

The IMF and the Adjustment of Global Imbalances

by Ariel Buira and Martin Abeles

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Abstract

The paper discusses the trends of recent global imbalances and the financial flows that sustain them, as well as the associated risks with regard to international financial stability and worldwide economic growth. It considers the responsibilities of the IMF surveillance in their correction under Article IV of the Articles of Agreement.

The paper analyzes the likely impact of a potential dollar crisis on developing countries through a reduction of capital flows, increased interest rates and higher spreads on debt service and on their access to and cost of borrowing. The impact of a crisis on their export revenues is also considered. In this connection, the paper assesses the Fund's likely response to a dollar crisis, and considers the Fund's most constructive possible response consistent with its purposes.

The paper discusses the Fund's potential role in dealing with global imbalances in the light of the Articles and of the Fund's own history, particularly the precedent set by the Oil Facility of the mid-1970s. The paper suggests the establishment of a counter cyclical facility to deal with exogenous shocks to assist developing and emerging countries.

In order to reduce the risks and the deflationary impact on the international economy of a reduction in US aggregate demand, the paper proposes a coordinated approach to the management of the global economy and the correction of global imbalances by the largest 20 economies with the Fund's technical support.

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1. Introduction

The build-up of global macroeconomic imbalances poses a serious threat for the global economy. In the United States the current account deficit widened to 6.5% of GDP in 2005 and is expected to approach 7 per cent of GDP in 2006. On present policies the US current account deficit would approach 10 per cent of GDP in five years, and consequently US debt would rise to 60 percent of GDP by 2010, and to more than 100 percent by 2015¹ (Eichengreen and Park 2006). On the other hand, the current account surplus in Japan and China increased in 2005, while emerging Asia continued to run large current account surpluses. Current account surpluses also increased in the Middle East and Russia due to high oil prices; these surpluses are currently roughly equal to those in emerging Asia and Japan (IMF 2005). As a result, net international assets of emerging Asia, Japan, the Middle East, and Russia continued to rise in 2005 and are expected to rise further in 2006.

The trend shown by these variables poses considerable risks for international financial stability and worldwide economic activity. To be sure, the growing US current account deficit is on an unsustainable path. The question is “whether the adjustment needed to limit [US] long-term net liabilities comes early and thus is smaller and less painful or comes later and thus is larger, more painful, and potentially much more disruptive” (Cline 2005). In this context a sudden reallocation of portfolios away from dollar-denominated assets, or even just a gradual decline in the demand of US dollars as a reserve currency due to diversification, would entail large costs as the value of these assets falls and dollar interest rates rise, leading to a slowdown of the US economy and (given the structure of global demand) to a decline in worldwide economic activity. A fall in worldwide economic activity could in turn trigger pervasive “beggar-thy-neighbor” policy responses, including protectionism and extensive competitive devaluations. Such a scenario would affect economies across the globe, but would be particularly harmful to developing economies, as rising interest rates, coupled with the likely fall in commodity prices and exports of manufactures, would force severe macroeconomic adjustments. The magnitude of this menace calls for an assessment of the Fund’s potential role in dealing with an orderly adjustment of global imbalances.

The paper is organized as follows. Section 2 addresses the Fund’s responsibilities under the Articles of Agreement with regard to global imbalances. Section 3 describes the most salient trends of recent international financial flows, examines the main risks posed by global imbalances, and discusses the Fund’s

¹See Eichengreen and Park (2006); Yoshitomi et al (2005) show that even under favorable assumptions in 10 years time the US debt/GDP ratio would reach 150% of GDP, equal to 40% of the net wealth of the rest of the world.

likely response to a dollar crisis in connection with developing countries. Section 4 analyzes the Fund's potential role in dealing with global imbalances, reviews some relevant historical precedents (where the Fund played an effective countercyclical role), and proposes measures to prevent a global downturn and a facility to assist developing countries in the event of a dollar crisis. Section 5 concludes.

2. The Role of the Fund under the Articles of Agreement

The International Monetary Fund is charged, under Article I of its Articles of Agreement, with the responsibility of promoting international financial stability and facilitating "the expansion of international trade and the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy" (Article 1, Section 2). For that reason, the Fund is expected to work ceaselessly towards reducing the risk of a financial crisis leading to a global contraction. Among other responsibilities it is supposed to "oversee the international monetary system in order to ensure its effective operation, and oversee the compliance of each member with its obligations".

Regarding these obligations, it is worth quoting Section 1 of Article IV ("General obligations of members") in full:

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the *orderly underlying conditions that are necessary for financial and economic stability*, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a *stable system of exchange rates*. In particular, each member shall:

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a *monetary system that does not tend to produce erratic disruptions*;

(iii) *avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members*;

(iv) follow exchange policies compatible with the undertakings under this Section."

In relation to the role of the Fund, Section 3 of Article IV (“Surveillance over exchange rate arrangements”) states:

a) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article [quoted above];

b) In order to fulfill its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall *adopt specific principles for the guidance of all members with respect to those policies...*The principles adopted by the Fund shall be consistent with the cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members... *consistent with the purposes of the Fund* and Section 1 of this Article (italics added)

Of course, as expressly stated in the Articles of Agreement, the Fund’s involvement should take each country’s specific situation into account.²

The Fund’s current failure to conduct effective multilateral surveillance, as well as its limited effectiveness in fostering coordination among systemically important economies, poses a serious matter of concern. Effective multilateral surveillance and international cooperation can prevent a disorderly unwinding of global imbalances and the contraction of world economic activity. The burden of adjustment to be borne by developing countries in the event of a sharp collapse of the US dollar comprises another serious matter of concern.

In this context, this paper will discuss the Fund’s potential role in 1) the prevention of disorderly adjustment of global imbalances; and 2) in dealing with the financial needs of developing economies in case a process of abrupt and disorderly adjustment eventually unfolds.

3. The risk posed by global macroeconomic imbalances

Since the mid-1970s the United States has experienced increasing deficits in its balance of trade in goods with pervasive effects for global financial arrangements. This trend, endorsed by international investors’ appetite for US dollar-denominated liabilities, has exacerbated in recent years raising concerns about its sustainability in the international community.³ As recently pointed out by the International Monetary Fund’s *World Economic Outlook*, an abrupt decline in capital inflows to the US “could engender a rapid dollar depreciation and a sharp increase in US interest rates, with potentially serious adverse consequences for global growth and international financial markets” (IMF 2005).

² “These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members” (Article IV; Section 3b).

³ See Blecker (1998) for an early warning.

As a consequence of large capital inflows in the 1990s, the US currently bears the world's largest net international debtor position. By the end of 2004 the rest of the world owned more than \$12.5 trillion of US assets, while US-owned assets in the rest of the world reached almost \$10 trillion; i.e. a net international investment position of minus \$2.5 trillion. As pointed out by Buirra (2005a), the shift in the United States net international investment position (a shift that mirrors the United States' switch from trade surpluses to deficits over the last three decades), entails one of the most important changes in the world economy since 1944, when the IMF was created: "The United States, which was the only large capital-surplus country up to the 1960s and thus the main provider of resources for the IMF and World Bank, has become a net debtor as its external liabilities have exceeded its assets abroad. Today, it is the largest debtor country."

