‘’Beyond the IMF”

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A new global financial crisis caused by a plunge in the US dollar is not only possible but also likely, and the effects could be quite devastating for many developing countries.

To prevent this, there should be pre-emptive group action by leading financial economies, while a loan facility should be set up to help developing countries affected by lower exports or higher interest rates.

This message was given recently by Ariel Buira, the Director of the Group of 24, which is a body of developing countries operating at the International Monetary Fund and World Bank.

Buira, who was also formerly Mexico’s executive director at the IMF, warned of devastating effects if a world recession results from a significant decline of the US dollar caused by the growing US trade deficit.

His paper, co-authored with Martin Abeles of the New School University, was presented at a Technical Group meeting of the G24 held on 16-17 March in Geneva.

Other speakers pointed out that the IMF is facing a crisis of confidence and its gravest threat of being irrelevant, as developing countries disenchanted by its policies are reducing their loan dependence on the agency, and alternatives to the Fund have emerged as sources of finance for the developing countries.

Buira and Abeles analysed the likely impact of a potential dollar crisis on developing countries through a reduction of capital flows, increased interest rates and falling exports.

It warns of the threat of a build-up in global economic imbalances. The US current account deficit widened to 6.5% of gross domestic product (GDP) in 2005 and is expected to approach 7% in 2006 and 10% in five years; while the current account surplus in Japan and China increased in 2005.

A sudden reallocation of portfolios away from dollar-denominated assets, or even just a gradual decline in the demand for US dollars as a reserve currency, 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 a decline in worldwide global economic activity.

This in turn could trigger trade protectionism and competitive devaluations. Developing countries would be harmed by rising interest rates coupled with the likely fall in commodity prices and exports of manufactures.

The authors point out that the IMF is responsible for promoting international financial stability, and its failure to do so is of serious concern.

The US is currently the world’s largest net debtor. By the end of 2004 the rest of the world owned US$12.5 trillion of US assets while US-owned assets in rest of the world was almost $10 trillion, giving the US a net international investment position of minus $2.5 trillion.

Until now the demand for US-dollar assets has financed the increase in US current account deficits, but the present strength of the US dollar is due to temporary factors. Interest rates will rise if foreign investors fear the US dollar will devalue. The US housing bubble could be pricked, reducing household spending and worsening the contractionary impact of rising interest rates.

The authors point out 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.'

This is likely to materialise, as surplus savers seek to diversify their portfolios (with China and OPEC already indicating they would do this).

A consequent rise in US interest rates will pose a menace to public finances in many developing countries and this will be compounded by the likely increase also in interest rate spreads. This would increase the cost of servicing existing variable-rate debt, and increase interest rates on new debt.

An IMF paper estimates that an increase in developed countries' interest rates by 3 percentage points relative to end-2004 level would cause developing countries to spend 1.5% of their GDP in increased debt servicing.

According to the World Bank, a 2-percentage-point rise in US interest rates would reduce economic growth in emerging economies by 1%. If interest rate spreads also widen, the slowdown would be worse, by 2 additional percentage points in 2005 and 4.5 additional percentage points in 2006.

Another negative effect would be on trade, especially on a fall in commodity prices. The impact of a US downturn on China and India is most worrying as this would also affect the countries' demand for other developing countries' products. In particular, China is now an important market for Africa, Latin America and the Caribbean.

The burden of US dollar depreciation would mostly fall on countries with floating-exchange rate regimes, mostly Europe, Latin America and Africa. Asia would be affected by falling exports, and the Asian slowdown would hit Latin America and Africa again as the demand and prices for their commodities fall.

Another paper by Devesh Kapur and Richard Webb, 'Beyond the IMF', argues that the IMF has rapidly lost its relevance and legitimacy and is suffering an identity crisis and waning interest. Webb was formerly Governor of the Central Reserve Bank of Peru.

Demand for the IMF's resources is at a historic low, and borrowers are rushing to prepay their loans. It has also become increasingly irrelevant as countries borrow from the private markets, or build up their foreign reserves (thus they do not need to borrow) and are developing regional arrangements such as swap facilities between the Asian central banks to fight a speculative attack, and a regional market for local currency bonds. ✍✍✍

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