



Will we never learn?

As the financial crisis becomes increasingly global, the world economy is caught in a loop of weaknesses and seems headed for a deep and synchronized downturn. Some developing and emerging economies will be particularly affected because of their vulnerability to declining exports, falling commodity prices, and negative wealth effects stemming from currency mismatches. But the world seems not to have learned the lessons from previous financial crises: that traditional adjustment packages can be counterproductive, and that better global exchange rate arrangements will be critical if we are to achieve and maintain monetary and financial stability. This policy brief contends that all countries whose real economies are exposed will need to adopt countercyclical policies to stimulate domestic demand and compensate for shrinking foreign demand. Contrary to conventional wisdom, this also applies to countries with devaluing currencies. The current IMF approach asking for pro-cyclical policies in crisis countries is inadequate. UNCTAD has long argued that multilateral coordination is the only viable solution.

It is still too early to gauge the real depth of the downturn. But there is little doubt that the economic and financial weaknesses afflicting the world economy are mutually reinforcing. Many industrial countries are on the verge of recession. Combating deflation takes precedence over inflationary concerns, as headline inflation is likely to dip below zero in the coming months. While many developing and emerging economies are still growing, their economic outlook has severely deteriorated in recent months.

Despite this downward trend, however, economic activity has been resilient for some time in a number of developing and emerging economies. Before the crisis fully unfolded, domestic demand had assumed a bigger role in their growth performance and they had reduced their dependence on foreign capital by building up current account surpluses. In fact, those developing countries that have shown some resilience are those with a high share of manufactures in their total trade. These countries were able to improve their external positions in the aftermath of the Asian and Latin American financial crises of a decade ago and the associated large real exchange rate depreciations. Governments and central banks subsequently sought to maintain a competitive real exchange rate through active exchange rate management.¹ This made them less vulnerable to speculative attacks and also allowed them to soften adjustment pressures – in other words, it considerably enlarged their policy space.

Traditional conditionality counterproductive

The countries most exposed to the crisis, by contrast, are those that combine high current-account deficits with a substantial build-up of foreign liabilities by the private sector. These countries have been the victims of “carry trade” – portfolio investment based on borrowing in low-yielding currencies and investing in high-yielding ones, which has led to overvaluation and a loss of competitiveness. Typical cases are Brazil, Hungary, Iceland, Romania and Turkey, but there are many others. Triggered by the subprime collapse, this currency speculation unwound and caused a sharp depreciation of the nominal and real exchange rates of the affected countries.

While exchange rate adjustment usually improves the overall international competitiveness of a country's enterprises, which will eventually benefit their external accounts and help the real economy to recover, it can also entail major adverse balance-sheet effects for households and banks, at least in the short term. These short-term effects may cause severe stress in the domestic banking sector and a decline in household consumption, with serious consequences for growth and employment. A secondary negative impact stems from the efforts of central banks to defend the depreciated level of the currency through monetary and fiscal tightening. But such tightening – reminiscent of the IMF-supported policy response to the Asian crisis

¹ The nominal exchange rate adjusted for inflation or unit labour cost differentials between countries is the most comprehensive measure of the international competitiveness of economies.



– is jeopardizing their economic recovery and unnecessarily tightening the global policy stance now, during one of the most severe recessions of the past century.

IMF assistance – at times combined with swap agreements or direct financial assistance from the EU or, recently, even the United States – has helped ease the immediate pressure on the currencies and banking systems of the troubled countries. But the origin of the problem – speculation of the carry trade type – raises doubts about the adequacy of the traditional IMF approach for tackling such a crisis. Raising interest rates to avoid further devaluation is rather like the tail wagging the dog (*see chart*). As in the Asian and Latin American crises, this policy response suggests that developed countries have failed to address the most pressing issue in international finance and trade. That issue is the need for an exchange rate regime that provides a stable international value of money and helps minimize the cost of adjusting the nominal exchange rate to differences in the cost levels of trading partners – an adjustment that is as indispensable as it is unavoidable.

