Global Economic Imbalances and Current Economic Crisis: A Case for Reforms in Global Economic Governance

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Abstract

The structures of the governance of the world economy are evolving with changes occurring after the World economic crisis, as it was exemplified by the creation of the Summits of the Group of Twenty (G20).

Global imbalances—meaning imbalances between savings and investment in the major world economies reflected in large and growing current account imbalances—did indeed play a major role in creating the current crisis. The paper analyses as to how in the absence of any macro-prudential regulatory mechanism, large deficits in U.S. and surpluses in emerging East Asian economies (especially China) and oil-exporting countries in the Middle East developed increasingly. In turn, the savings and investment imbalances gave rise to the so-called savings glut in developing countries and spawned sizable net flows of capital from developing to advanced countries, with the United States being the primary recipient of these flows. Risk controls failed, and all of this combined to precipitate unprecedented turmoil in global financial markets beginning in mid-2007.

The Paper discusses the basic features of the international financial system that facilitated the growth of these imbalances and allowed countries to delay dealing with them. This paper suggests the possible form of a new global economic governance architecture which is more attuned to the new economic evolution and more “representative, plural, credible, accountable and effective.” that responds forcefully to financial booms will be the most important lever for avoiding financial busts in the future.

Keywords: Global Economic Imbalances, Financial Crisis, Global Economic Governance

Introduction

The contemporary international financial system in recent decades has expanded greatly in size, reach, and liquidity. At the same time, however, it has become much more susceptible to crisis and instability, not only in emerging markets but more recently in the developed economies as well. (1) The financial crisis that engulfed East Asia in the late 1990s was especially important in highlighting the potentially devastating effects of exposing immature domestic financial systems to highly volatile international capital flows. Debates about a “new financial architecture” and new coordinating institutions followed in the wake of these events. (2) A report by the Bundesbank's president, Hans Tietmeyer, was endorsed by the Group of 7 (G7) in 1999 and led to the creation of the Group of 20 (G-20) and the Financial Stability Forum (FSF). The focus of this article is the G-20, a forum designed to promote dialogue on financial and global economic governance issues in which nations of both the North and the South come together to discuss and attempt to manage common systemic problems. Its key participants are finance ministers and central bankers from the traditional G7/8 countries as well as from Australia, Argentina, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, the Russian Federation, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union (EU). These are countries that together represent over 85 percent of world gross domestic product (GDP), 80 percent of world trade, and two-thirds of the world's population. The G-20 also has representatives from the EU, the International Monetary Fund (IMF), and the World Bank.

Global Imbalances and the Financial Crisis

Most explanations of the current economic and financial crisis focus on financial causes. The standard account runs along the following lines: relatively low interest rates worldwide for much of the 2000s drove investors to seek higher yields, and relative stability in financial markets, reflecting the low cost of funds and solid economic growth, led to significant under pricing of risk. Lending standards were weakened and leverage increased. The rise in leverage sharpened the exposure to liquidity risk for financial institutions as they depended increasingly on wholesale markets for funding and these funds became increasingly short term. New, complex financial products obfuscated risks and contributed to serious mis-pricing. Risk controls failed and good old fashioned fraud also created significant losses. All of this combined to precipitate unprecedented turmoil in global financial markets beginning in mid-2007.

But missing is a discussion of how the seeds of the crisis were sown by the economic policies in those major countries that fostered global imbalances and by the features of the international financial system that facilitated the growth of those imbalances. Substantial imbalances in savings and investment emerged after 2000, and were reflected in growing current account imbalances within major world economies. Rising U.S. deficits and increasing surpluses in emerging East Asian economies (especially China) and oil-exporting countries in the Middle East developed. In turn, the savings and investment imbalances gave rise to the so-called savings glut in developing countries and spawned sizable net flows of capital from developing to advanced countries, with the United States
being the primary recipient of these flows. The savings glut helped to reduce world interest rates. At the same time, the substantial rise in demand, especially by East Asian and Middle Eastern economies, for official reserve assets crowded out private demand for such high-quality, low-risk assets. Consequently, a scramble by private investors for other higher-yielding but relatively low-risk assets contributed to the financial excesses that finally culminated in the present turmoil in world financial markets.