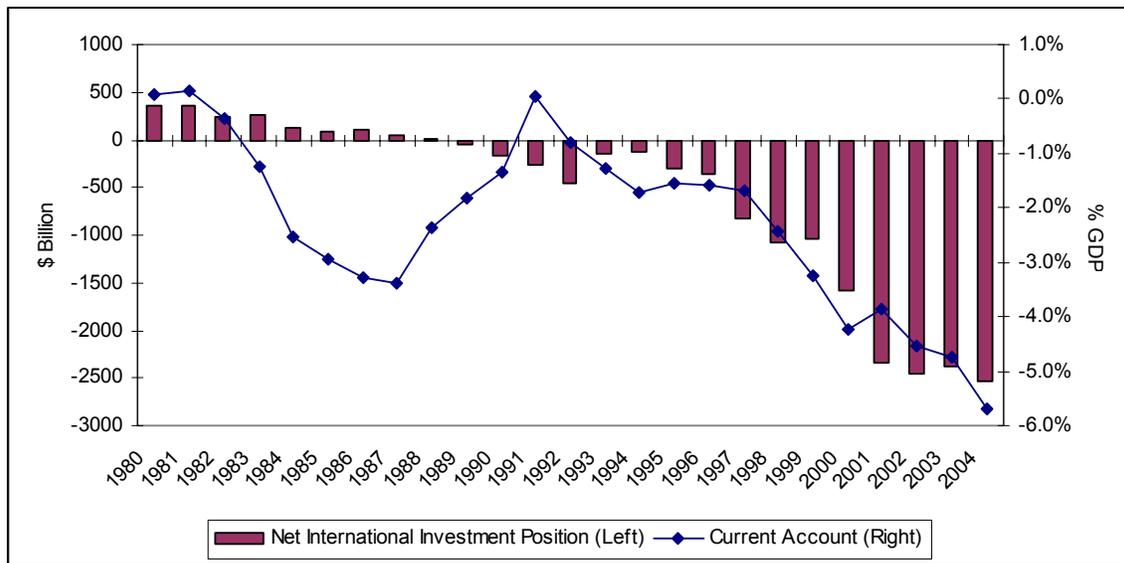
As indicated above, the US ran a current account deficit of 6.5% of its GDP in 2005, equivalent to over 1.5% of world GDP. As shown in Graph 1, the historical trend is disturbing, as current account deficits—which have to be financed by foreign capital inflows—have widened significantly over the past decade, facing policy makers across the globe with the prospect of a possible decline or collapse in the demand of the US dollar as a reserve currency. Until now, the unrelenting demand for US-dollar assets has financed the increase in US current account deficits allowing the US to sustain rising levels of domestic absorption despite its diminishing international competitiveness.⁴ In fact, after the slowdown of 2001, when GDP's annual growth rate fell below 1%, GDP growth rates in the US have risen to 1.9% in 2002, 3.0% in 2003, 4.4% in 2004, and an estimated 3.5% in 2005. It is widely accepted that this growth in output has been sustained by deficit-financed spending of the US government⁵ and by debt-financed consumption of US households⁶.

⁴ Poole (2005) argues that US's lower competitiveness is the result of international investors' confidence in US dollar-denominated assets: "[I]nstead of thinking that capital flows are financing the current account deficit, it may well be that the trade deficit is driven by—is financing, so to speak—capital flows determined by investors seeking the best combination of risk and return in the international capital market. The mechanism creating this outcome is that capital inflows keep the dollar stronger than it otherwise would be, tending to boost imports and suppress exports, thus leading to a current account deficit."

⁵ After four consecutive years of fiscal surplus (1998-2001), following the recession of 2001 the United States' federal budget deficit rose to 2.0% of GDP in 2002, 3.5% in 2003, 3.3% in 2004, and estimated of 2.7% in 2005.

⁶ Debt-financed spending by United States households also contributed to keep domestic demand on the rise, encouraged by a combination of low long-term interest rates and the associated wealth effect resulting from the housing boom and swelling real state prices (which are in turn fed by low long-term interest rates). According to Zamparelli et al (2005), personal net borrowing comprises the main domestic counterpart of foreign net lending in the US.

Graph 1: US Current Account and Net International Investment Position



Source: International Financial Statistics, IMF

In spite of the growing concern regarding the possibility of a decline in the demand for US dollars capital has not ceased to flow into the US.⁷ Such an appetite for US dollar-denominated liabilities has contributed to finance the swelling US current account deficits at appreciably low interest rates.⁸ Resulting low US dollar interest rates have contributed to finance the housing boom in the US, which in turn allowed for increased debt-financed spending by US households due to the resulting wealth effects. A similar process, albeit less significant for the global economy, can be traced for the United Kingdom.

In 2005, despite the large US current account and budget deficits, the US dollar strengthened and remained at fairly high levels. However, the present strength of the US dollar seems to result from a combination of temporary factors, namely:

- A relatively aggressive interest rate policy by the Fed, coupled with a passive interest rate policy by other central banks giving rise to an interest rate differential in favor of dollar assets.

⁷ It should be noted, as pointed out by D'Arista (2005), that "for all the attention paid to foreign central banks purchasing US Treasuries in order to curb the appreciation of their currencies, this sector's net acquisition of US assets amounted to only 27.4 percent of the total net inflow [in 2004]. The remaining 72.6% (\$1.05 trillion) consisted of private investment that was mostly channeled into purchases of corporate and other bonds (\$309.3 billion) and banks' liabilities (\$322.6 billion)".

⁸ Long-term interest rates have remained fairly low despite the Fed's 1½-year drive to increase short-term rates (the so-called "Greenspan's conundrum").

- Higher growth rates in the US than in other industrial economies, particularly Japan and Germany, which gave rise to higher returns on investments in the US.
- The demand for dollars resulting from the repatriation of profits fostered by the Homeland Investment Act.
- The dismal political performance of the EU, viz. the rejection of the European Constitution by France and The Netherlands and the protracted difficulties for the approval of the EU budget—all factors that have undermined investor's confidence and discouraged US-dollar denominated investments from moving into the Euro.

As pointed out by numerous financial analysts, current low interest rates are also unlikely to persist in the medium term. For sure, interest rates will rise if foreign investors fear the possibility US dollar devaluation and respond by reducing the rate of accumulation of dollar-denominated assets; or (even worse) if they react by cutting back their holdings of dollar-denominated assets. A dollar devaluation would itself entail domestic price increases in the US, as the rise in the price of tradable goods impinges on domestic prices. The increase in domestic prices could in turn trigger a contractionary response by the Federal Reserve, which may decide to raise short-term interest rates.⁹ A rise in interest rates due to either of these causes (or most likely due to a combination of both) could prick the housing bubble reducing household consumption further thus worsening the contractionary impact of rising interest rates.

Consumption growth in the US may also prove to be unsustainable at the current rate, for the following reasons:

- It is based on borrowing by households, whose debt has risen markedly to 126% of disposable income (more than 7% of GDP), and whose debt service has increased to 14% of disposable income despite prevailing low interest rates (Wolf 2006). As consumption has been fueled by the wealth effect of rising house prices, a softening or a decline in the housing market—as noted above, the effect of higher interest rates—would lead to a fall in consumer purchases and an economic slowdown. If the rise in interest rates in the US continues, the US could suffer a recession or a slowdown in 2007, with a good chance that the global economy would also slow down (more on this below).
- The differential in returns between dollar and other bonds is very narrow, (1% on euro bonds and about 3% on yen in 10-year bonds) and not enough to compensate for the fall in the dollar that is likely to occur over

⁹ The increase of oil prices and the ultimate pass-through of general inflation into core-inflation would most likely move the Fed in the same direction.

the next few years. As pointed at by Martin Felstein (2006), “the dollar must fall faster than these small interest differentials to prevent the current account deficit from increasing faster than GDP.” This means that investors in dollar bonds will eventually have lower returns, potentially much lower returns than investors in bonds denominated in other currencies. At some point that will trigger a shift away from the dollar into other currencies to avoid the loss of value of their dollar bonds (*ibid.*).

It should be noted that a sudden loss of appeal of US-dollar denominated assets is not necessary for the dollar to weaken. All that is necessary is that the willingness of others to continue to purchase US-dollar denominated assets lags behind the insatiable US demand for borrowing to finance its deficits. There are several reasons why this second scenario is likely to materialize. First, surplus savers in rest of the world may seek to *diversify* their portfolios. We have been given notice by the Chinese authorities that while they are unlikely to sell off a large part of their dollar holdings, they will use some proportion of their fast growing reserves to purchase other assets and diversify their portfolio.¹⁰ Similarly, the BIS has noted that bank deposits held by OPEC are sensitive to interest rate differentials as well as a longer term tendency for OPEC to diversify out of US assets. Some of the OPEC funds are temporarily held in US paper until they are invested.¹¹

Second, while it is expected that the US will continue to grow faster than Europe and Japan, the growth rate differential with these countries will probably narrow in the second half of 2006. This means that the attractiveness of dollar assets declines while the investment needs and opportunities in these countries, which could absorb a greater share of their savings, rise. The interest rate differential in favor of the dollar may decline, as the Fed adopts a neutral stance and interest rates stop rising in the US in the second semester while they may be expected to rise in other industrial countries.

3.1. From global excess liquidity to higher interest rates

The risks posed by the growing US current account deficits have attracted substantial attention in international policy circles. However, international financial markets appear to be complacent regarding present interest rate and trade risks. Indeed, the future path of interest rates and spreads, which have been at historically low levels for an extended period of time, comprises another important source of uncertainty in international financial markets. However, no

¹⁰ “We won’t sell off our dollar-denominated assets,” said Tang Xu, head of the research bureau at the People’s Bank of China. But buying other assets with growing inflows is likely, he stated, adding that China does not exclude buying oil for petroleum reserves (IMF Morning Press, January 10, 2006).

¹¹ The sharp increase in the price of gold, to around \$540-\$550 per troy ounce must be seen as a sign of diversification by some surplus savers.

financial authority or institution seems to be making contingency plans in connection with a potential dollar crisis.

