

SEOUL-SEARCHING IN G20

The focus should shift from imbalances to sustaining growth, says ALOK SHEEL

The proximate trigger for the trans-Atlantic financial crisis lay in the US sub-prime housing market. Most analysts, however, trace the ultimate origins of the crisis to the interrelated phenomena of weaknesses in financial regulation and monetary policy in advanced markets on the one hand, and to the build-up of global imbalances on an epic scale on the other.

The most concerted response to the global financial crisis, that may have averted a second Great Depression, came from the G20, which has since assumed the mantle of the premier multilateral forum for economic cooperation. Eminently successful in crisis situations, going forward, the challenge before the G20 lies in proving its efficacy in addressing structural issues in non-crisis situations.

The “Framework for Strong, Sustainable and Balanced Growth”, agreed upon by G20 leaders at their fourth Summit in Toronto in July 2010, needs to be perceived against such a backdrop. Groups of advanced and emerging surplus and deficit countries committed to appropriate baskets of policy actions to reduce imbalances and raise potential growth. Since country circumstances within the same group can vary, they also agreed that at their fifth Summit in Seoul in November 2010, they would commit to country-specific policies to further refine the Framework.

The assumption in the Framework exercise is that future risks to the global economy would be considerably mitigated if countries moved towards external balance. Since much of the demand behind high global growth in the period preceding the crisis came from leveraged consumption in advanced deficit countries, it is also assumed that as advanced deficit countries move towards greater external balance and clean up their financial systems, global growth could decline permanently, unless structural policies, such as those recommended by the OECD in its “Going for Growth” framework, are implemented to raise the growth potential of all, but particularly advanced, economies.

Despite this ambitious exercise, the IMF expects global imbalances to widen further rather than wane. Moreover, there needs to be a single storyline that is consistent with imbalances, growth, development, climate change, demographic transition and fiscal consolidation, all of which are being debated directly or indirectly within the G20.

Implicit in the Framework is the assumption that growth and development

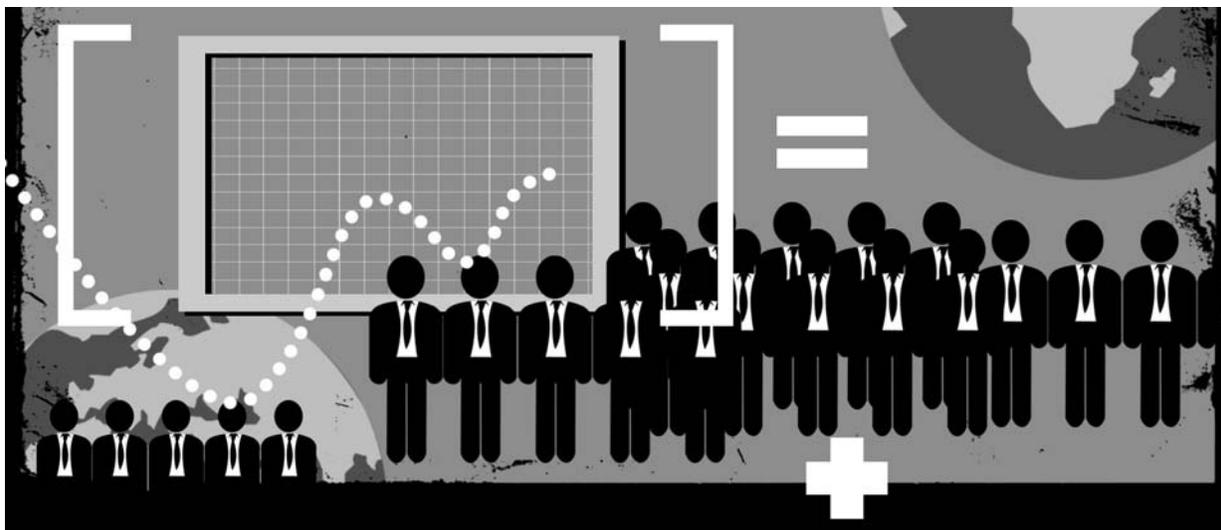


ILLUSTRATION BY BINAY SINHA

should primarily be based on domestic savings. However, according to traditional development economics, developing countries should run current account deficits to top up domestic savings with external savings for boosting investment. The size of the deficit should, of course, be prudent and sustainable, or contained at levels that can reasonably be expected to be funded over the medium to long term. There could be liquidity crises from time to time, deriving from financial shocks and consequential sudden stops, but the IMF exists to provide liquidity backstop.

The problem arose because the equation was reversed, and developing countries started running huge current account surpluses, and developed countries similarly large deficits. This led to a “savings glut” that lowered the cost of capital, fuelling excessive consumption via a leveraged asset price boom in developed countries through financial innovation in a lightly regulated financial system.

If this analysis is correct, should the IMF and the G20 shift their focus from imbalances *per se* to their structure and direction? While the American and Chinese imbalances appear anomalous, it is not clear why the surpluses of Germany and Japan are a major problem. As developed countries, they should run surpluses to smoothen global developmental imbalances by generating savings for investment in developing countries. Of course, if developed countries end up exporting low-technology consumer goods, they could stifle growth in developing countries. But this is patently not the case, as

both Germany and Japan increasingly specialise in high-technology/productivity products and capital goods.

From the viewpoint of climate change too, the wisdom of advising some developed countries with high per capita incomes to further increase consumption, while at the same time inducing them to agree to stiff and binding emission cuts to create environmental space for developing countries to grow, seems contradictory.

Traditional development economics overlooked the growth dynamics of ageing. As the share of the working population shrinks, savings in developed economies can be expected to decline, although structural reforms, such as raising the age of retirement and liberal immigration policies, can stagger this process. Nevertheless, one would expect developed economies to eventually move from external surpluses to deficits, which would need to be funded through current account surpluses of either younger, newly emerged developing economies, like China.

Since America is not an advanced ageing economy, its huge deficits are anomalous. They are sustained at their present levels only through the reserve currency status of the US dollar. Being a low middle income developing country, Chinese surpluses are also anomalous, and sustainable only on account of American deficits, which they mirror.

To the extent American household consumption might decline through deleveraging and repair of household balance sheets, Chinese surpluses should shrink.

However, the increase in US government deficits has countervailed the rise in US private savings. But such expansion cannot be sustained indefinitely, and the G20 countries have consequently separately agreed on a road map of fiscal consolidation. The moot question is: Will staggered US fiscal consolidation result in the long-awaited disorderly unwinding of global imbalances and collapse of the dollar? It is intriguing that the IMF had long anticipated a financial crisis through a disorderly unwinding of global imbalances and collapse of the dollar fuelled by private deficits. The global crisis, however, further strengthened the safe haven status of the global reserve currency. There are now even fewer signs of public deficit-fuelled imbalances weakening the global reserve currency.

It is only when public deficits in advanced countries shrink significantly can we expect global imbalances to start unwinding. This unwinding can be expected to adversely affect global trend growth — the so-called “New Normal” — unless difficult structural changes are effected to sustain growth in advanced deficit countries and boost domestic demand in emerging surplus countries. Such changes are politically challenging and take time to take effect. Even so, capital may continue to flow uphill and, therefore, the financial system needs to be strengthened to prevent past excesses.

The writer is a civil servant responsible for G20 in the Union finance ministry. The views expressed are personal