded vigorously to trade and financial fallout from the subprime crisis, policy response has not always been designed to address their structural problems. China's stimulus package focused on investment rather than underconsumption, while several countries running current account deficits started to appreciate their currencies even faster once capital inflows recovered in 2009, allowing their deficits and hence dependence on foreign capital to grow even more rapidly. Given the sluggish growth and even the risk of a double dip in the US and Europe and the growing risk of renewed financial stress, extreme risk aversion and reversal of capital flows, the developing world is unlikely to sustain the strong growth seen since mid-2009. And they would be in a much weaker position to respond to another crisis with their own means.

DEEs need to take measures in order to sustain growth and reduce their vulnerability to external shocks. The main challenge facing East Asia is to reduce their dependence on exports to advanced economies and expand national and regional markets. This calls for a redistribution of income to secure higher shares of wages and the household sector in national income and to establish a welfare state to provide basic needs in housing, health and education to the poor.

For most emerging economies in other regions, there is a need to reduce dependence on capital inflows. Collectively DEEs have been running a current account surplus and they do not need capital from advanced economies for external financing. In fact they have been recycling their twin surpluses to the advanced economies in the form of investment in reserve currencies. However, a number of DEEs have been running structural deficits and are dependent on capital inflows to finance imports, investment and growth. There is thus a need to establish, at both the regional and global levels, reliable and stable

mechanisms for South-South recycling from surplus to deficit countries without going through Wall Street or the City.

Finally, many major emerging economies outside Asia need to move away from dependence on commodities, towards high-value manufacturing. This calls for fresh thinking on industrial policy, adapting the traditional instruments and mechanisms to the changed new global environment and innovating new and effective ones.

*Yilmaz Akyüz*  
*Geneva,*  
*October 2011*



# Chapter 1

## POLICY RESPONSE TO THE GLOBAL FINANCIAL CRISIS: KEY ISSUES FOR DEVELOPING COUNTRIES<sup>1</sup>

9

### A. INTRODUCTION

The global financial crisis triggered by widespread speculative lending and investment in major international financial centres poses two sets of policy challenges. First, it calls for an immediate policy response in order to stabilize financial markets and international capital flows, halt economic decline and initiate recovery. So far major industrial countries have taken a range of measures for these purposes, including bailout operations through infusion of capital into weakened financial institutions and industrial firms and government guarantees for impaired financial assets and bank deposits; significant easing of monetary conditions and speedy and sharp reductions in interest rates; and large fiscal stimulus packages. Developing and emerging economies (DEEs) have also adopted measures to ease credit conditions and stimulate private spending to counter destabilizing and deflationary impulses from the crisis. However, several of them face resource constraints in responding to the crisis with countercyclical policies. There is a strong rationale and some scope for using trade and financial policies to ease the resource constraint. But, in many cases effective policy response depends crucially on the provision of adequate

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<sup>1</sup> First published as a South Centre research paper in May 2009.

international liquidity on appropriate terms and conditions through multilateral financial institutions.

Secondly, this crisis has indicated once again the need for a fundamental reform of the international financial system in order to secure greater stability and prevent virulent crises with global ramifications. A consensus appears to have emerged among the major players in the world economy on the need for reform and a number of ad hoc initiatives have been launched and proposals put forward in various fora including the United Nations, the Group of 20 and the Bretton Woods Institutions. But to what extent these will result in the kind of changes needed is highly uncertain. The past record in this respect is not very encouraging. Despite wide agreement on a systemic reform to bring about more effective governance to international finance after a series of crises in emerging economies in the 1990s and proliferation of proposals for reform, the Financing for Development initiative launched has yielded no significant outcome in this respect in the past seven years.<sup>2</sup> DEEs have a considerably greater stake in such a reform in view of the disproportionately large damage that international financial instability inflicts on them. It is therefore important that they lead the process and form a coherent view for real change in a broad range of areas of crucial interest to them, including the mandate, resources, operational modalities and governance of the IMF, so as to reduce their vulnerability to financial instability and crises while preserving adequate policy autonomy in managing their integration into the international financial system, and capital flows and exchange rates.