The statement of the November 2008 G20 summit hints at the role that imbalances played: “Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruptions.” The term “unsustainable global macroeconomic outcomes” appears to be a rather oblique reference to global imbalances.

The rise in global imbalances during the 2000s was driven by a combination of factors with mutually reinforcing effects. Significant changes took place in savings and investment behavior in major countries. In the United States, national savings declined as the fiscal position shifted from a surplus to a substantial deficit and as household savings fell, resulting in a dramatic rise in the current account deficit (Figure 1).

The decline in household savings in part reflected relatively low interest rates and increased availability of financing related to housing that sparked a boom in consumption and residential investment. Consumption-fuelled growth in the United States fostered economic recoveries in Japan and Europe on the back of higher exports. Particularly in Europe, corporate profits rose. But problems in the structures of these countries’ economies—especially rigidities in product and labor markets—limited investment opportunities. The combination of high corporate savings and sluggish investment led to rising national savings and external surpluses (Figure 2).

Savings and investment imbalances and current account surpluses of developing countries also rose sharply (Figure 3). In emerging economies in East Asia other than China, savings increased. More important, the increases in the external surpluses of these countries reflected a decline relative to GDP in investment—especially in structures—following the excesses in such investment that occurred in the build up to the Asian financial crisis of 1997–98. External surpluses also reflected policy decisions in many of these countries to rebuild official reserves, which had been decimated during the financial crisis. The years after 2000 also showed a dramatic rise in the savings and investment imbalance in China. Despite a very strong investment performance, Chinese savings rose even more dramatically. The fiscal position (government savings) improved and corporate savings posted a sharp rise. In East Asia generally, external surpluses put upward pressure on exchange rates, but this pressure was mitigated by substantial sterilized currency intervention, delaying adjustment. After 2002, current account surpluses of Middle East oil-exporting countries began to rise as strong global demand and concerns about the security of oil supplies drove up prices.

Figure 1. U.S. Current Account Deficit (percentage of world GDP)

Figure 2. Euro Area and Japan Current Account Surpluses (percentage of world GDP)

Figure 3. China, Emerging East Asia, and Middle East Current Account Surpluses (percentage of world GDP)
Among these countries, China’s current account surplus skyrocketed and official reserves rose to record levels. Competitive pressures from China also created pressure on other East Asian countries to limit the appreciation of their currencies against the U.S. dollar, boosting external surpluses and reserve accumulation in these countries. The current account surpluses of oil-exporting countries in the Middle East also rose because increasing worldwide demand continued to push up oil prices. In turn, through net capital flows, developing countries’ external surpluses were funnelled back to the United States. This financing then helped fund a continuation of the consumption and housing boom and a steady rise in asset prices.

To a significant extent, the strong preference for U.S. dollar assets that emerged reflected the pivotal role the dollar plays as a reserve currency in the international financial system. Consequently, the United States was able to finance its growing external deficits relatively easily and delay needed adjustments in domestic savings and in its balance of payments (reflecting the first feature of the international financial system). However, there was also a net flow of private capital into the United States, as shown in Figure 4. This reflected the sense that U.S. markets were better regulated, had better governance, and were more secure than markets in emerging economies.

To be sure, the flat yield curve did not imply that the Fed could not bring about an increase in long-term interest rates. Monetary policy certainly could have been used to limit the effect of the inflows of capital to the United States and prevented some of the excesses that occurred. However, to be successful, there would have had to be a substantial tightening of monetary policy. Such aggressive use of monetary policy to deal with this problem would have inflicted a high cost on the U.S. economy and, in turn, the rest of the world. Granted, the costs inflicted by the current economic and financial crisis are quite high, but the relevant question is whether other policy alternatives would have been better placed than monetary policy in dealing with the situation at a much lower cost. Obviously, dealing more aggressively with global imbalances would have been the best policy response.