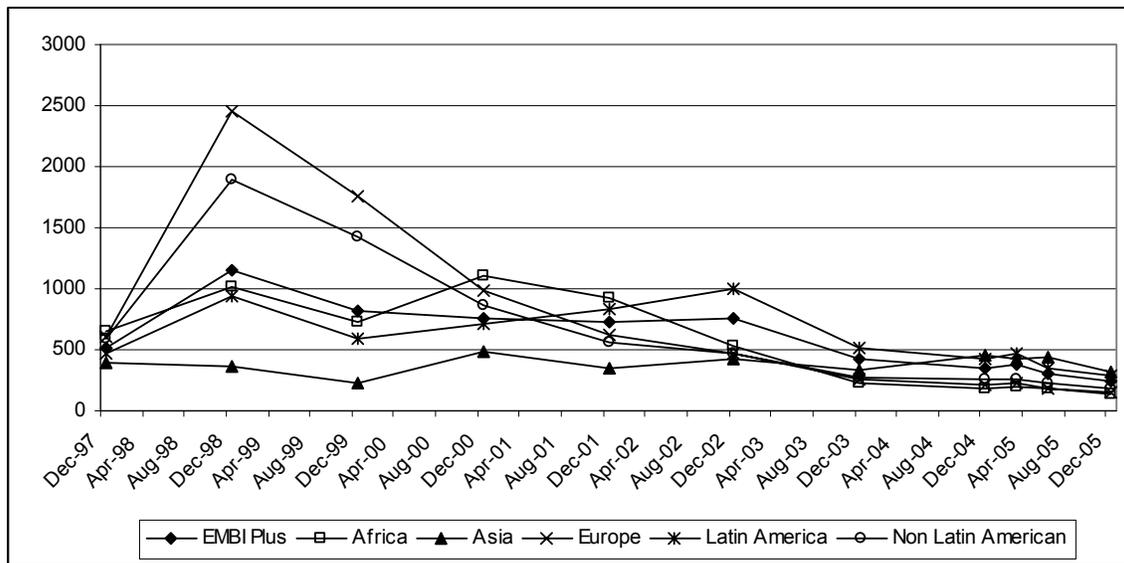
The prolonged low interest rate environment has considerably increased global liquidity and seems to have led financial market participants to become excessively leveraged, leaving them vulnerable to a sharp increase in interest rates.¹² In this context, the growing US current account deficit not only poses a clear danger to foreign exchange markets, but also threatens the stability of the global financial system more broadly. As the cycle matures macroeconomic imbalances could unwind abruptly and bring about unanticipated interest rate spikes.

Concerns not only relate to interest rate levels, but also to historically low interest rate spreads, as illustrated by J.P. Morgan's Emerging Markets Bond Index (EMBI), which tracks total returns for traded external debt instruments in emerging markets (Graph 2). The long-standing low level of interest rates has encouraged financial market participants to channel funds into riskier financial assets in search for higher returns, as perceived in the growing interest in longer-term financial assets, which tend to carry more risk. As funds have been channeled into long-term debt, yields have fallen contributing to historically low real government bond yields.

This phenomenon has not only affected advanced countries, but also developing countries. Indeed, low yields have encouraged the purchase of long-term debt that offers a premium over the return provided by government debt in industrialized countries. As a result, considerable funds have been directed towards corporate and emerging market debt, causing a significant narrowing in their interest rate spreads vis-à-vis government debt. The underlying strategy of borrowing at short-term rates to invest in long-term assets introduces considerable interest rate risk, and entails increased vulnerability to a sudden rise in interest rates. As a result, global financial markets appear more vulnerable today to unexpected shocks than they have been in the past.

¹² Many analysts point to the prolonged "hyper-stimulative stance" of monetary policy in many countries as the source of recent financial excesses. In the United States the real Fed funds rate was negative from October 2001 to November 2004, significantly below the positive 1.98 per cent average of the ten years prior to the 2001 downturn (see Bank Financial Group 2005). Similarly, in inflation adjusted terms the European Central Bank has averaged roughly 0.5 per cent over the past three years, also low compared to an average of about 2 per cent over the preceding decade (*ibid.*).

Graph 2: Interest Rate Spreads



Source: JP Morgan

Although over the past two years emerging market economies have reduced their public debt levels, debt-related vulnerabilities are still important. According to the *World Economic Outlook*, by the end of 2005 public debt ratios in emerging markets had fallen by approximately 8 percentage points of GDP since 2002, to an average of 60 percent of GDP.¹³ Despite this relative improvement, a rise in US interest rates would still pose a menace to public finances in many developing countries. Furthermore, the impact of such a rise in US interest rates would be compounded in the developing world by the likely concurrent increase in interest rate spreads.¹⁴

Higher interest rates and higher spreads would affect public finances in developing countries in two ways: by increasing the cost of servicing existing variable-rate debt and by increasing interest rates on new debt commitments. Naturally, the fiscal impact of the second effect is bound to increase over time as old debt at lower rates is replaced with new debt at higher rates. An IMF Working Paper estimates the impact on emerging market fiscal performance in 2006–07 of an increase in global interest rates by 100 to 300 basis points relative to the end-2004 level, finding a substantial negative fiscal impact of future higher interest rates on many emerging markets' future fiscal performance (Hauner and

¹³ Public debt ratios have fallen most significantly in Latin America (an average decline of 13 percent of GDP, to approximately 52 percent of GDP by end-2005), followed by the Middle East and Africa (by 11 percent of GDP, to about 77 percent of GDP), and Asia (by 5 percent of GDP, to 58 percent of GDP). Only in the central and eastern European countries have public debt ratios increased about 1 percent of GDP, to around 53 percent of GDP (IMF 2005).

¹⁴ The extent to which rising interest rates in advanced countries would entail a widening of spreads on emerging market debt is uncertain, although historical experience seems to indicate that this is likely to be the case. Indeed, if interest rates rise in the US, investors would be less pressed to look for high yield elsewhere and the pursuit of risk could diminish.

Kumar 2005). In the most highly indebted developing economies the fiscal impact of a 300 basis points rise in industrial country base interest rates would amount to approximately 1½ percent of GDP in 2006–07, their impact rising as maturing debt at lower rates is replaced with new debt at higher rates (*ibid.*).

Similarly, according to the World Bank's (2005) *Global Development Finance*, an increase in US short- and long-term interest rates of 200 basis points would reduce economic growth in emerging economies by 1% in 2005 and 2006. Furthermore, if such increases in US interest rates were associated with widening interest rate spreads, the slowdown would be much more pronounced, by more than 2 additional percentage points in 2005 and by around 4.5 additional percentage points in 2006.

Note that in the event of a steep rise in global interest rates and the widening of interest rate spreads the fiscal strain on developing countries would stem from an exogenous event. Furthermore, the weakening of public finances resulting from rising debt obligations would come about despite the recent decline in public debt to GDP ratios in the developing world (IMF 2005). The potential increase in developing countries' risk premiums due to a fall in the US dollar would be unrelated to domestic policies, a crucial aspect to be considered from a multilateral perspective. Under such circumstances further fiscal adjustment—a likely IMF recommendation—would only make things worse. Furthermore, in the context of global contraction, fiscal adjustment would not affect individual debtor economies—it would also contribute to exacerbate the slowdown of global economic activity.¹⁵

3.2. Trade and interdependence

The risks for developing countries not only stem from the possible reversal in the low interest rate environment, but also from the associated slow-down of US (and global) economic activity and the likely fall in commodity prices. Given the structure of global macroeconomic imbalances, a recession in the US would unavoidably affect surplus countries, i.e. those economies whose thriving exports are directly or indirectly linked to high US growth rates.

The most obvious example at hand points to Canada and Mexico, two sizeable economies closely linked to the US, who would suffer enormously from a slowdown of economic activity in the US. In both cases, exports to the US

¹⁵ The cited IMF Working Paper suggests that developing countries should increase their already contractionary stance: “[T]he fiscal risks for emerging markets stemming from a reversal in the benign global financial environment are substantial, even more so as a deterioration in global financial conditions could be accompanied by a slowing pace of global activity and lower commodity prices. This increases the onus on emerging markets to aim for a consolidation of their underlying fiscal position, and to press ahead with fiscal reforms to preserve benign financial conditions for their countries, even if the global financial environment should deteriorate” (Hauner and Kumar 2005).

represent more than 80% of their total exports (see Table A.1 in the Appendix).¹⁶ A slowdown in Canada and Mexico, induced by a downturn in the US, would in turn affect third parties involved, particularly among developing countries, as Canada and Mexico tend to increasingly import goods and services from the developing world (Table A.2).

