



# SOUTH CENTRE

**Statement by  
MR. MARTIN KHOR  
EXECUTIVE DIRECTOR  
TO THE MINISTERIAL MEETING OF THE GROUP OF 24  
Washington DC, 19 April 2018**

There is a decided upturn in global economic prospects with the synchronized recovery in the world's largest economies in 2018. However, a reasonably stable and predictable global economic environment is necessary for developing countries to pursue structural change and economic diversification. Will the international community take advantage of this favorable backdrop to transition to inclusive growth and make progress in resolving long-standing systemic weaknesses?

Uncertainties in the global trade environment, pressures from rising interest rates, gaps in the management of external debt and financial sectors, and capital flow volatility cloud medium term prospects and need to be addressed.

It is ironic that the new millennium started with a widespread optimism that development-conducive conditions were being secured. This was expressed with the notion of Great Moderation in the advanced economies. These economies had almost two decades of tranquility, with reduced business fluctuations, increased macroeconomic stability, low inflation and mild recessions. Better monetary policy was seen as the driving factor. Emerging and developing economies (EDEs) had also recovered rapidly from recurrent crises of the 1990s, growing much faster than advanced economies and becoming major players in world trade. BRICS were seen as new engines of growth.

Then came the global crisis and the Great Moderation was replaced by Great Recession, moving from the US first to Europe and then to EDEs.

The policy response in advanced economies was unprecedented. Interest rates were cut to zero and massive liquidity was pumped into the world economy. However, these unleashed speculative forces, rather than forces of capital accumulation, job creation and economic growth. They led to credit and assets bubbles and massive accumulation of debt both in the North and the South. Slow recovery from the crisis led to widespread pessimism that the world economy had entered a period of stagnation because of structural problems, including chronic demand gap due to vanishing investment opportunities and slow growth of productivity and labour supply. The crisis and the policy response by

advanced economies were believed to have aggravated these problems by increasing inequality, reducing the purchasing power of labour, widening the demand gap, depressing potential growth and creating a massive debt overhang.

Despite exceptionally low interest rates and ample liquidity, there has been very little productive investment of the kind needed for sustainable development and not much finance for development. Until the beginning of the last year there was a widespread concern that the world economy was poised for yet another crisis and recession. US recovery was sluggish, Europe was not growing, three of the BRICS were in recession, China and Africa had slowed sharply, commodity prices collapsed, and capital flows to EDEs slowed and became highly unstable.

### **Is the recent economic bounce back sustainable?**

The growing pessimism was recently replaced by optimism and confidence as growth in advanced economies picked up and slowdown in many EDEs came to an end. What accounts for this bounce-back? Have structural imbalances and fragilities that were a major concern 15 months ago gone away? What made them disappear? Is there a fundamental reorientation of policies that account for this change?

The answer is clearly no. Current optimism is a reflection of complacency of low expectations. Average growth in the South is half of what it was before the onset of the crisis and much of it is concentrated in Asia. Similarly, actual and potential growth in the North is weak compared to the past. In all likelihood the current global economic upturn is cyclical, rather than structural; it may simply peter out within a year and two.

In fact, there are several potential threats to global economic stability and growth, and the international community is unprepared for a new round of shocks and crises. The world has become addicted to cheap money and accumulated massive debt for a decade in order to overcome its structural problems.

There are at least **six** sources of **potential shocks** that can end this adventure. First, there is the threat of a rapid tightening of monetary policy in the US. The US is growing faster than its potential by drawing on unused capacity. This, together with Trump tax cuts, can lead to overheating, faster inflation and higher interest rates. These would raise the cost and reduce the availability of finance for EDEs. There is some similarity with the 1980s when hikes in US interest rates by Volcker was a major factor in the Latin American debt crisis. It is not possible to say how and when this process will end, but it is clearly not sustainable and may well end with a hard-landing.

Second, after some 30 quarters of continued but sluggish expansion, the US economy can enter into recession. If global income contracts as a result, much of the debt accumulated in the past ten years can become unpayable even without hikes in interest rates. The US has very little policy space to respond to such an eventuality. It used most of its ammunition to fight the last recession without being able to bring policy back to normalcy.

Third, there can be a sharp and sustained change in market sentiments, a fundamental reassessment of risks as occurred during the subprime crisis, with markets turning bearish for an extended period. This would result in capital flight from many

EDEs, hikes in risk premia and borrowing costs even without monetary tightening in the US.

Financial turmoil in China is fourth potential risk. EDEs and international banks are not directly exposed, but there could be a strong negative impact on risk appetite, leading to tightening of global financial conditions.

Fifth, trade conflicts and trade war are potential threat to growth and stability. Sixth, political tensions in the Middle East and East Asia are elevated.

The chances of all these six happening at once is very slim, but any one of them happening is quite serious. Whatever the source of disruption, it could create severe balance of payments, liquidity and debt problems for EDEs.

In other words, after 15 years of relative calm and tranquility, EDEs may face another round of widespread instability and crises. The consequences can be particularly serious because of their deepened integration into the international financial system in the new millennium encouraged by cheap and plenty of money. There has been a rapid growth in their external liabilities, particularly external private debt in emerging economies and external sovereign debt in frontier markets, and an unprecedented presence of foreigners in their bond, equity, credit and deposit markets.

### **Responding to international economic crises**

Developing economies cannot respond to such shocks in the same way as the US and Europe – cutting interest rate sharply and expanding credit. This would lead to a free fall in their currencies, a hike in inflation and economic contraction. Their reserves may not be enough to meet large and sustained capital outflows because in most countries they came from capital inflows rather than current account surpluses. They may prove inadequate in the event of a massive exit of foreigners and capital flight by residents, greatly facilitated by liberalization in the past 15-20 years.

We are all familiar with the business-as-usual response to such shocks: keep the capital account open, try to stay current on debt payments, raise interest rates, use reserves to meet foreign claims and go to the IMF when reserves run out, pay foreign creditors and investors with the money borrowed from the IMF and practice austerity at home– fiscal retrenchment, wage cuts, and so on.

There are few other options where external imbalances are large, financial fragility are severe and shocks are strong and durable. In any case there is not much appetite for temporary debt standstills, exchange controls and selective trade measures as an alternative to business as usual.

### **An effective global strategy is lacking in responding to prospective shocks**

There is a need to focus now on building up a global strategy to deal with the next global financial crisis.

There are gaps in the provision of adequate international liquidity. The scale is now much bigger and IMF resources are limited. South-South mechanisms for liquidity

provision (Asian Chiang Mai initiative, BRICS's Contingent Reserve Arrangement or central bank swaps) are inadequate and ineffective. A massive SDR allocation could be a way out as private liquidity dries up, but it is likely to be resisted by advanced economies. Unlike some previous crises (Latin American debt crisis of the 1980s) advanced economies are unlikely to come to rescue because now their banks are not so exposed to EMEs. There is no viable scheme to involve private creditors in the resolution of liquidity crises; this is a perennial question that the IMF has been unable to resolve.

There are no international mechanisms for effective and equitable resolution of external debt crises. A scheme was proposed by UNCTAD more than three decades ago, but it has never been placed squarely on the international agenda.

It is an urgent task for the international community to reflect on and resolve these problems and develop a strategy before a new crisis befalls the global economy.