Need for Better IMF Surveillance

An important part of dealing with global imbalances (and trying to diminish the prospect of a similar situation arising again) entails finding ways to mitigate the potential effects of the features in the international financial system that can permit countries to delay adjustment to external imbalances. There are no easy or hard-and-fast solutions to these problems. The U.S. dollar’s status as a reserve currency is not likely to change in the near future. Even in the midst of the current financial crisis, money is pouring into the United States, which is seen as a safe haven despite the fact that the crisis originated in U.S. financial markets. U.S. Treasury securities remain the world’s premier risk-free asset. Accordingly, the United States is likely to remain the dominant provider of reserve assets, and when the global economy recovers from the current downturn, a steady underlying demand for foreign official holdings of U.S. dollar assets will continue. And just as the United States will be able to use this advantage to put off adjustment, so countries facing upward pressure on their currencies will be able to delay adjustments in their external surpluses. Likewise, it is not feasible to diminish the sheltering effect that exchange rate depreciation may have and how it may delay adjustment to structural shocks in countries with floating exchange rates. Nor would it be desirable, because floating rates undoubtedly make countries more resilient to temporary shocks and serve to stabilize the system overall.

Significant improvements in the IMF’s surveillance could be achieved by limiting the executive board’s role in the surveillance process and by making IMF management more effective. The board should no longer be involved directly in surveillance reviews. Its responsibility should be limited to approving the overall framework for surveillance (consistent with the articles of agreement) and holding IMF management responsible for the effective execution of surveillance. To carry out its responsibilities effectively, IMF management, including the managing director and the deputy managing directors, needs to be selected in an open process solely on the basis of the candidates’ qualifications and competence.

**IMF : Reforms towards a new more independent Institution**

The G20 promised to treble the resources of the IMF to give the institution about $1 trillion in resources. What has the impact of this increase been on power within the institution and the relative influence of the G7, the emerging economies and other developing countries within the organisation?

Delving behind the statement of the G20, it is worth closely examining the composition of the new resources for the IMF. The IMF has not had its capital increased. Mostly the new money comprises credit lines which member countries have made available to the IMF if it needs them. This means that if the IMF believes that its forward commitment capacity might fall short of its member countries’ needs, it can activate pledges by a group of countries to stand ready to lend to the IMF. On 24 November 2009, after heated political wrangling between the new emerging economy members and traditional economic power, agreement was finally reached on a new $600 billion NAB from the 26 Countries which belonged before the crisis to that arrangement, along with 13 new participant countries. The
Recognising Role of Emerging Economies?
The ‘far-reaching’ governance reforms agreed by the IMF’s Board of Governors in April 2008, as described above, were aimed in large part at recognising the rise in economic power of emerging economies. Many thought that by giving emerging economies larger voting shares, these countries could thereby be induced to engage more closely with the IMF as shareholders. But the governance reforms were modest. The largest ‘winners’ from the reforms were Korea, Singapore, Turkey, China, India, Brazil and Mexico. From their perspective, the changes were small. China’s share of votes in the organisation was increased by 0.88 per cent, giving it a total of 3.81 per cent of votes. India’s voting power has risen to 2.34 per cent. Brazil got an increment of 0.31 per cent of total voting power, raising its share to 1.72 per cent while the addition of 0.27 per cent of IMF votes to Mexico gave it a voting share of 1.47 per cent. These changes were hard won and took endless negotiation among the G7 powers. At the same time, the results do little to offset the perception of emerging economies that the IMF is mostly a US organisation – a perception fed by the fact that the United States has a veto power in the IMF, the senior management are all appointed only with the approval of the United States and Europe, the institution is situated amid US government agencies in Washington DC, and it works in English, with a large proportion of its staff being US-trained.