Given the Chinese and (to a lesser extent) Indian growing dependence on US demand, as well as their growing influence on third parties, the impact of a downturn in the US on China and India would give rise to a most preoccupying situation. To illustrate, more than 20% of China's exports go to the US, whereas more than 50% of China's imports come from the developing world. Although less significantly, India has also become increasingly dependent on US economic growth, and its imports from developing countries are also significant (Tables A.3 and A.4).

As suggested above, a reduction in China's exports brought about by a reduction in US demand for Chinese goods would, in the absence of counteracting factors, e.g. sharp growth of domestic absorption in China and other Asian economies (China by itself is too small to offset a decline in US consumption), immediately affect other economies in the developing world. Consider the case of Africa. While Africa's overall exports have doubled between 1998 and 2004, from \$92 billion to \$190 billion, Africa's exports to China alone have grown more than tenfold, from less than \$1 billion to more than \$11 billion. As a result, between 1998 and 2004 the share of China as a destination for African exports increased from less than 1% to more than 6%.¹⁷ In short, China's significance for Africa has grown in recent years, especially after 2000. While 30% of Africa's total exports currently go to developing countries, of which around half go to Asian countries, almost 50% of Africa's exports to Asia go to China alone. Consequently, a slowdown in China would seriously affect Africa's exports.

In the case of Latin America and the Caribbean, China has become an increasingly relevant market. While overall exports of Latin America and the Caribbean increased by 70% between 1998 and 2004, (from \$284 billion to \$484 billion), the region's exports to China have grown more than sixfold (from less than \$2½ billion to more than \$15 billion). As a result, between 1998 and 2004

¹⁶ In the 1990s Mexico displaced Japan as the second-largest U.S. trading partner. Since 2003, however, Mexico was displaced by China as the second largest supplier of U.S. imports (after Canada, which remains the largest U.S. trading partner regarding both exports and imports).

¹⁷ It should be noted that African exports to the US more than doubled in the same period, from around \$13 billion to \$30.5 billion. While the increase in African exports to China in the period 1998 and 2004 explains approximately 10% of the overall increase, the increase in African exports to the US explains close to 18% of the overall increase between 1998 and 2004. Hence, a slowdown in the US GDP growth would affect Africa directly, not just indirectly due to its impact in Chinese growth.

the share of China as a destination for Latin America and Caribbean exports rose from less than 1% to more than 3%.¹⁸

One of the most important impacts of China and India's outstanding growth performance is associated with the recent rise in commodity prices. China and India's extraordinary growth rates (their combined contribution to global economic growth has been estimated to be of approximately 30%) have helped keep global output growth rates and prices above trend, a critical factor in improving the terms of trade of primary commodity producers.¹⁹

The recovering Japanese economy also seems to rely increasingly on China as a market for its exports. Note that between 1998 and 2004 the increase of 8 percentage points in Japanese exports to China matches the decrease in its exports to the US (Table A.5). While in 1998 China represented only 11% of Japanese exports to the developing world, in 2004 China absorbs 23% of Japanese exports to developing countries, which have themselves increased as a proportion of total Japanese exports.

To be sure no economy in the world would remain unaffected in the event of a US dollar depreciation-cum-recession. While many Asian economies, including India and China would be directly affected by the fall in US demand, many countries in Latin America and Africa, who depend on growing Asian demand of primary goods, would also face a fall in their exports and be forced to adjust downwards. A likely fall in commodity prices would only contribute to make things worse.

3.3. The Fund's likely response to a systemic crisis

The world economy has become dependent on the US as a "consumer of last resort", fueled by US government deficit-spending and US household debt-financed consumption. Aided by the willingness of surplus-country residents to acquire dollar-denominated assets the US has been able to pull approximately 70% of global capital flows in order to finance its current account deficits (Rajan 2006).

¹⁸ In the case of Latin America and the Caribbean the growth of exports to the US is also very significant in absolute terms. The region's exports to the US increased by 74% between 1998 and 2004, from around \$146 billion to approximately \$254 billion. This increase of more than \$100 billion between 1998 and 2004 represents more than 50% of the overall increase of exports originated in Latin America and the Caribbean during this period. Here again a slowdown in the US GDP growth would affect Latin America and the Caribbean directly, not just via its impact in Chinese growth.

¹⁹ According to Chen et al (2005): "If world industrial growth exceeds 4 per cent, the barter terms of trade of primary commodity to finished goods prices rise. High global growth thus counteracts the Prebisch-Singer hypothesis that technological progress has led to a secular decline for raw commodity prices since World War II".

These deficits are not being financed mostly by other developed economies; Japan and Germany, the two largest industrial surplus countries explain only 30% of aggregate current account surpluses. Developing and transition economies have become crucial sources of finance of the United States' current account deficits, particularly oil-exporting countries of the Middle East, whose financing flows have recently surpassed emerging Asia. As pointed out by Chandrasekhar and Ghosh (2005), "the bulk of the increase in the US current account deficit was balanced by changes in the current account positions of developing countries, which moved from a collective deficit of \$90 billion to a surplus of \$326—a net change of \$416 billion—between 1996 and 2004". This is one outstanding paradox of current global imbalances—namely, the fact that poor countries finance rich countries and not the other way around.

If the international community does not intervene, the likelihood of a disorderly adjustment that would result in global contraction increases, with unpredictable downward dynamics. While the burden of US dollar depreciation would mostly fall on countries with floating-exchange rate regimes, mostly in the European Union²⁰, Latin America and Africa, the rise in dollar interest rates and the slowdown in US economic growth would directly affect Asian countries, even if their currencies remain pegged to the US dollar, as their exports largely depend on US demand. The slowdown in Asian economies would hit Latin American and African countries yet again, as the demand for their primary goods exports falls, and their terms of trade decline. Such a generalized deteriorating situation is likely to trigger defensive responses and "beggar-thy-neighbor" dynamics.

Such is precisely the type of development (e.g. growing restrictions on trade, a chain reaction of competitive devaluations, etc) that the Fund's "founding fathers" had intended to avert. Indeed, according to Article I of its Articles of Agreement the Fund should:

- Promote international monetary cooperation providing the machinery for consultation and collaboration on international monetary problems.
- Facilitate the expansion and balanced growth of international trade, and contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- Give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national and international prosperity.

²⁰ To the extent that in this process the Euro strengthens *vis-à-vis* the US dollar, the African countries which peg their currencies to the Euro would suffer as well.

- In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in international balances of payments of members

Developing countries' prevalent export-led development strategy, which sustains existing global imbalances, seems to be related to the Fund's response to recent financial and currency crises. In fact, the so-called "savings glut", a term popularized by Ben Bernanke,²¹ which points to the excess of savings *vis-à-vis* investment in developing countries (particularly in Asia) as the main culprit for global imbalances, results to a great extent from developing economies ubiquitous export-led growth strategies, which necessitate competitive exchange rates and tend to limit domestic absorption.²²

While in the cases of India and China current account surpluses seem to be related to domestic expansion strategies, other developing countries' current account surpluses appear to be a defensive response to inadequate Fund intervention in the past, particularly after the 1997 Asian financial crisis, where Fund conditionality was considered to be inappropriate, turning a liquidity crisis into a solvency crisis (Taylor 1998). In order to avoid resorting to Fund assistance-cum-conditionality in the future, Asian countries have decided to build up international reserves and to develop regional monetary arrangements as a form of self-insurance.²³ The development of alternative regional monetary cooperation arrangements and the accumulation of high levels of international reserves seem to comprise costly forms of insurance, not just for the Asian economies, but given its contractionary bias also for the global economy as a whole.²⁴ Such a contractionary bias is apparent in global investment figures (Graph 3):

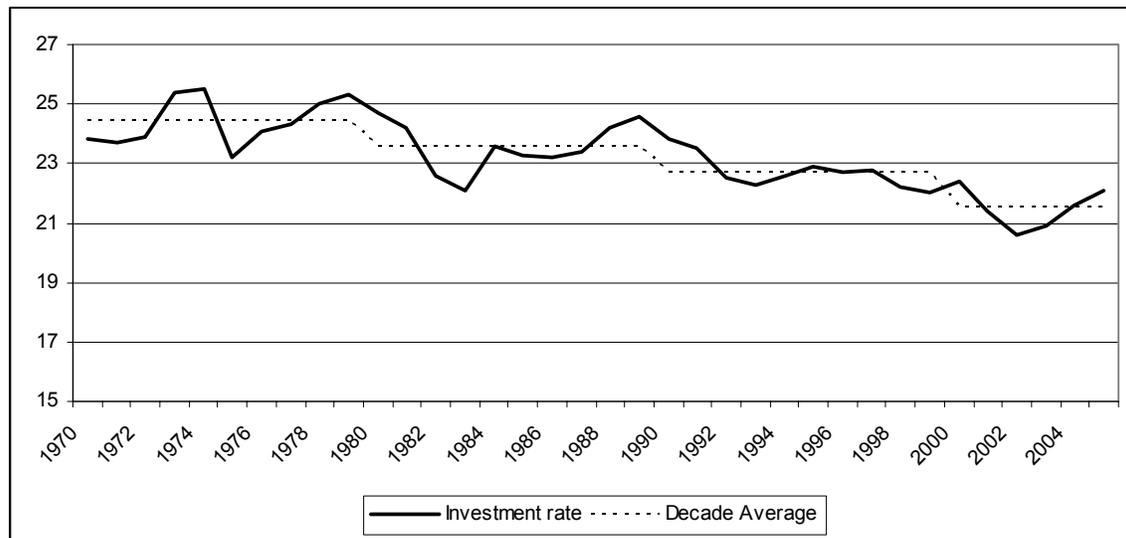
²¹ Chairman of the US Federal Reserve System.