These two sets of issues overlap in certain respects. In particular many of the shortcomings in the immediate policy response to the crisis by the international community have their roots in the deficiencies in global institutional arrangements for crisis management and resolution. The next section will discuss the constraints DEEs are facing in responding to deflationary and destabilizing impulses from the crisis, making an assessment of the international initiatives undertaken so far to provide support. This is followed by a discussion of the reform of the international financial architecture under two headings: crisis prevention and crisis intervention and resolution. Discussions will focus on issues that are viewed as of particular importance for stability and growth in DEEs, rather than on every issue raised by the current

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<sup>2</sup> See Akyüz (2002 ed.) for the issues raised and proposals made after the Asian financial crisis.

crisis. The final section will give a summary of the policy proposals advanced in the chapter.

## **B. POLICY RESPONSE IN DEEs: PAYMENTS CONSTRAINT AND INTERNATIONAL SUPPORT**

### **1. *Crisis impact and domestic policy options***

The fallouts from the global financial crisis are wreaking havoc in DEEs. The combination of sharply declining commodity and manufactured export earnings, collapse of remittances, reversal of private capital flows, rising risk spreads, an extreme degree of credit squeeze affecting even trade finance and losses of asset values is giving rise to a sharp economic slowdown and even contraction in many parts of the developing world. According to the most recent projections by the IMF, average growth in DEEs is expected to be as low as 1.6 per cent in 2009, down from 8.7 per cent in 2007. At more than 7 percentage points, the expected loss of growth in these economies exceeds that in the centre of the crisis, the United States economy, where output is projected to contract by 2.8 per cent in 2009 after growing by 2 per cent in 2007. This deceleration will result in sizeable drops in per capita incomes in most developing regions and countries. Consequently, there is a risk of reversal of many of the benefits achieved in poverty alleviation and development as a result of intense policy efforts and reforms carried out in recent years.

There is now broad agreement on the need for expansionary, countercyclical macroeconomic policy response to deflationary impulses emanating from the crisis. It is also agreed that under current conditions of extreme liquidity preference and risk aversion, monetary policy would have very little impact on credit expansion and private spending. Consequently, the burden falls primarily on expansionary fiscal policies, particularly increased public spending.

The main impediment to countercyclical macroeconomic policy in many DEEs is the balance-of-payments constraint. Although several middle-income countries have succeeded in building up relatively strong payments positions and large stocks of international reserves during the preceding expansion, the balance-of-payments constraint has generally become tighter with declines

in export earnings and the reversal of private capital flows. Indeed reserves have been falling almost everywhere in the developing world and even strong surplus economies such as China have been experiencing capital outflows. An acceleration of growth based on the expansion of domestic demand would certainly drain reserves further as imports pick up, exerting pressure on the currency and threatening external and financial stability. This means that for resource-constrained DEEs expansionary macroeconomic policies would depend crucially on the provision of adequate external financing. For poorer countries where official flows are directly linked to the budget, injection of additional external financing would also help ease the fiscal constraint which has generally become tighter as a result of adverse effects of declines in export earnings and incomes on government revenues and of currency depreciations on public external debt servicing.

According to the World Bank (2009a: p. 6), external financing needs in 2009 are expected to exceed private sources of financing in 98 of the 102 DEEs. In the absence of adequate official financing to fill the gap, these countries would have to use whatever domestic policy instruments they have under their control in order to weather the crisis with minimum damage. But options are quite limited. Currency adjustments would not be very effective in promoting exports when markets abroad are shrinking. Sharp devaluations in countries with extensive liability dollarization could also create deleterious effects on private balance sheets with large currency and maturity mismatches.

