

# THE UNFINISHED BUSINESS OF GLOBAL REBALANCING

*The G20 has won critical acclaim so far, but its true credibility hinges on its success in addressing long-standing structural problems in the global economy*

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**T**he G20 has won critical acclaim for coordinating an aggressive global macro-economic policy response to the global financial crisis and averting a second Great Depression. It has since turned its attention to addressing unresolved medium- to long-term structural problems in the global economy. It is currently debating and guiding the outcomes on a wide range of important global issues. However, most of the original work is being done elsewhere, such as financial sector reform within the Financial Stability Board (FSB) and Basle system, World Bank and IMF reforms within the international financial institutions system, international trade within the World Trade Organisation (WTO), climate change and finance within the United Nations Framework Convention on Climate Change (UNFCCC) and anti-corruption within the United Nations Convention against Corruption (UNCAC). The Framework for Strong, Sustainable and Balanced Growth, on the other hand, is a signature initiative of the G20 where the original work is being done by the G20 itself.

The issue of global rebalancing is arguably the most high profile unfinished business currently before the G20. Its credibility in addressing long-standing structural problems in the global economy arguably hinges on the success of this exercise. Global imbalances are nothing new. They were a prominent feature of the economic landscape both preceding and following the Great Depression. According to the 'Triffin Paradox', the issuer of the global reserve currency must necessarily have substantial external imbalances to provide global liquidity; developing countries are expected to run current account deficits financed by surpluses of developed countries to top up domestic savings to optimise investment; as developed societies age, their savings rate can be expected to decline and consequently their current account balance may turn negative and need to be financed by capital inflows; economies with higher productivity or with large natural resources are also likely to run large surpluses.

Economic literature suggests that under a floating exchange rate regime the market penalises, and hence corrects, large current account deficits. However, this does not hold good for current account surpluses, as pointed out by Keynes several years ago. Nevertheless, in the absence of intervention in currency markets, the current account surplus should automatically adjust and move towards balance through an appreciation of the real exchange rate.

Floating exchange rates have however not worked to correct external imbalances for a number of reasons. Firstly, some East Asian countries, most notably China, have followed a neo-mercantilist policy of export-led growth. They have intervened in currency markets to prevent their currency from appreciating against the global reserve currency — the US dollar — despite mounting current account surpluses.

The other major countries running big current account surpluses, namely Japan and Germany, have floating exchange rates. Japan's surplus however derives from its investment income, as its trade is more or less balanced. Germany has sustained a huge current account surplus despite a floating currency because the Euro currency area has suppressed the exchange rate equilibrating mechanism. This has allowed countries with high-



US President Obama at last year's G20 summit. The IMF has warned against the danger of unchecked US deficits

er productivity, such as Germany, to run big surpluses, and low-income countries to run big deficits, even as the Euro area as a whole is externally balanced. Such internal imbalances have nevertheless spilled over into global financial markets. Since peripheral Euro countries have accessed global financial safety nets (IMF resources), and adversely impacted global sovereign debt markets, these imbalances cannot be treated as simply internal to the Euro area.

Thirdly, the market does not penalise the US, the major deficit country, because its domestic currency is also the global reserve currency. There is a global demand for US dollars that extends far beyond the demand for financing US current account deficits. The IMF has long been warning about a disorderly unwinding of global imbalances through a collapse of the dollar. However, the safe-haven status of the dollar has prevented it from depreciating in tandem with growing US external deficits. Indeed, the US dollar has become the bellwether currency, signalling the appetite for risk-taking in the global economy. Risk-aversion results in safe-haven flows and a strengthening of the dollar, and vice versa.

Fourthly, large cross-border capital flows prevent exchange rates from responding to fundamentals even under a floating currency regime. Thus, exchange rates of countries such as India and Brazil are under upward pressure despite current account deficits, on account of large capital inflows far exceeding levels required to balance the current account.

The chief concern regarding large persistent imbalances at the present juncture is the continuing deleveraging, demand retrenchment and consequential increase in private savings in OECD (Organisation for Economic Cooperation and Development) countries.

This makes it difficult to return to pre-crisis levels of growth in the absence of global demand rebalancing between developed and developing countries. The G20 Framework exercise seeks agreement on indicators that would identify imbalances, as well as policy instruments that would essentially get surplus countries and the global reserve currency issuing deficit country to adjust their imbalances. It is hoped that this would put global growth back on a high growth trajectory on a sustainable basis.

Broadly speaking, there are two types of policy interventions to address large imbalances. The first is trade-based, where the entire burden of adjustment is borne by the exchange rate. The second approach focuses on the savings-investment behaviour that drives imbalances. Such behavior can be influenced through monetary, fiscal and other structural policies, although it is generally considered to be sticky, and much less amenable to policy action. Exchange rate adjustment, on the other hand, can be done through market intervention. An eclectic approach based on both approaches could be considered.

While monetary, fiscal and structural policy instruments can be used by all countries, in countries with fixed exchange rates and non-fully convertible currencies, exchange rate policy constitutes an additional critical policy lever. Recent experience with the use of fiscal and monetary policies during the global financial crisis indicates that their aggressive use can have adverse fiscal and liquidity consequences as well. The G20 would therefore need to be mindful of the possible spillover effects of policy guidelines and actions to correct large imbalances.

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