²² While at the individual country level an export oriented strategy may give rise to a short-term expansionary thrust, as in the case of Japan in the 1960s-70s, the Four Tigers (Hong Kong, Singapore, South Korea, and Taiwan) in the 1970s-80s, and more recently other countries (including Thailand, Malaysia, and Vietnam), at the global level such a strategy tends to create a contractionary bias (see Blecker and Razmi 2005).

²³ The Chiang Mai initiative was established to provide liquidity support to its members facing contagion and/or speculative attacks against their currencies. In the words of Masahiro Kawai, a former high official of the Japanese finance ministry who will head the new regional financial integration office at the ADB, "The Chiang Mai initiative has the potential to become an Asian monetary fund" (*Financial Times*, May 6, 2005).

²⁴ Baker and Walentin (2001) estimate that "the increase in the ratio of reserve holdings to GDP over the last four decades has imposed costs that exceed 1.0 percent of GDP, and possibly 2 percent of GDP, for many developing countries" and point out to increasing international financial instability as the main explanation of the over-accumulation of reserves, especially after the 1997 East Asian crisis.

Graph 3: Global Investment Rate (% GDP)



Source: IMF

In the *World Economic Outlook*, the Fund's staff reject the idea that current global imbalances result from a "savings glut", a supply-sided approach, and appear to believe that the problem lies on the demand side.²⁵ Indeed, the staff's judgment points to the need to boost investment demand worldwide (with the exception of China), especially in surplus countries, as a means to balance global real and financial flows.

However, the staff seem to lay excessive emphasis on medium-term reforms to promote supply-side responses, including financial sector reforms in emerging Asia and structural reforms in Europe and Japan. Irrespective of the merits of such reforms, it seems unlikely they would be suitable to cope with the macroeconomic disequilibria faced today in the short and medium term.²⁶ Indeed, the effect of structural reforms in terms of reverting current account imbalances seems to be small, at least in the short and medium run. There seems to be a disconnect between the Fund's demand-side assessment of global macroeconomic imbalances, on the one hand, and the medium- and, long-term nature of the recommended supply-side policy response, on the other.

²⁵ In a recent lecture about global imbalances the Director of the IMF's Research Department asserted: "Unlike those who view the imbalances as mirroring a savings glut, I see the problem as the world is investing too little" (Rajan 2005).

²⁶ The diagnosis in terms of demand side constraints followed by supply-sided policy recommendations is clear in the following passage by the Director of the IMF's Research Department: "[W]e need more investment, especially in low-income countries, emerging markets, and oil producers. China is an exception in needing less, not more, investment. The easy way to get more investment is a low-quality investment binge led by the government or fuelled by easy credit [...]. The harder, and correct, way is through product, labor, and especially financial market reforms, which will ensure that high-quality investment emerges" (Rajan 2005).

For instance, as regards Europe (a surplus region), the emphasis seems to be on labor market reforms, a policy which can only be expected to be practicable if applied in stages and which can at best bring forth significant effects over the long run. Similarly, with reference to developing countries in Asia, including China, besides sensible demands for some exchange rate realignment, the Fund seems to be excessively concerned with long-term financial system reform (IMF 2005). Finally, as regards Latin American countries, the emphasis seems to be on further fiscal adjustment, a policy that, if not cyclically adjusted, would be entirely inappropriate.

As pointed out by Blecker (2005) in a slightly different (albeit related) context, when stressing the convenience of Yuan revaluation, long-term structural reforms, whether appropriate or not, are certainly incapable of coping with short term disequilibria: “There is no reason to wait for long-run policy reforms [viz. liberalization of Chinese financial markets] that could take decades to enact before making a relatively simple adjustment that is vitally necessary for rectifying the current asymmetries in the global trading system” (Blecker 2005).

Recent documents and historical evidence suggest that, as regards global macroeconomic disequilibria, the IMF seems inclined to push for further structural market reform and short-term contractionary adjustment—the very conditions that have led many developing countries to run substantial current account surpluses (so that they do not have to turn to the Fund again), bringing down global aggregate demand. Such a policy stance, if not modified, would reduce both the pace and the amount of financial resources that many developing would require in order to cope with a downfall in foreign demand and/or a rise in their foreign debt obligations. As we argue below, what developing countries would need in the current juncture is the very opposite approach—the provision of timely and sufficient financial support subject to appropriate conditionality.

4. The Fund’s potential role in dealing with global imbalances

What would be the Fund’s expected reaction to an abrupt unwinding of existing global imbalances, including steep rises in interest rates and declining global growth rates? According to recent experience, it is to be expected that the rising interest rate spreads would be perceived as signs of diminished credit worthiness. In that context, the Fund is likely to recommend, first and foremost, adjustment in primary fiscal balances, thereby adding to global contractionary pressures. As suggested above, in addition to short-term fiscal adjustment the Fund is likely to incorporate long-term structural market reforms as a key component of the conditionalities attached to any Fund supported program.²⁷

²⁷ The need to reduce conditionality has been acknowledged by the IMF itself, as reflected in the revised *Guidelines on Conditionality* (2002), but has given way to barely any substantial reduction of conditionality in practice (Buirra 2005b).

As many analysts have pointed out, the pro-cyclical bias attached to the Fund's stand-by agreements points to the pressing need to amend Fund-supported programs, which should seek to minimize undesirable short-term contractionary effects—not exacerbate them.²⁸ Given these precedents, what would the Fund's stance be as regards developing countries in the event of a fall in the value of the US dollar and the subsequent tightening of world financial markets brought about by an abrupt adjustment of global imbalances?

At the present time neither the IMF nor any financial authority seem to be adopting measures to minimize the risk of a disorderly adjustment of international financial imbalances. Neither do they appear prepared to have thought out what their policy response should be in the event of a dollar crisis.

Current global imbalances call for the strong involvement of the Fund under its monetary cooperation and multilateral surveillance functions. International financial stability is the Fund's primary responsibility. In the present context, a first concern arises from the fact that the risks posed to the international economy by global imbalances are not being addressed. Currently, each systemically significant country pursues its own policies in accordance with its individual, often short-term interests, with little or no regard for their international consequences. There is no effective IMF oversight and no overall policy coordination to ensure that the outcome of these policies is consistent with international financial stability and sustained worldwide economic growth. Thus, while the risks posed by global imbalances increase unabated there can be no assurance that they will not lead to a crisis and a major global recession.

In order to prevent a disorderly adjustment and help sustain economic activity worldwide the IMF should adopt a preemptive stance and encourage a coordinated approach to the resolution of global imbalances.²⁹ Acting along these lines, the IMF should assume a central role in the resolution of global imbalances by promoting a coordinated shift of aggregate demand from countries running current payments deficits to countries running current surpluses.³⁰ This would require a more pro-active and assertive implementation of Fund surveillance. The Fund, based on its own analytical work, would provide the basis for a policy discussion that would not only identify and make explicit the risks inherent in the continuation of current trends, but also explore the policy options available for the solution of the problem and put them on the table for discussion by the international community, with a view to influencing the policy stance of major countries and inducing them to adopt concerted actions.

²⁸ As asserted by Helleiner (1998): "Finance that is supplied only on the basis of negotiated conditions and which is released only the basis of compliance with them ... is not liquidity" (quoted by Taylor 1998).

²⁹ in contrast to its now customary policy of lending only *after* a crisis has developed.

