

THEIR VIEW

MINT CURATOR

The post-pandemic G-20 role in the global financial architecture

G-20 leaders must rally institutions and coordinate efforts like they did in the last global crisis to fight off the current one



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The 15th Summit of G-20 leaders was scheduled to take place virtually over the weekend in Saudi Arabia. Among the several important issues expected to be on their agenda was the health of the extant Global Financial Architecture (GFA) in addressing the covid-related economic crisis. Reshaping the GFA, along with tightening financial regulation, was one of the big challenges before G-20 leaders when they first met in the wake of the Global Financial Crisis (GFC) of 2008-09.

Since financial markets in emerging economies were already fairly tightly regulated, they were not too heavily engaged in the intense G-20 debates over financial regulation, but they took a keen interest in the debates over GFA reform.

This architecture can be seen as a triptych, with international capital markets dominated by advanced economies in the central frame, bilateral and multilateral assistance on which developing countries were dependent for balancing their current accounts on one side of it, and the large self-insurance mechanism of foreign currency reserves of major emerging economies on the other side.

Emerging economies had long accessed international capital markets for commercial borrowings and private equity flows. These markets, however, exposed them to the vagaries of shifts in US Federal Reserve policies, sudden stops and balance of payments (BoP) crises. This is what happened during the Latin American debt crisis of the 1980s, India's BoP crisis of the early 1990s, the Asian financial crisis of 1997, and the GFC.

The resources of multilateral financial institutions (MFIs), however, did not grow in tandem with their external financing needs, as the fiscal space of their advanced-economy donors shrank with their declining trend growth. International Monetary Fund (IMF) procedures were also not considered nimble enough, and following the Asian financial crisis, they became wary of the stigma effect of IMF packages on markets that raised their borrowing costs. Emerging economies consequently built up their own self-insurance mechanism of foreign currency reserves, aided by a strategy of export-led hyper growth. Low income and Latin American countries, though, continued to depend on MFIs.

The G-20 strengthened the firepower of MFIs to deal with crises, and marginally enhanced the representation of emerging economies in the IMF's governance structure. Emerging economies, however, were not the direct beneficiaries of the enhanced global safety net to which they contributed, as this was mostly used to bail out countries in the European Monetary Union. The IMF was also nudged towards streamlining its crisis lending protocols by mitigating the stigma effect and becoming nimbler in providing liquidity in future crises.



One of the surprise outcomes of the GFC was the emergence of the US Federal Reserve, issuer of the world's de facto reserve currency, as a major pillar of the GFA. It was the Fed that first got off the block in providing global liquidity during the GFC, well before the IMF, through swap arrangements with major central banks that offered them standby dollar funding. These swaps were mainly for major allies of the US, though, and not for poorer countries, which stayed dependent on multilateral and bilateral aid.

Back then, the G-20 was of the view that the robustness of its reinforcement of the GFA and its reforms in the area of financial regulation would be tested in the next crisis. That crisis is upon us now. The financial system has held up quite well so far, aided by a strong monetary response by central banks through the lowering of interest rates, liquidity provisions and asset purchases.

As it did during the GFC, the US Fed has made dollar funding available to other central banks during the ongoing covid crisis. In addition to extending the maturity of its existing swap lines to central banks in Canada, England, the Eurozone, Japan and Switzerland, it has also extended fresh swap lines to the central banks of Australia, Brazil, Denmark, Korea, Mexico, New Zealand, Norway, Singapore and Sweden.

The IMF has been more nimble in providing assistance during the current crisis. Of the roughly \$150 billion mobilized as emergency multilateral assistance for covid-19 to date, about two-thirds has come from the IMF. Another 25% has come from the Asian Development Bank and European Bank for Regional Development, for Asia and poorer European countries respectively. Whereas during the GFC much of the IMF lending had gone to European countries, this time round, over 90%

has gone to the western hemisphere, which is worst affected by covid, Sub Saharan Africa, the Middle East and Central Asia.

Both Asia and Europe now appear to be less dependent on the IMF for crisis support, the mantle having devolved upon regional multilateral institutions. These are the Asian Development Bank, The Asian Infrastructure Investment Bank, and the New Development Bank in Asia. The European Stability Mechanism and the European Central Bank play a similar role in Europe.

However, the continued inability of Asian countries to unlock their vast foreign currency reserves by operationalizing their regional financial safety net through the Chiang Mai Initiative Multilateralization has been a major failure of the GFA during the current crisis. Over the weekend, the G-20 took the initiative to suspend debt repayments by poor countries during the pandemic and pressure MFIs to use their existing tools and resources effectively.

The covid pandemic, however, is by no means under control. If it were to escalate, the G-20 would be expected to further bolster the extant GFA. The environment of global economic governance has changed vastly since the early G-20 summits. Sentiment across the world has turned sharply against globalization, and US President Donald Trump skipped the latest summit's covid session. The G-20 might remain the most effective extant international institution to address the challenges that arise from globalization, which will likely continue its inexorable march, the rise of nationalist sentiments notwithstanding.