By contrast, selective restriction of non-essential, luxury imports, as well as of imports of goods and services for which domestic substitutes are available, could be more effective in easing the payments constraints and facilitating expansionary macroeconomic policies by allowing increased imports of intermediate and capital goods needed for the expansion of domestic production and income. For some DEEs the space between applied and WTO-bound tariffs can provide adequate room for such an action, but the margins are generally quite narrow and even non-existent for a large number of DEEs. By contrast, under current conditions prevailing in many countries, there is a strong rationale, as a last resort, for invoking GATT (and GATS) balance-of-payments safeguard provisions, notably those of Article XVIII B which are directed particularly at payments difficulties arising from a country's efforts to expand its internal market or from instability in its terms of trade.

Ideally, when global deflationary forces are at work, it would be highly desirable to avoid restrictive trade measures, particularly those of a discriminatory nature. Indeed the interwar experience shows that ad hoc, discriminatory trade restrictions, together with beggar-my-neighbour exchange rate policies, can aggravate rather than ease economic difficulties and lead to conflicts. The recent G20 summit pledged not to “repeat the historic mistakes of protectionism of previous eras” and to “refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organisation (WTO) inconsistent measures to stimulate exports” (G20 2009c: para 22). However, there was no indication of what kind of actions would be considered as protectionist and what kind as WTO-consistent, nor was there any specific commitment.

Whether or not a particular trade measure can be considered as protectionism depends on the conditions under which it is adopted. In this respect a distinction should be made between restrictions applied by reserve-currency and reserve-rich countries, and those applied by DEEs facing balance-of-payments constraints. Import restrictions in the former cases would effectively imply exporting unemployment abroad, since by raising net exports such an action would substitute foreign for domestic demand. But this would not be so for restrictions applied by DEEs facing shortages of international liquidity. In this latter case, the alternative would be to face stagnation or contraction, and hence reduced demand for foreign goods and services. Selective restrictions over imports would allow allocation of scarce foreign exchange to facilitate domestic expansion without reducing the overall demand for foreign goods. This cannot be considered as a protectionist action.

Thus, resource-constrained DEEs should not be denied their rights embodied in multilateral trade agreements to use legitimate measures so as to avoid contraction in economic activity. Such trade measures should be distinguished from beggar-my-neighbour import restrictions and subsidies, including those used by some major industrial economies – such as the “Buy American” provisions and industrial subsidies in United States stimulus and bailout packages – which serve to protect jobs at home rather than facilitate expansionary policy actions, and beg the question of conformity to the WTO rules.

A second set of measures that could be employed by countries facing shortage of international liquidity to support domestic expansion relates to the capital account. DEEs are now experiencing net outflows on portfolio

investment and international bank lending. Furthermore, residents in several of these countries have joined international lenders and investors in capital flight. This is in large part the outcome of widespread liberalization of resident investment abroad in recent years, often in an effort to relieve the upward pressure of the surge in capital inflows on currencies. Clearly, to the extent that reserves, export earnings and official lending are used to finance capital flight, international liquidity available for current account financing would be reduced. Furthermore, under present conditions capital flight would also compromise the ability to use monetary policy for expansion. Thus, there is a strong case for restricting capital outflows in countries facing rapid loss of reserves. Restrictions would also widen the space for countercyclical monetary and fiscal policy response to the crisis in order to stabilize economic activity and restrain declines in currencies and the consequent dislocations in private balance sheets.

## **2. *International liquidity support***

The extent to which trade and financial restrictions would need to be applied by resource-constrained DEEs depends on the speed with which international trade, financial markets and capital flows are stabilized and on the availability of adequate financing from multilateral financial institutions. In the latter respect a number of initiatives have been taken in the G20 and the Bretton Woods Institutions in recent months, seeking improvement in three main areas: increased funding for multilateral financial institutions, widened access of DEEs to multilateral financing, and improvements in the terms and conditions of multilateral lending. Some of these initiatives have implications that go beyond matters of immediate policy response to the crisis and could, in fact, entail systemic and more permanent changes in the way the IMF intervenes in financial crises. These features will be discussed in the subsequent section in the context of the reform of the international financial architecture. Here a brief description will be given of the steps so far taken in the three areas, an assessment will be made of their adequacy in meeting immediate policy challenges for stabilizing economic conditions in DEEs and preparing the ground for recovery, and proposals will be made for further action.