³⁰ This is similar to what has been recommended by Bergsten, Cline, Goldstein, Truman, Mussa and Williamson (2005)

The US Treasury has recently increased pressure on the Fund to take a more pro-active stance in addressing the question of exchange rate adjustments in surplus countries in Asia, particularly China, as a means to correct global imbalances. This issue presents a collective action problem, as countries in the region will be more prepared to move their exchange rate if their neighbours and competitors also adjust their own. While this seems in keeping with the Fund's role under Article IV of the Articles of agreement, it is clear that exchange rate adjustments will not of themselves resolve the matter of global imbalances. Since a current account imbalance is the reflection of an imbalance between aggregate savings and investment, the US current deficit may be reduced to a more sustainable level, but will not be resolved merely by exchange rate movements. US action to increase domestic savings and reduce its growing budget deficit to a level is required for confidence in the dollar's prospects is to be fully restored. On the other hand, surplus countries must increase domestic absorption.

The risks for the stability of the global economy inherent in the current situation call for a Fund surveillance that is effective. But this requires that the Fund is not seen as being managed according to the interest of its major shareholders. Indeed, the situation calls for a governance structure that is representative of its membership, one that is more independent of major shareholders and is ready to exercise leadership in the discharge of its responsibilities under the Articles.

The impact of a disorderly adjustment on developing countries, whose access to international financial markets tends to fade precisely when it is most needed, gives rise to another concern. In the absence of sufficient financial assistance on appropriate terms, a financial crisis could result in a severe recession or even a protracted adjustment process, reminiscent of Latin America's "lost decade". Therefore, the Fund should stand ready to provide financial support on terms that do not deepen the contraction in economic activity. This would be in keeping with one of the Fund's purposes, i.e. "to provide its member countries with the opportunity to correct external imbalances *without* resorting to measures destructive of national and international prosperity." (Article 1, Section 5; italics added).

In addition, we also recommend the establishment of a countercyclical facility to help developing countries sustain aggregate demand in the event of a major exogenous shock arising from a disorderly correction of international financial imbalances; a facility meant to cover export income loss and increased external debt service due to a sharp rise in dollar interest rates in the event of an exogenous fall in external demand, due to an abrupt exchange rate re-alignment and likely slowdown in US and world economic activity.

Most developing countries have been unable to carry out countercyclical macroeconomic policies in the recent past. This is partly related to the pro-

cyclical bias built into the working of international financial markets, and partly to the limited availability of financing and excess conditionality attached to IMF facilities. In recent times the Fund has often failed to provide timely and sufficient financial assistance to stressed economies; assistance has been provided only after a financial crisis had detonated. By so doing, the Fund appeared incapable of *preventing* the typical sequel of currency devaluation, interest rate spikes, extended private sector bankruptcy, financial sector rescue, and increasing unemployment—an outcome that is totally at variance with the Fund’s mandate of providing member countries with the opportunity to correct macroeconomic imbalances “without resorting to measures destructive of national and international prosperity”. A different approach, one more consistent with the Fund’s mandate, would allow for multilateral *precautionary* intervention, with sufficient financial support provided in a timely manner, i.e. before existing disequilibria unwind into a market-driven debt-deflation.

The same lack of precautionary concern seems to underlie the Fund’s current stance regarding global imbalances. As argued above, present global macroeconomic imbalances call for *preemptive* intervention. Indeed, the world economy needs a degree of management and coordination among major economies to reduce the probability of a crisis. In the event of a crisis, developing countries will need counter-cyclical programs with adequate financial support. Before elaborating on the convenience of developing a counter-cyclical facility, it may be worth recalling the Fund’s response to somewhat comparable global imbalances in the past: i.e. the establishment of an Oil Facility in the mid-1970s, and the discussion regarding the establishment of a “substitution account” in the late 1970s.

4.1. Oil Facility (1974-75)

The Fund’s belated reaction in the face of financial crises in the past decade differs significantly from the pre-emptive policy it adopted in the mid-1970s, a period of profound global imbalances. As pointed out by Buirra (2005a), “with the world economy emerging from three years (1969 to 1971) of a combination of recession and high rates of inflation, the sharp increase in oil prices in 1973 and 1974, which deepened the recession and fueled inflation, posed for the Fund what was perhaps its greatest challenge to that date”. The Fund recognized that many developing countries would find it difficult to borrow from international capital markets in order to pay for the increased cost of oil. Furthermore, there was a growing uncertainty regarding the ability of international banks to recycle the sizeable flows involved.

Facing these unprecedented circumstances, in 1974 Johannes Witteveen, the Fund’s Managing Director, proposed the establishment of an Oil Facility to help recycle the surplus from oil-exporting to oil-importing countries. This facility would help oil-importing developing countries finance the external imbalances resulting from increased oil prices, thus reducing their adverse impact on economic

activity, allowing for a longer-term process of adjustment to the change in oil prices, including the adoption of energy-saving technologies. Despite initial resistance by the United States, the initiative was brought into being in 1974 with strong support of European and developing countries, including the oil-exporting countries that would finance the facility. The Oil Facility proved to be effective and was renewed in 1975.

With this policy, the Fund helped recycle the surplus of oil-exporting to oil-importing countries, which could therefore avoid a disproportionate reduction of domestic absorption, what would have compounded the problems already being faced by the international economy.

It should be stressed that the 1974 Oil Facility involved minimum conditionality. The only requirement for access to the Oil Facility by oil-importing countries was the existence of a balance of payments problem. There was virtually no other conditionality than for borrowing countries to desist from imposing restrictions on trade and payments without the Fund's consent. Under the 1975 Oil Facility the Fund imposed somewhat stricter conditions. Still, conditionality was minimal if compared with more recent IMF programs.³¹

The Fund's foresight during the mid-1970s, which led to the development of the counter-cyclical Oil Facilities of 1974-75, should serve as an example of the Fund's potential role in preventing the acceleration of global recessionary forces.

4.2. Substitution Account

There is another interesting historical precedent in which the Fund sought (though finally failed) to adopt a pre-emptive policy stance meant to counterbalance a loss of confidence in the reserve currency at a time of mounting international payments disequilibria.

In the early 1970s, the recognition that SDRs, whose original purpose was to serve as a supplement of the US dollar as a reserve asset, could serve as a substitute of a portion of the US-dollar assets held in Central Banks' portfolios led the Fund to devote substantial effort to the development of a practical approach for promoting large-scale reserve diversification into SDRs: "By acquiring SDRs through allocations by the Fund or in exchange for dollars through transactions with other central banks, a country could gain a single asset with a more stable exchange value than the dollar" (Boughton 2005, p. 937).

³¹ Under the auspices of the 1975 Oil Facility borrowing member countries were required to discuss and get the Fund's approval of the policies designed to solve their balance of payments problem, including measures to reduce oil imports and/or develop alternative energy sources.

The idea of a “substitution account”³² (as it was then called) did not make much progress until the end of 1977, when the dollar became increasingly exposed to selling pressures.³³ In the first half of 1979 the Fund’s staff put forth a proposal whereby

the Fund would establish and administer an account in which central banks would voluntarily deposit dollars (typically, short-term US treasury bills). In exchange, they would receive SDR-denominated claims, which they could use in the same limited manner as any other SDR. The account would convert its assets into longer-term dollar-denominated claims on the US Treasury, which would pay a suitable long-term interest rate on them. Interest would be paid to depositors at the official SDR interest rate (which at the same time was maintained below the market rate). The intention was that the account’s exchange risk would be covered by the difference between the long-term US bond rate and the official SDR interest rate (Boughton 2005, p. 939).

The project, driven by the hope to overcome the weakness of the US dollar in exchange markets, could lead to the realization of the amended Article VIII (Articles of Agreement), which sought to make SDR the main reserve asset of the international monetary system. Most importantly, the establishment of such a substitution account would have implied a radical blow to the US dollar as an international reserve currency; namely the “substitution” of the dollar for SDR as the ultimate reserve asset in the international monetary system.

The project, put forth by the Fund’s Managing Director, Jacques de Larosiere, together with the Fund’s Chief Economist, Jacques Polak, proved in the end to be politically unacceptable. Apparently none of the parties involved was prepared to bear the underlying currency risk involved in the substitution of US dollar denominated assets for SDRs (Boughton 2001). By 1980, the tightening of US monetary policy (that had begun in late 1979) eased fears concerning the dollar collapse, contributing to dispel the imbalances that had motivated the initiation of the project.³⁴ Most fundamentally, it seems, the implications of a strengthened SDR reducing the role of the US dollar proved unpalatable for US authorities.