No surprise then that in the aftermath of the crisis, emerging economies were reluctant to extend credit lines to the Institution. At first, China, Brazil and India refused to join and participate in the NAB until more substantial reforms were undertaken in the IMF’s governance and arrangements. Initially, they agreed instead to purchase IMF notes. For example, China agreed to purchase $50 billion, presenting this as an investment in the IMF, rather than a loan to the institution, the latter being an action that might be interpreted as an implicit acceptance of the institutional status quo. The logic of the emerging economies’ position was spelled out by the Brazilian finance minister in April 2009.

Depending on how they are designed, IMF notes or bonds could be an option to provide immediate resources to the institution without undermining the reform process. The New Arrangements to Borrow (NAB) may not constitute an adequate mechanism because it is a standing arrangement. Its expansion could limit the scope for and delay quota reform. We could support a proposal to set up a proposed plurilateral agreement, a Temporary Arrangement to Borrow (TAB), with more flexible rules than the NAB. Put simply, emerging economies, while willing to assist, were not willing to lose the opportunity to ensure more serious reform of the institution. At the Pittsburgh Leaders Summit, however, a new compromise was introduced. China, India, Brazil and Russia agreed that their purchases of notes could be rolled into the IMF’s arrangements to borrow. In return they have been promised a further phase of quota reform in the IMF: a further shift of 5 per cent of voting power, as yet undefined in terms of who will lose and who will gain. They also negotiated new terms for participation in the NAB.

Equipped to Deal with the ‘Development Emergency’
As discussed by Ngaire Woods that at the onset of the crisis nobody foresaw the devastating impact it would have on some of the poorest countries of the world. However, in the title of their 2009 Global Monitoring Report the IMF and World Bank describe a ‘development emergency’ (World Bank and IMF, 2009). The G20 at their London Summit announced:

We recognise that the current crisis has a disproportionate impact on the vulnerable in the poorest countries and recognise our collective responsibility to mitigate the social impact of the crisis to minimise long-lasting damage to global potential.

To this end the leaders pledged new resources for the IMF, new support for social protection and trade, new concessional lending and to live up to all their previous aid commitments. The IMF has sprung into action, lending record amounts to its members, pledging to deliver more resources to its countries (sometimes relabelled as crisis response). There are two risks in this. First, there is a postponed funding gap which will need filling in the near future. Second, there are many countries that have been rendered fragile and desperate by the crisis which did not have a pre-existing loan from the World Bank and which can therefore not avail themselves of frontloading. Ensuring that such gaps do not emerge in the overall assistance to poor countries is one of the core reasons for a multilateral approach – since a donor -by- donor approach would risk creating such gaps.

For example, in Latin America, while Brazil has been very slow to offer support to the IMF, its national development bank has lent some $15 billion to countries in the region in the wake of the crisis. Meanwhile Venezuela’s regional programmes have attracted much attention. Similarly in Asia there is a determination to pursue and to strengthen regional alternatives to the multilateralism of old. To quote Jiang Zemin at the opening ceremony of the Asian Development Bank Annual Meeting in May 2009.

Role of UN in Global Economic Governance
The role of the UN in global economic governance should be among the first issues to be taken up in the follow-up to the UN conference. Once it is established that the UN is the appropriate forum for discussing issues related to “international economic and financial system and architecture” from a broad development perspective, the task is to reform the UN system by setting up appropriate bodies and mechanisms. One option could be to create a UN body at the level of the General Assembly and the Security Council with authority to take binding decisions in areas of activity of specialized multilateral agencies and to secure consistency, compliance and accountability. It could draw on the existing G20, supplemented by elected members as in the Security Council. Under such an arrangement ECOSOC, duly extended to include all
members of the UN, could well replace the Second and Third Committees (Social, Cultural and Humanitarian, and Economic and Finance Committees) as a single UN General Assembly body for economic, financial and social issues.

