# 37th Asian Shadow Financial Regulatory Committee Statement
# June 26th, 2023 – Ho Chi Minh City

## The Twin Problems of Inflation and Deficits

1 Global inflation continues to persist.

2 Following the Covid pandemic and supply-side disruptions, including the war in Ukraine, China's rising reliance on domestic consumption, and the trade reducing effects of the US-China tariff war amidst rising protectionism globally, inflation rose sharply, particularly in Europe and the West. This led to tightening monetary policy by central banks, with the Federal Reserve raising interest rates eight times from March 16th, 2022, to their current high of 5 – 5.25%. On the 21st of June, the Chairman of the Federal Reserve, Jerome Powell, testified before the House Financial Services Committee hinting there will be two more increases in the key lending rate as inflation remains stubbornly high at an average of around 4%, against the target of 2%. Inflation rates in Europe remain much higher still, driven, to a large extent, by the end of cheap energy and food from Russia. Increases in interest rates in the US have an impact far wider than the US and, on this occasion, expectations given the long period of extremely low interest rates following the global financial crisis has made the situation worse.

3 Globally, rising interest rates to contain inflation simultaneously adversely affects financial stability and fiscal sustainability. Within the US, the collapse of Silicon Valley Bank, a regional bank, was driven primarily by the significant drop in value of the bank's long-term bond holdings, which constituted a large share of the bank's assets. The ensuing bank run was triggered by the prospect of falling confidence in the bank's ability to remain viable. Furthermore medium-sized banks in the US remain vulnerable to the risk of failure, raising the need for a Federal Reserve bailout.

4 Likewise, rising interest rates raises the cost of servicing an already high current debt level, especially in the US, brought about by rising military spending as well as increasing expenditures on health and an aging population. In 2022, US debt, at USD24T, is equivalent to 95 percent of its GDP. According to the US

Congressional Budget Office, by 2052, it will reach 185 percent of GDP. US annual military spending is now around USD 900B, roughly 40 percent of the world's total military spending, and greater than the next ten countries combined.

5 Rising interest rates in the US forces countries in the rest of the world to raise their interest rates as well to prevent capital outflows and currency depreciation vis-a-vis the USD, which would worsen inflation in these countries. Whereas currency depreciation vis-a-vis the USD helped spur export growth in these countries in the past, today, in the face of a global downturn, export growth has been muted and even declined. The presence of trade deficits, as well as the attempts of central banks to prevent currency depreciation through intervention in the foreign exchange market has reduced the level of international reserves at central banks.

6 Both rising interest rates and high and persistent inflation tend to mirror what is happening in the US because of the interconnectivity of markets. Fifty years after the shift to a more flexible exchange rate regime following the collapse of the Bretton Woods system, countries have been hampered in their efforts to conduct more independent monetary policy, with their domestic interest and inflation rates tightly linked to those in the US.

7 Inflation and rising interest rates affect the poor and disadvantaged, in particular, whereas the rich, on balance, tends to benefit. The share of expenditures on food of the poor in their consumption basket is larger than that of the rich. Food inflation, which has driven overall CPI inflation, hurts the poor more. For the poor, prices, on average, are generally sticky downwards. However, higher interest rates yield higher returns on investments for the rich. Overall, the distribution of income worsens.

8 Recommendations

(1) Countries should reaffirm their support for the global multilateral trading system and bring down and reverse barriers to trade. A freer global trading environment will make companies, including those in the US and Asia, more competitive, allow output to increase, and reduce inflationary pressure in the US as well as globally. As output increases, employment will also increase, bringing prosperity to many, including the poor, and thereby reduce income inequality.

(2) In this post-Covid period, countries should make efforts to reduce their fiscal deficits, especially in cases where inflation is high. High and rising interest rates and large deficits can be detrimental to the world. An obvious area is to reduce

military spending, which constitutes a large percentage of total government spending in some countries, particularly the US. An option is to reduce wars of choice, and additionally, for the US, to negotiate new arms control agreements with Russia and China, among others.

(3) Countries should consider administrative methods to help manage inflation to enhance competition and productivity in the economy. Efforts should be made to ensure that no group can take undue advantage of the inflationary environment and to reduce the pressure on the poor and disadvantaged.