Despite the failure to establish the substitution account, some of its attributes are worthy of consideration. The *precautionary* nature of the substitution account, meant to prevent a systemic crisis (rather than dealing with mounting disequilibria *ex post facto*), is worth emphasizing. It would certainly be beneficial

³² For a detailed description of the discussions behind the substitution account, see Boughton (2001).

³³ Support for the substitution account included some US officials who esteemed the possibility of promoting the role of SDRs as a means to diminishing speculative pressure against the US dollar (Boughton 2005).

³⁴ The decline in oil-exporters surpluses also contributed to moderate the concerns about the fall of the US dollar.

for the entire world economy if the IMF regained such a preemptive concern, both as regards countercyclical financial intervention and the reconsideration of some of the (acknowledged) risks introduced by full-fledged capital deregulation over the past two decades (Prasad, Rogoff et al 2003).

4.3. A G20 Accord

Following the precedents of the Smithsonian and the Plaza Accords, signed in 1973 and 1985, which successfully achieved the realignment of the US dollar, a concerted approach to the correction of global imbalances would involve the members of the G20. While the US would pledge to tighten its fiscal policy and Japan and China and other countries in large surplus were to revalue and increase private demand all countries would contribute to a non recessionary adjustment of global imbalances and carry out exchange rate interventions to depreciate the US-dollar in an orderly fashion.

As argued recently by various analysts (Buirea 2005; Williamson 2005; Cline 2005), presently there seems to be a need for an initiative comparable to the 1985 Plaza Agreement, though in this case to be agreed upon by a larger group, say the G20, of major industrial and emerging-market economies, rather than just by the G-5. In this Accord countries that have pegged their currencies to the dollar and intervened in exchange rate markets to prevent their currencies from appreciating against the US-dollar would desist from such a course of action. Central Banks could in turn agree to sell US-dollar reserves. And the US could similarly agree to purchase euros, yens and other currencies. All surplus countries would be required to persist in this policy until their exchange rate against the US-dollar had been sufficiently realigned.

In support of this exercise, the IMF could suggest an approximate range of exchange rates for the G20 currencies that would be consistent with external balance at high levels of employment in all participating countries. According to Cline's (2005) own estimations, the entire adjustment process could be expected to last no less than three years.

A concerted approach as described above should involve a shift in global demand from deficit to surplus countries. This is a key component of any workable solution to global imbalances: In the absence of a boost in the demand by the surplus economies, a US fiscal correction and the decline in the US dollar would undoubtedly bring about a worldwide recession. For a such an approach to succeed other countries would have to adopt domestic expansionary measures in order to make up for the reduction in global demand resulting from the lower net exports related to US external adjustment. Hence, to be successful the shift in demand from deficit to surplus countries should involve the entire G-20. Obviously, the Chinese economy (which amounts to 20% of the US economy) alone cannot by itself offset the fall in global demand resulting from a slowdown of the US economy.

There are several benefits of a concerted action agreement vis-à-vis a market-based solution. First and foremost, such an agreement is capable of minimizing the recessionary bias of alternative adjustment processes, such as the abrupt fall in the rate of consumption growth in the US, or the sudden adjustment of international portfolio away from US-dollar assets. Second, it would resolve the collective action problem faced by many developing countries which have pegged their currencies to the US-dollar and are unwilling to appreciate their currencies for fear of a loss of competitiveness if acting in isolation (Cline 2005). Third, it would provide a framework for coordinated intervention in exchange rate markets (*ibid.*). And lastly, by including US fiscal adjustment, a concerted action accord would assure the rest of the countries involved that the US would also make the necessary corrections.

For the above reasons the best solution would come about as part of an agreement, with the consequent checks and balances. Still, in the context of a G20 Plaza-type accord the benefits of the IMF assuming a leading role in the pre-emptive resolution of global imbalances are vast. First, the Fund could provide technical support regarding the realignment of the exchange rates involved (Williamson 2005). Second, as the adjustment process is unlikely to proceed as smoothly as portrayed above, even under the assumption that such an Accord is agreed upon, the Fund should expand the array of financial facilities to sustain demand in developing countries in the event of contractionary shocks. The mechanics of such a facility, which would also serve in the event of profoundly disruptive adjustment, is described below.

4.4. The mechanics of a facility

As indicated above, disorderly adjustment of global imbalances would result in the fall of the US dollar and the increase in the level of US-dollar interest rates, and most likely of interest spreads worldwide. An increase in US-dollar interest rates would in turn induce a sharp slowdown in the level of economic activity (or even a recession) in the US, bringing other major economies down with it, with the consequent decline in their demand for imported goods and services from third countries, and so forth. The threat such a situation poses for developing countries' balance of payments should be apparent, given developing countries' (direct or indirect) reliance on US demand.

For this reason we suggest the creation of a countercyclical facility to sustain demand in developing countries and prevent a downfall of the US dollar from triggering a downward spiral of competitive devaluations. It should be noted that, as opposed to relatively more commonplace balance of payments distress triggered by exchange rate misalignment and/or excessive domestic absorption, the type of crisis under consideration would be caused by exogenous factors

beyond developing countries control.³⁵ Under such circumstances efforts to reduce domestic absorption, as typically put forward by the Fund, would be unsuitable and exacerbate rather than contribute to solve the effect of the initial exogenous shock.

The proposed credit line would resemble the existing Extended Fund Facility (EFF), in that the EFF consists of longer-term assistance and allows for longer-term repayment terms.³⁶

4.4.1. Access to Fund resources

Under the proposed facility, countries facing an exogenous sharp fall in the demand for their exports and/or an exogenous marked rise in interest rates on their outstanding foreign debt would qualify for financial support in amounts linked to the decline in export demand and/or to the rise in their debt service obligations. Given the exogenous nature of the shock, access would be determined as a function of the decline in GDP of the US or other major trading partners, and the rise in dollar interest rates, rather than in proportion to the countries' quotas (i.e. the 300% access limit would not apply).³⁷ For instance, if the growth of exports can be estimated as a proportion of US GDP growth, the fall in GDP can be used to make a preliminary estimate of the export shortfall. Similarly, the rise in US interest rates may be applied to floating rate debt to estimate the increase in total debt service payments. Both effects would be added in order to determine access to the Fund facility, which could fully cover the shortfall or could be established as a proportion (of say 90%) of the estimated total foreign currency losses to the country.³⁸

4.4.2. Conditionality

Since, as indicated above, the export income loss and the increased debt service burden would be the result of causes beyond the control of the borrowing countries, it would not be appropriate to impose any conditionality on countries

³⁵ Towards the end of 2005, the Fund's Executive Board approved an Exogenous Shocks Facility (ESF) to provide financial support for low income countries facing shocks, such as commodity price shocks, or abrupt changes in their terms of trade. However, the ESF is subject to upper credit tranche conditionality and only available to countries eligible for the Poverty Reduction Growth Facility (PRGF); access limits are very restrictive, as annual access is set at 25% of the member's quota subject to a cumulative access limit of 50 percent of quota.

³⁶ In actual fact, the purpose of the EFF is to provide longer-term assistance to support structural reforms to address balance of payments problems of a longer-term character. Recipient countries, which can borrow up to 300% of their quotas, are to adopt 3-year programs of structural reform, and the repayment period can be extended up to 10 years.

³⁷ To prevent the risk of "moral hazard", loans could be made at progressively rising rates for larger amounts.

³⁸ In order to reflect the evolution of the exogenous variables on which drawings under the facility are based, drawings could be established and made quarterly.

whose fiscal accounts were in approximate (inter-temporal) balance when cyclically adjusted. The logic of this facility is that it would not be desirable to raise taxes at a time of economic recession. Tax or other revenue-related measures could be required to become effective only when the economic upturn materialized. In addition, consistent with the purposes of the facility and of the Fund, borrowers would commit not to impose new restrictions on trade and current payments.

In order to foster recovery Fund disbursements would have to be made without delay so as to sustain a rising tide of international demand from which all countries' exports and worldwide economic activity would benefit. Indeed, there should be virtually no need to negotiate an elaborate program with the borrower; drawings should be automatic and expeditious, and could be approved on a quarterly or six monthly basis, following the estimated impact of the crisis, i.e. the sum of export shortfall and increase in debt service.

Since access to such a facility should not give rise to unwarranted government expenditure, in order to prevent an increase in governments' current expenditures, the Fund could require that recipient countries allocate a certain proportion of the resources thus obtained to public investment. Conditionality would therefore apply mainly to the level and type of public expenditure.