Regarding new resources, according to the agreement reached in the April G20 summit, commitments have been secured for an additional \$1.1 trillion for international support. This includes a decision to allocate \$250 billion of

Special Drawing Rights (SDRs), approved in the subsequent meeting of the IMF; trebling of resources available to the IMF to \$750 billion; an additional \$100 billion for multilateral development banks, presumably to be raised through bond issues;<sup>3</sup> and \$250 billion trade finance from various public and private institutions including export credit agencies. Of the additional \$500 billion for the IMF, only \$250 billion is readily available through bilateral lending by some of its major shareholders, to be subsequently incorporated into an “expanded and more flexible” New Arrangements to Borrow.<sup>4</sup> However, there does not seem to be an agreement on how the rest should be raised. While some major shareholders favour increasing the NAB by an additional \$250 billion and encourage reserve-rich economies to make bilateral loans, major emerging economies, notably China, India, Russia and Brazil, appear to insist that these resources be raised by borrowing from the markets, and have expressed interest in buying short-term notes (bonds) that the Fund could issue for this purpose.<sup>5</sup> This matter is now under consideration in the Fund.

Regarding access of DEEs to multilateral financing, the major recent initiatives include, in addition to the agreement on the SDR allocation noted above, doubling the normal access limits in the IMF; doubling of borrowing limits for poorest countries eligible for the Poverty Reduction and Growth Facility (PRGF) and Exogenous Shock Facility (ESF); and a new Flexible Credit Line (FCL) established for crisis prevention in emerging economies facing contagion from the global crisis. The FCL is said to be available “for countries with strong fundamentals, policies and track records of policy implementation”, to be assessed by the IMF according to several pre-determined criteria. It can be drawn or used as a precautionary instrument. Unlike the Short-Term Liquidity

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<sup>3</sup> The World Bank has also set up the Vulnerability Financing Facility for countries hardest hit by the food and financial crises, but its potential contribution to crisis response in DEEs is not very clear.

<sup>4</sup> The Fund has two agreements for bilateral borrowing from its shareholders; the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB). The GAB was established in 1962 on the basis of the provisions of the Articles of Agreement (Article VII, Section 2) for replenishment of scarce currencies, which gave birth to G-10. It has been renewed ten times, raised from the original amount of SDR6 billion to SDR17 billion in 1983 in response to the debt crisis. The NAB was established in 1998 as a set of credit arrangements with 26 members, for a total of SDR17 billion and renewed twice since then. In both the GAB and NAB commitments by individual countries are based on their quotas. Between the two the total amount available to the Fund is around \$50 billion.

<sup>5</sup> See *New York Times*, “IMF Planning to Sell Bonds to Finance New Loans”, 26 April 2009.

Facility (SLF) it replaces, the FCL has no hard cap.<sup>6</sup> However, it is not clear if this implies that the Fund will act as a lender-of-last-resort to countries it deems eligible, lending in unlimited amounts and without conditions except for penalty rates. So far a \$47 billion FCL arrangement has been approved for Mexico. Poland has requested some \$20 billion as a precautionary FCL arrangement and Colombia has expressed interest in a similar arrangement for \$10 billion.

Finally, certain steps have been taken for “modernizing IMF conditionality for all borrowers” as part of the overhaul of the IMF lending framework.<sup>7</sup> First, access to the FCL will be based on *ex ante* rather than *ex post* conditionality. Second, a decision has been taken to discontinue structural performance criteria in all Fund arrangements including those with low-income economies. This is expected to allow the Fund to focus on core objectives.