Unfortunately, global cooperation of the kind seen at the time of the GFC a little over a decade ago still looks difficult in the current environment, unless the incoming US President takes the nationalist bull by the horns.

MY VIEW | GENERAL DISEQUILIBRIUM

Inflation might just be about to pick up sharply in the West

Central banks may not be able to suppress interest rates for too long



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It may seem strange to be worried about inflation in the midst of a global recession, a pandemic and huge political ructions in the US, but I suspect that it's about to pick up both soon and sharply. How fast this happens depends on how quickly the developed world recovers over the next few months, but pressures are building. As has been the case for many years, global inflation has "Made in Asia" stamped all over it. This time, though, that's likely to be compounded by much greater supply constraints in the economy.

First, a little humility. Forecasting inflation is fiendishly hard. Generally, the best forecast is what inflation is at the moment. Central banks have been neither good at forecasting inflation nor creating it. This is because, in essence, classical economics largely assumes that, all things being equal, increasing the supply of money pushes inflation higher. And yet, after years of rate cutting, quantitative easing and so forth, the only thing that has gone up is asset prices.

Clearly, then, not all things are equal. Economic models assumed that how quickly money changes hands (its velocity, in the jargon) is both stable and predictable. Instead, it has collapsed. That's why all those people who predicted a massive rise in inflation as a result of central bank QE have been wrong. Velocity may pick up, but that wouldn't tell us much about what happens in the next couple of years. And there are signs aplenty that inflation is headed higher.

Ask yourself the following counterfactual. Had you known that the developed-world economy would be largely shut down, what would you have expected to happen to prices of traded goods? Probably, you'd have expected them to collapse. But they didn't even fall as much as in the manufacturing recession of 2015, let alone during the global financial crisis.

Prices are now rising strongly, in part because Asian growth is humming. Chinese export prices have risen year over year. Excluding oil, industrial commodity prices are also now higher than they were at the end of last year. Even if nothing moves between now and late spring of 2021, year-over-year comparisons will start to look very dramatic—as prices this spring were at their low point. These trends are already making themselves felt in the developed world.

Yet much of the developed world is still in the midst of a pandemic, subduing demand. When the vaccine comes or the virus blows itself out, demand will pick up smartly. What will happen to prices when



The 'velocity of money' is a factor that few analysts have kept track of

it does? I suspect that much manufacturing capacity has been lost. Transportation is at once more difficult and more expensive. [Recent trends have] probably also meant a lack of investment in stuff you dig out of the ground or drop on your foot.

Assuming that all this takes a fairly long time to get up and running, you would expect these constraints to last. The same is probably true of services. A lot of companies have already been put out of business and many more are likely to go to the wall. There has been, then, severe losses to economies' supply potential. All of which means that the path of least resistance when demand picks up is higher prices.

How central banks react is key. They have told us that they will let economies run hot. What they're really saying is that nothing they've done has made the slightest difference to overall inflation and they don't know why. Still, let's take them at their word. What would it mean in practice? Would they avoid putting up short rates or try to hold down long rates at a time when government borrowing is likely to remain huge? Either would, in effect, loosen monetary policy by driving real rates down when economies—and inflation—are rising. This is not credible and countries that do nothing would probably see their currencies fall instead, thereby pushing imported inflation higher.

I suspect that private holders of longer-dated bonds won't wait for central banks to change their minds, knowing that they'll have to hike at some point. The risk is asymmetric. Bond yields are breathtakingly low and sooner or later they will rise, possibly rapidly. There is a lot of leverage in fixed income, and bonds with de minimis coupons potentially move a lot more in price than those that actually pay a decent rate of interest.

Those with a few grey hairs will remember the bond carnage of 1994. At some point, I'd expect yield curves to steepen dramatically from today's levels. Avoiding longer-dated government and corporate debt and keeping to the very short end seems sensible. As would buying out-of-the-money, long-dated put options on long-dated debt. Central banks have suppressed volatility and rates in debt markets for years. This is about to become much harder.

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RBI's impossible duality: Policy clarity versus whimsy

RAJRISHI SINGHAL

Let's examine the LVB-DBIL regulatory action first. RBI is within its rights, under Section 45 of Banking Regulation Act, to announce a moratorium on any troubled scheduled bank, as well as merge it with another bank to safeguard depositors, share-

Foreign banks have been demanding a level playing field with domestic banks in many operational areas, including in acquiring local institutions (but not for priority sector lending). On his visit to India as Citigroup board member (after retiring as US Secretary

vent HSBC from circumventing the upcoming policy guidelines."

So, there you have it: foreign banks allowed to acquire local banks under RBI governor Bimal Jalan in 2002, but vetoed by his successor, Raddy in 2004, and once again near-

with Oriental Commerce Bank in 2004. In both these RBI-orchestrated rescue acts, depositors have been accorded higher weightage than shareholders.

Yet, one question refuses to go away: Will RBI similarly force the government to write