Embedding the G20 into the UN system would not only enhance its legitimacy, but also secure that its developing-country members would continue to play a central role in multilateral governance in economic and social issues – rather than being called upon when things go wrong and forgotten subsequently. The current global crisis presents developing countries with an opportunity for shaping multilateral institutions and globalization according to their collective interests. For the first time after recurrent crises and hardships, developing countries have begun to fashion a common vision of what kind of international economic and financial architecture they should be seeking in support of development, rather than simply reacting to positions and proposals coming from governments of advanced economies. But the opportunity may well be lost if these matters are pursued in ad hoc groups which do not enjoy institutional legitimacy and political mandate, rather than taken to where they belong.

WTO and Reforms
Reform is a viable strategy when the system is question is fundamentally fair but has simply been corrupted such as the case with some democracies. It is not a viable strategy when a system is so fundamentally unequal in purposes, principles, and processes as the WTO. The WTO systematically protects and the trade and economic advantages of the rich countries, particularly the United States. It is based on a paradigm or philosophy that denigrates the right to take activist measures to achieve development on the part of less developed countries, thus leading to a radical dilution of their right to “special and differential treatment.” The WTO raises inequality into a principle of decision-making.

The WTO is often promoted as a “rules-based” trading framework that protects the weaker and poorer countries from unilateral actions by the stronger states. The opposite is true: the WTO, like many other multilateral international agreements, is meant to institutionalize and legitimize inequality. Its main purpose is to reduce the tremendous policing costs to the stronger powers that would be involved in disciplining many small countries in a more fluid, less structured international system.

It is not surprising that both the WTO and the IMF are currently mired in a severe crisis of legitimacy. For both are highly centralized, highly unaccountable, highly non-transparent global institutions that seek to subjugate, control, or harness vast swathes of global economic, social, political, and environmental processes to the needs and interests of a global minority of states, elites, and TNCs. The dynamics of such institutions clash with the burgeoning democratic aspirations of peoples, countries, and communities in both the North and the South. The centralizing dynamics of these institutions clash with the efforts of communities and nations to regain control of their fate and achieve a modicum of security by deconcentrating and decentralizing economic and political power. In other words, these are Jurassic institutions in an age of participatory political and economic democracy.

Conclusions
The G20 has emerged as the main group for discussions on the global economy and reforms of the international financial system. The group’s November 2008 summit made a reasonable start, despite its hasty organization. Understandably, the summit focused on actions to arrest the slide in economic activity and get growth restarted. It also seized on the proximate cause of the economic and financial crisis—significant failures in the supervision and regulation of the financial sector in advanced countries—and proposed a credible action plan to begin to address these failures. But the problem of global imbalances was largely ignored.

If the G20 is to prevent similar crises in the future, it will have to reckon with global imbalances and the features in the international financial system that facilitated their growth. If nothing is done, the imbalances will simply build up again as the world economy recovers, and in time they will become a major contributing factor to the next global crisis. Diplomacy through the G20 process is an important opportunity to make the world economy more sound. The reforms of the IMF proposed in this report would help strengthen surveillance and encourage the policy adjustments needed to unwind imbalances. Yet in the end it must be recognized that solutions lie not with any international gathering but with governments. The international system has allowed governments to build up huge balance-of-payments imbalances; the international system will continue to allow them to do so. But the past year or so of crisis demonstrates the difference between doing what may be politically expedient and doing what is sound economic policy. If country authorities do not learn their lessons from the current economic and financial crisis, they will find themselves reliving it.

Endnotes


iii It is not readily apparent why global imbalances were not directly cited as a root cause of the current crisis. The strange phrasing, along with what appears to be a typographical error in the list of underlying factors and a missing reference to the role played by exchange rate policies, would suggest that there was opposition from the Chinese authorities to the inclusion of a reference to global imbalances in the communiqué.
REFERENCES


