Project: The G-20 Architecture in 2020 --Securing a Legitimate Role for the G-20

Meeting: "The G20 at Leaders' Level?"
February 29th, 2004
IDRC, Ottawa

Would the Outcomes of a G20 Process Differ from those of the G7?

Ariel Buira

Director, G24 (Mexico)

The world economy has undergone a major transformation since 1945. At present, the G7 countries account for 44 percent of world output and 14 percent of world population. By comparison, the developing countries, accounting for 39 percent of global output,[1] measured in terms of purchasing power, and over 80 percent of world population. Consequently:

- There are major issues confronting the world economy that cannot be resolved without the active participation of developing countries: global payments imbalances, international trade, migration, and others.

- There are a number of issues of interest to developing countries that would receive more attention in a broader process: counter-cyclical policies, financial market volatility, commodity shocks and others.

Decisions taken by the larger group in a participatory process, would be more effective, and be seen as having greater credibility and legitimacy.

This note will focus on five topics in Money and Finance which, if addressed in the broader perspective of a G20 process, could produce a different outcome and contribute to a fuller utilization of resources, reduced financial and commodity risks and as a result, higher and more stable rates of economic growth at the global level.

Addressing Global Payments Imbalances

In recent years, growing U.S. current account deficits have led to the depreciation of the U.S. dollar. The burden of the dollar depreciation has fallen on countries with floating exchange regimes, which have seen their currencies appreciate substantially, i.e. the euro area, Canada and a few other industrial countries and developing countries, mostly in Latin America.

The depreciation of the dollar has become an impediment to the recovery of the EU and other countries with floating currencies, giving rise to trade tensions and calls for protection. On the other hand, Asian economies that have pegged their currency to the dollar have experienced rapid growth and substantial accumulation of international reserves, which are invested mostly in U.S. Treasury paper. To ease global payments adjustments requires a correction of U.S. imbalances but also greater exchange rate flexibility among Asian countries, which are not part of the G7.

Counter-Cyclical Policies

The G7 countries, having fully developed financial markets, have been able to pursue strong anti-cyclical fiscal and monetary policies in recent years by borrowing in their own currency. On the other hand, due to the narrowness of their domestic financial markets, most of the sovereign borrowing by the developing and emerging market countries is

external and denominated in foreign currency, thus exposing them to significant exchange risk. Moreover, with very few exceptions, the developing countries have faced significant net negative capital transfers since 1997, and have been unable to pursue anti-cyclical policies. Indeed, faced with a contraction of investment flows and restricted access to global financial markets, and fearing that the volatility of capital might lead to financial crisis, emerging market economies that had opened their capital account have had to adopt restrictive, pro-cyclical fiscal and monetary policies and to build up their international reserves in order to protect themselves against this risk. In so doing, they contributed to the deepening of both their own and the international economic downturn. Given their importance in international output and trade, this led to a protracted recession and to a slowdown in global trade flows. The repeated application of restrictive policies to meet short term exigencies by developing and emerging market countries has led to a decline in longer term investment levels and lowered global growth rates.

Was there an alternative? Recent lending by the World Bank remains at some 54 percent of its statutory lending capacity and did not expand in response to the international recession. Contrast the recent passivity of the World Bank and IMF with the counter-cyclical policies they pursued following the oil price increases of 1973-1974 to help countries avoid an international recession. Note that by recycling the oil surpluses, the IMF and World Bank lent to many countries that had no access to financial markets. Could the large Asian surpluses been recycled through the BWIs to a larger set of countries instead of simply financing the U.S. financial imbalances? If developing country leaders had been able to push this issue at a G20 summit, the outcome might well have been different.

Managing Financial Market Volatility

The position promoted by the IMF on the issue of the complete liberalization of capital movements very much reflected the interests of G7 members, including several countries which have a strong commercial interest in the matter. If the group had included countries such as India and China, that believe capital controls have allowed them to sustain high rates of economic growth and avoid financial crises, the policy outcome would have been different.

At present, the financial system is incomplete, as it lacks both a mechanism for financial support to countries under threat of a financial crisis and a mechanism for a payments standstill to allow the orderly restructuring of external liabilities. Thus any support actions are undertaken on an "ad hoc", discretionary basis. The developing countries would call for a more predictable, rules based approach. For emerging market economies to avoid unduly contractionary policies in response to the risks of financial crises posed by financial market volatility, they must be offered very substantial and timely financial support in order to sustain market confidence and overcome speculative attacks on their currency. This was the approach followed by Germany in 1983 to support the French Franc and was the idea underlying the CCL facility, recently closed down by the IMF.

International Liquidity and SDR Allocations

The views toward the creation of international liquidity by an allocation of SDRs to supplement reserves at a time of international recession differ. The G7 countries, able to borrow as much as they need, generally take the view that there is no need to expand international liquidity. On the other hand, most developing countries with limited or no

access to financial markets must build up reserves by forgoing consumption and investment. For them an SDR allocation would be a welcome addition to their reserves and would allow them to sustain higher levels of imports and investment. Since the SDR interest rate is the average of the short term interest rates on the basket of currencies that compose the SDR, it is market determined, and would not impose costs on other countries.

At a time of an incipient international economic recovery, an allocation of say, SDR 90 billion, spread over three years would not only not pose any inflationary risks, it would be positively helpful for the recovery of the world economy and not only for the recipients of SDRs, as it would boost international confidence.

Moreover, the cost of holding international reserves for recipients of SDRs would decline, since the return they can obtain on the investment of their international reserves would be similar to the SDR interest rate. For those countries that can not borrow in financial markets, the benefits of an SDR allocation, including transfers of SDRs originally allocated to industrial countries, are unquestionably larger, though more difficult to estimate since there is no market price with which the cost of external borrowing can be compared.

Commodity Shocks

Commodity shocks are a subject of vital interest to low income primary producers. More than 50 developing countries depend on three or fewer commodities for most of their merchandise export earnings. On average, commodity shocks have been estimated to occur every two or three years and there is reason to believe that those related to extreme weather are on the rise. The average shock has been estimated as equivalent to some 2.5%

of GDP (IMF) to 7% of GDP (WB) and if indirect shocks are considered, as much as 20% of GDP.

Countries with less diversified economies and per capita incomes of under $1000 are the most affected by commodity shocks, be they the result of natural disasters, such as droughts and floods or of price shocks.

The G7 countries take a negative view of commodity price support mechanisms and are reluctant to consider arrangements related to commodity price stabilization. Unfortunately, this attitude has permeated their view of mechanisms such as the IMF Compensatory Financing Facility, whose use has been made difficult since the mid-eighties through increasing conditionality on its use.

If the arguments for compensatory financing type support measures, which envisage full repayment of financial support received, were put to the G20 by low income countries subject to commodity shocks, their case would be difficult to resist, since it is incongruous to increase aid flows to low income countries on the one hand and to deny them temporary financial support to deal with reversible commodity shocks.

Conclusion

It seems reasonable to expect that an open G20 discussion of a broader agenda would lead to a better understanding and greater accommodation of developing country interests and the outcome would differ from one restricted to deliberations among the G7. A G20 dialogue, by broadening the agenda and including major players may help promote the necessary adjustments and tend to improve the working of the international economy.

[1] Or 44% of world GDP if transition economies are included. Source: World Bank, World Development Index, 2003.