The critical point is this: Traditional assistance packages or swap agreements, combined with restrictive policy prescriptions – or at least an expectation by donors that the spirit of such belt-tightening exercises will be applied by beneficiary countries – are clearly counterproductive. Indeed, countries that have been exposed to carry trade speculation need a real devaluation in order to restore their international competitiveness. They also need assistance to avoid a downward overshooting of the exchange rate, which would both hamper their ability to check inflation and unnecessarily distort international trade. But they do not need belt-tightening. Rising interest rates and falling government expenditure will only reinvoke speculation and worsen matters in the real economy. In such situations, countries need expansionary fiscal and monetary policies to compensate for the fall in domestic demand, as long as the expansionary effects of devaluation have failed to materialize in a contracting global economy.

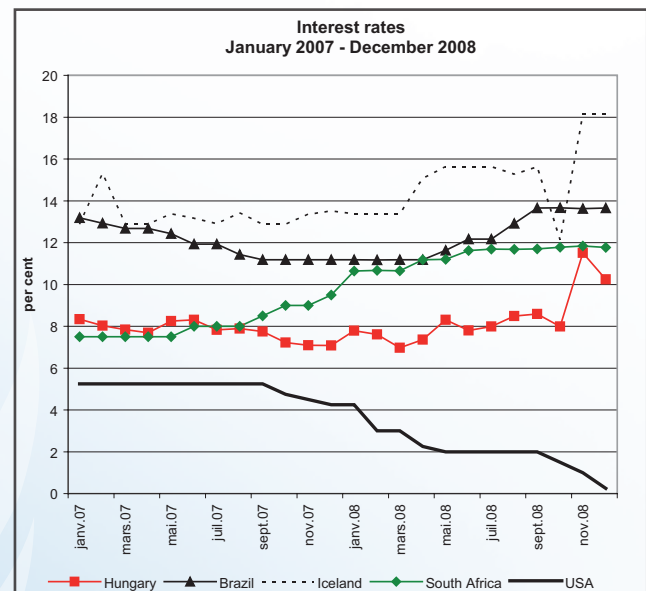
To stop an overshooting devaluation – which is the rule and not the exception – is very costly if attempted unilaterally, but very inexpensive if countries under pressure to devalue join forces with countries facing revaluation. Countries that are struggling to stem the tide of devaluation are in a weak position, as they have to intervene with foreign currency, which is available only in limited amounts. If the countries with appreciating currencies engage in a symmetrical intervention to stop the “undershooting”, international speculation would not even attempt to challenge the intervention, because the appreciating currency is available in unlimited amounts: It can be printed.

Multilateral approach indispensable

Unless there is a fundamental rethinking of the exchange rate mechanism and the cost involved in the traditional “solution” of assistance packages without symmetrical intervention, the negative spill-over of the financial crisis into the real economy will be much higher than needed. In addition, “undershooting”

of exchange rates will change trade structures and trade flows much more profoundly than is justified, given the losses of overall competitiveness experienced during the build-up of speculative positions. This would clearly jeopardize the effects of a conclusion of the Doha trade agenda and the attempt to abstain from protectionism – as reflected in the outcome of the recent G20 meeting in Washington.

Multilateral or even global exchange rate arrangements are clearly necessary to achieve and maintain global monetary and financial stability and to combine such stability efficiently with an open trading system. The idea of a cooperative global financial and monetary system would be to ensure, on a multilateral basis, the same rules of the game for all parties, just as multilateral trade rules apply to all trading partners. The main idea behind the creation of the International Monetary Fund was precisely to avoid destructive competitive devaluations. In a well-designed global monetary system, the advantages of currency depreciation in one country would have to be balanced against the disadvantages in another. Since changes in the exchange rate that deviate from purchasing power parity affect international trade in a very similar way to changes in tariffs and export duties, such changes should be governed by multilateral regulations. A multilateral regime would, among other things, require countries to specify the reasons for real devaluations and the dimension of the necessary changes. If such rules were applied strictly, the real exchange rate of all parties would tend to remain more or less constant, since the creation of competitive advantages for specific countries or groups of countries would not likely be accepted.



Notes: Monthly interest rate refers to the value on the 15th day of the month. Data from December 2008 refers to the value on the 16th day of the month. Interest rates refers to Hungary interbank overnight (middle rate), Brazil financing overnight SELIC, Iceland interbank 1-day, South African interbank call and US Federal funds target rate.

Source: UNCTAD secretariat calculations based on data from Thomson Datastream