It is difficult to make a precise judgment on whether these initiatives would meet the external financing needs of DEEs since this crucially depends on the effectiveness of the measures adopted by the advanced economies responsible for the crisis in restoring stability and growth. According to the World Bank (2009a: p. 6), the total external official financing needs of the 98 DEEs with shortfalls are expected to be at least \$270 billion, and this figure could go up significantly, reaching \$700 billion. According to UNCTAD (2009), the gap could turn out to be \$2,000 billion. While the G20 summit is claimed to have come up with a commitment for an extra \$1.1 trillion, the real additional amount readily available appears to be lower, certainly much less than the latter figures.<sup>8</sup> It is notable that despite these highly-publicized initiatives for additional financing for DEEs, the April 2009 growth projections by the IMF for these economies show downward revisions by 1.7 percentage points for 2009 and 1 percentage point for 2010 from those given in January

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<sup>6</sup> The SLF was introduced in October 2008 with the deepening and global spread of the crisis for members with “solid policy track records and strong fundamentals” and access was based on *ex ante* qualification. Unlike the FCL it had a cap of 500 per cent of the quota and it could not be used as a precautionary credit line. It remained unused until replaced by the FCL. Members who do not qualify for the FCL can use the so-called High-Access Precautionary Stand-by Arrangements (HAPAs) on a precautionary basis, with a cap and frontloading subject to *ex post* review; see IMF (2009a).

<sup>7</sup> See IMF Press Release 09/85, March 24, 2009.

<sup>8</sup> In particular the additional \$250 billion for the Fund is not yet in sight, the source of the additional \$100 billion for the World Bank is not clear, and the so-called \$250 billion in additional money for trade financing seems to be fictitious; see Giles (2009) and Khor (2009).

2009 – more or less by the same amounts as for advanced economies (IMF WEO, April 2009: table 1.1).

The volume, terms and conditions of additional financing to be made available by the multilateral financial institutions can be expected to show considerable variations among DEEs according to their access limits and eligibility to different categories of financing. Of the \$250 billion SDR allocation, DEEs would receive some \$80 billion of which less than a quarter should be available to low-income countries. These amounts are small fractions of estimated external financing needs of the developing world. Any additional IBRD lending funded by bond issues would not be available to a large number of poor countries, including those in low-income and lower-middle-income categories. On current rules additional IMF lending financed by bilateral and/or market borrowing should in principle be non-concessional. Judging on the basis of the established pre-qualification criteria, a very large number of DEEs, including several emerging market countries with large current account deficits, high levels of public debt, high and unstable inflation etc., should not be eligible to the FCL.

It is generally agreed that when the balance-of-payments difficulties of a member of the Fund result from external shocks of a permanent nature, or from excessive expansion of domestic absorption, IMF financing should be accompanied by domestic policy adjustments to reduce the deficits. However, when payments difficulties are due to temporary external shocks, they need to be financed rather than reduced through policy adjustment. The current financial crisis appears to contain both permanent and temporary elements of change. It can be expected that the crisis will bring a durable adjustment to the external deficits of the United States resulting from the long-awaited consumer retrenchment. This certainly calls for an adjustment in surplus countries, including the Asian developing countries, notably China, but not resource-constrained DEEs.<sup>9</sup> This means that deficit DEEs should not be subjected to procyclical macroeconomic policy conditionality for any additional borrowing needed to meet their balance-of-payments shortfalls resulting from trade and financial shocks from the crisis. However, despite the “recent modernization of conditionality”, the Fund has continued to impose procyclical macroeconomic tightening in almost all recent standby programmes – fiscal tightening in Pakistan, Hungary and Ukraine, and interest rate hikes in Latvia and Pakistan

<sup>9</sup> For implications of the current crisis for external adjustment in the United States and China, see Akyüz (2008a).

(TWN 2009). Even though some of these countries may have had large budget deficits when they approached the Fund for loans, recessions are not the best times to undertake fiscal adjustment.

Nor should multilateral financing made available to DEEs to meet their balance-of-payments difficulties due to a global crisis for which they have no responsibility place a heavy burden on them. This means that a high degree of concessionality would be needed. Indeed the IMF had established two highly concessional oil facilities in the 1970s as deliberate countercyclical devices to prevent oil price hikes from triggering a global recession, with countries enjoying almost automatic access without countercyclical macroeconomic conditions.