4.4.3. Cost of borrowing and repayments

Since the crisis would result from factors beyond the control of the borrower, i.e. with no "moral hazard" risk, loans would be made at the normal Fund basic lending rate, even if the rate is below the rate at which the country was able to borrow in financial markets before the crisis. Nonetheless, a rising interest rate scale could be established to discourage access beyond certain threshold, as suggested above.

While repayments could be linked to the recovery in the borrower's rate of growth, which by itself would reflect the growth of exports and the reduction in interest rates, they could also be linked to the same exogenous factors that gave rise to the drawing, i.e. the growth performance of the US economy and the level of US interest rates. The second option would be beyond authorities' control and might provide more suitable incentives for them to remain competitive.

Subject to the reversal of the exogenous conditions that triggered the initial need for Fund's assistance, repayment terms of the countercyclical facility could coincide with those of existing Extended Fund Facilities (EFF), i.e. 4½-10 years for obligations and 4½-7 years for expectations, with an increasing interest rate scale to provide sufficient incentives for timely (or even early) repayment.

4.4.4. Source of Funding

At current levels, Fund resources and access policies would not be sufficient to cover the potential requirements of this facility. Total Fund resources stood at only 3.2% of current payments in 2003 and may be presumed to be smaller now. Quotas averaged 0.9 of 1% of member's GDP on that date.³⁹ With access limits of 100% of quota in one year and in exceptional circumstances 300% of quota over three years, those levels of Fund support would be clearly insufficient.

One first option is that Fund resources be increased through a quota review. But experience suggests that a quota review process would probably take several years to complete, while its outcome would be uncertain.

A second option is that the Fund borrow from surplus countries to recycle funds to deficit countries—a procedure that would resemble that followed under the Oil Facility of the mid-1970s (Section 4.1). This may be a suitable option at the present time of excess global liquidity.⁴⁰

A third option for increasing Fund resources rapidly could involve a special allocation of SDRs. This alternative is perfectly consistent with the Fund's Articles of Agreement.⁴¹ Since SDRs have to be allocated to members in proportion to their quota, recipient countries would commit to lend or donate the SDRs received to the Fund to increase its resources. The possibility of combining new allocations of SDRs with a mechanism similar to that of the substitution account discussed in the late 1970s (when there were also fears of a dollar sudden collapse) should not be disregarded.

For a countercyclical policy to be effective, how large should the increase in Fund resources (or an SDR allocation be)? Estimates of the size of the expected contraction should be made. As an initial rough conjecture, the additional resources should not be less than the contraction in international aggregate demand estimated as a proportion of the GDP of developing countries. The US current account deficit, at 1.5% of world GDP provides an outside limit.

4. Conclusions

The build-up of global imbalances poses a serious menace for global financial stability and worldwide economic activity. As expressed throughout this paper, the adverse impact of a global contraction on developing countries, in the

³⁹ This is not to ignore that in a few cases access to Fund resources has been substantially larger, but these cases are not predictable.

⁴⁰ The Fund could also activate the GAB and the NAB.

⁴¹ In fact, the Fund is in a position to either expand or reduce SDR allocations at its own will: "In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such a manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world" (*Articles of Agreement*; Article XVIII, Section 1).

absence of adequate multilateral financial support could be very severe. Moreover, the IMF, whose *raison d'être* is to maintain global financial stability and facilitate the expansion of world trade in the context of sustained economic growth, is increasingly being questioned as it appears unable to discharge its surveillance duties effectively.

Industrial countries have the ability to pursue countercyclical policies and foster economic growth; this might explain some of the passivity mentioned above. In contrast, in a world of increasingly integrated capital markets, most developing countries have been unable to carry out similar countercyclical policies. Given the procyclical bias evidenced by international financial flows, frequently exacerbated by IMF conditionality, developing and low-income countries have had little choice but to adopt contractionary measures to protect their balance of payments and avoid crises of confidence and massive capital outflows. One of the effects of this defensive response to growing capital account volatility has been the tendency shown by developing countries to maintain competitive exchange rates, run current account surpluses and build up international reserves as a form of self-insurance.

As pointed out above, from the standpoint of the world economy this ubiquitous strategy entails a deflationary bias. Thus far, such contractionary forces have been offset by mounting US current account deficits, which have allowed the world economy to sustain high rates of economic growth. However, for the reasons indicated above (Section 3), the strong US-dollar will eventually decline; interest rates will increase; and consequently the high consumption levels in the US will fall. Indeed, an expansion based on the accumulation of consumer debt cannot be sustained indefinitely. Eventually, consumption has to give way to higher levels of saving and investment in the US, whereas global demand has to shift from deficit nations, like the US and UK, to nations running surpluses, like China and other Asian economies. The question is whether the required adjustment will take place gradually and with minimal disruption or abruptly and causing a serious recession in the international economy and major damage to most of the developing world.

So long as the global economic cycle remains in the current expansionary phase the risks described above may be small. But as the housing market cools down in the US and capital gains diminish or disappear, consumers may be inclined or compelled to increase their savings; consumption would thus stall, removing the driving force behind current worldwide economic growth, and leading to downward adjustment across the globe. Furthermore, in this context the global labor arbitrage that has been squeezing employment and real wages in developed countries may well give rise to a strong protectionist backlash as economic activity decelerates.

This paper is the result of concern about the Fund's role in the event of a scenario of disorderly adjustment of global imbalances—the “hard landing”

scenario— in which a faulty Fund response would exacerbate, rather than counter, contractionary forces. To deal with this situation we have proposed two different policies:

First, we argue that in order to reduce the risk of a disorderly adjustment-cum-global recession it is necessary to seek increased policy coordination among the entire G-20; this would call for the realignment of exchange rates accompanied by fiscal measures to gradually shift demand from deficit to surplus countries. In order to bring about such a coordinated outcome, the Fund would have to adopt a proactive, *preemptive* policy stance, going beyond the policy of identifying sources of imbalances, monitoring the performance of countries and acting only *after* a crisis has developed.

Second, in the event of disorderly adjustment-cum-global recession, we propose the establishment of a countercyclical Fund facility that sustains the aggregate demand in developing and emerging countries directly or indirectly affected by the slowdown in world economic activity (lower exports) and/or the increase in their foreign debt obligations (higher interest rates). The facility would cover export revenue loss and increased foreign debt service due to an exogenous rise in interest rates.

The policy instruments proposed in this paper are meant to stimulate a necessary discussion and are not intended as an exhaustive list of possible solutions.

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Appendix

Table A.1: Canada and Mexico: Exports to the US

	1990	1995	2000	2001	2002	2003	2004
Canada	75%	80%	87%	88%	88%	87%	85%
Mexico	69%	84%	89%	88%	88%	88%	88%

Source: Direction of Trade Statistics, IMF

Table A.2: Canada and Mexico: Imports by Origin

	1990	1995	2000	2001	2002	2003	2004
Canada							
- From Industrial Countries	84%	84%	82%	81%	80%	79%	76%
- From Developing Countries	12%	14%	16%	17%	18%	20%	22%
Mexico							
- From Industrial Countries	91%	91%	87%	83%	80%	79%	74%
- From Developing Countries	8%	8%	13%	17%	20%	21%	26%

Source: Direction of Trade Statistics, IMF

Table A.3: China and India – Exports by Destination

	1990	1995	2000	2001	2002	2003	2004
China							
- US	8%	17%	21%	20%	22%	21%	21%
- Industrial Countries excl. US	27%	35%	35%	35%	33%	33%	33%
India							
- US	15%	17%	21%	21%	20%	19%	17%
- Industrial Countries excl. US	40%	37%	32%	32%	29%	28%	27%

Source: Direction of Trade Statistics, IMF

Table A.4: China and India – Imports by Origin

	1990	1995	2000	2001	2002	2003	2004
China							
- From Industrial Countries	50%	55%	47%	48%	45%	43%	41%
- From Developing Countries	48%	43%	50%	48%	50%	51%	52%
India							
- From Industrial Countries	57%	48%	41%	35%	38%	38%	36%
- From Developing Countries	42%	46%	36%	43%	33%	35%	37%

Source: Direction of Trade Statistics, IMF

Table A.5: Japan – Exports and Imports by Destination/Origin

	1998	1999	2000	2001	2002	2003	2004
<i>Exports</i>							
- US	31%	31%	30%	30%	29%	25%	23%
- Industrial Countries excl. US	23%	23%	21%	20%	19%	20%	19%
- Developing Countries	46%	46%	49%	49%	52%	55%	58%
- China	5%	6%	6%	8%	10%	12%	13%
<i>Imports</i>							
- From Industrial Countries	48%	44%	39%	39%	39%	36%	34%
- From Developing Countries	52%	56%	61%	61%	61%	64%	66%

Source: Direction of Trade Statistics, IMF