Low-income countries should be compensated, not burdened with additional debt and debt servicing because of financing they receive to meet the shocks from the crisis. For political reasons as well as effectiveness ODA grants are not the best way to achieve this. An option would be to make a one-off permanent SDR allocation to these countries, based on some criteria of need.<sup>10</sup> The cost of drawing on such allocations could be financed collectively from the IMF resources, including gold sales. This should be combined with a moratorium on servicing debt owed by these countries to official creditors, without any additional interest charges.<sup>11</sup>

A no-cost SDR allocation to low-income countries can be combined with a large reversible SDR allocation to other DEEs, to be repurchased when the crisis is over, to provide them with low-cost, no-conditionality resources. Proposals for reversible SDR allocations were made in the 1990s in order to allow the IMF to act as a lender-of-last-resort for financial bailout operations in emerging economies hit by financial crises. The rationale for such an allocation is no doubt much stronger now given the sharp contraction in global output and trade.

A large and reversible SDR allocation would extend to the global level the policy of “quantitative easing” widely used by some major economies in stabilizing conditions in domestic credit and financial markets and stimulating spending. Reversibility would also provide automatic exit, thereby preventing inflationary pressures once recovery is under way. Furthermore, relying mainly

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<sup>10</sup> For a discussion of SDR allocation to poor countries as a way of reducing costs of holding reserves, see Polak and Clark (2006).

<sup>11</sup> UNCTAD has also called for a temporary moratorium on official debt servicing by DEEs; see UNCTAD (2009).

on SDR allocation to meet external financing needs would also help avoid several undesirable consequences of funding IMF lending with bilateral loans from its shareholders, discussed in the subsequent section. Finally, a large SDR allocation could allow surplus emerging economies such as China to diversify their reserve holdings and reduce their vulnerability to dollar instability.

The exact purpose and use of IMF lending under current conditions also need to be scrutinized. As in the past, the existing standby programmes of the Fund appear to be premised on maintaining open capital accounts and ensuring that developing-country debtors stay current on their payments to private creditors. Of all the countries with IMF standby programmes, only Iceland has widespread capital controls over resident and non-resident outflows, introduced in the early days of the crisis. None of the emerging markets with IMF programmes has introduced similar measures despite continued capital outflows. Even though the Fund may no longer be actively promoting capital account liberalization, its aversion to restrictions seems to continue unabated.

There can be little doubt that the rationale for capital controls over outflows in countries facing severe balance-of-payments difficulties is much stronger than that for trade restrictions. However, the latter have proliferated both in DEEs and advanced economies after the outbreak of the credit crunch while capital accounts have remained largely open even in countries facing large and continued outflows.<sup>12</sup>

In such cases the Fund should not only support but also recommend use of temporary exchange restrictions, preventing the burden of adjustment falling disproportionately on trade. These restrictions should also include temporary debt standstills. It is true that the international community has not been able to establish an orderly mechanism for the protection of debtors against litigation in such cases – an issue to be taken up in section C. But the IMF can express its support by “lending into arrears”, thereby deterring potential hostile action by private creditors.

Such restrictions should also be applied in FCL-eligible countries if the precautionary access provided by the FCL fails to stem speculative attacks and there are large and persistent outflows. Outflows can indeed accelerate if emerging economies lag in recovery behind advanced economies. Borrowing from the IMF to finance such outflows could lead to considerable increases in government debt burden, particularly where an important part of foreign claims

<sup>12</sup> On trade restrictions, see Gamberoni and Newfarmer (2009) and World Bank (2009a).

**FINANCIAL CRISIS AND GLOBAL IMBALANCES** examines – from a standpoint of promoting stability and growth in developing countries – key policy lessons to be drawn from the devastating global economic crisis of 2008-09.

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ISBN 978-92-9162-037-1



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