13 This time *will* be different? Addressing the unsound post-crisis drivers of global imbalances

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In this chapter, the author urges G20 members to bolster their previously agreed 'framework for strong, sustainable and balanced growth' so that nations adhere to it in good times as well as bad. Washington's goals must be fiscal policies that ensure US economic resilience and compel others to adjust; China needs to be both pressured and co-opted through institutions as well as recognise that cultivating new sources of growth is in its economic and political self-interest.[1]

As the US current account deficit peaked at 6.5% of GDP in 2006, confidence in the US economy was feared to erode and the dollar deemed to fall. However, the 2008-09 crisis was not caused by a "sudden stop" in the US. Instead, as the crisis globalised, money flowed to the US in escape of turbulence elsewhere. While studies on the contribution of the imbalances or any of their drivers to the crisis remain inconclusive, they do not imply that imbalances are necessarily good for the world economy or that they could not perpetrate a crisis of different kind in the future. Policies to contain them could still be warranted.

At their Pittsburgh Summit in September 2009, the G20 committed to the US-sponsored "Framework for strong, sustainable and balanced growth," a concerted effort to contain global imbalances. The Framework builds on the first G20 Summit declaration in November 2008, which blamed both regulatory failures and the drivers of the imbalances ("inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms") for the crisis.[2] Under

1 This article draws on the author's recent contributions to VoxEU.org and on Suominen (forthcoming). The author would like to thank Richard Baldwin and Simon Evenett for constructive comments.

2 The Declaration (G20 2008) states:"During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policymakers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.

"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 disruption."

the Framework, each G20 member is to subject its economic policies to a peer review managed by the IMF, which, in turn, determines whether the member's efforts are "collectively consistent" with global growth goals.

The G20 members will take the first look at their progress on the Framework at their 26-27 June Summit in Canada. The timing is opportune. With trade, credit, and commodity prices recovering, the IMF (2010) recently revised its projections of US current account deficit to 3.3% of GDP in 2010 and 3.4% in 2011. Also UK, Canada, Australia, India, Turkey, France, and southern European nations would run steep trade deficits. The mirroring surplus nations are familiar – China, Japan, emerging East Asia, Germany, and oil producing nations. What are the challenges to keeping the imbalances in check? How to make the Framework work?

Strengthened by the crisis: Unsound drivers of imbalances

National accounts do not need to be balanced, and imbalances do not have to result from distortive or unsustainable policies. Instead, they can reflect cross-national differences in rates of return on capital, propensity to save, and degree of risk.[3] But if imbalances result from distortive regulatory, currency, and/or trade policies, or risking an unruly unwinding, they can, research suggests, impair macroeconomic performance. Cline and Williamson (2009) note that "[L]arge external imbalances can only aggravate not moderate, fragility in the financial system." Besides, regardless of their cause, imbalances sour trade politics: current account deficits are America's historic precursor of protectionism (Bergsten 1981, 2007).

The crisis exacerbated the unhealthy policy drivers of the imbalances – that are discounted in the IMF's imbalance projections. Emerging Asia saw the episode as validating reserve accumulation and is now reaffirming that strategy, even though it diverts investments from, say, infrastructure and education, and although pooling insurance globally would be much more efficient. US debt, ballooning on the back of the crisis-era deficits, is projected to rival the wartime record highs, and will in all likelihood require even more expansive foreign borrowing.

Europe's lackluster growth projections and post-crisis fiscal retrenchment – including Germany's €95 billion austerity measures through 2014 and belt-tightening in UK and southern Europe – re-emphasise US role as the consumer of last resort. Germans also tend to see the global imbalances as a US-China problem, and Berlin appears resolved to reclaim its place as the world's export champion, a drive facilitated by the weak euro (Der Spiegel 2009, Smith 2010).[4]

Meanwhile, China, the main surplus nation, continues catering to export lobbies and prodding state-owned enterprises as tools of political patronage. Neither builds a vibrant services economy or stokes consumer-led growth, and

3 See for example, Blanchard and Milesi-Ferretti (2009) and Kohn (2010).

4 To be sure, adjustment by Berlin would not necessarily significantly reduce global imbalances: even if Germany were to bring its overall trade surplus to zero, US trade deficit would be reduced by a mere 0.2 percentage points (Basasin 2009). But German support for global rebalancing would be useful for persuading China and other surplus nations to adjust.

both compel Beijing to undervalue the renminbi – as does the recent fall of the euro. Japan, battling its deflation, is unlikely to raise taxes or interests rates, let alone emerge as the global growth pole. Emerging Asian nations have scant incentives to revalue their currencies before China and Japan do so. In short, reversion to a policy *status quo ante* in the rest of the world is matched by a game-changer in the US, widened budget deficit.

Game changer: US debt

Dooley, Folkerts-Landau, and Garber (2004) have famously labeled the pre-crisis pattern of global demand as "Bretton Woods II." Imbalances were portrayed as a symbiotic pattern that channeled surplus nation savings to safe and liquid destinations, which, in turn, enjoyed greater availability of credit. US current account deficit in that setting was viewed to be near-permanent, and, as long as fiscal deficits were kept in check, it would also be sustainable.[5] The large pool of less sanguine analysts argued that at 5-6%, US current account deficit would be "unsustainable." At such a point, America was argued to be in for a sudden stop and hard landing – capital flight followed by collapse of the dollar, rise in interest rates, and decline in output. Obstfeld and Rogoff (2004) argued "hard" landing meant more than a 30% drop in the dollar's value.

Bibow (2010) suggests the next regime might be a "Bretton Woods III" where US current account deficits sustain US and global growth, only now fuelled by public rather than private spending. Such a regime would be perilous. Peterson Institute's well-known studies show that even if US annual growth was a decent 2.75% and fiscal deficit "only" 2% of GDP through 2030, US current account deficit would still rise to 4-5% of GDP. Runaway deficits soaring to 10% of GDP by 2030 would widen the imbalances to 5.2% of GDP in 2015, 7.5% in 2020, and a breathtaking 16% in 2030, or 2.5 times the historic 2006 level (Cline 2009). Foreign nations would need to devote over 65% of all their offshore investments to dollar assets, more than double today's figure (Mann 2009).[6] The Institute concludes that the dollar and US economy would probably collapse before such an ominous endpoint.

Granted, America's unique qualities that alleviate the implications of current account deficits are still in place: the dollar is peerless, US financial markets large and liquid, Europe's travails and recent market shakeups have yet again revealed the resilience of US status as the global safe haven. But imbalances now risk growing for the wrong reasons, US debt buildup and persistent policy distortions in Asia.

Indeed, while questions about the implications of the imbalances polarised academia pre-crisis, concerns over the debt in particular are now widely shared among imbalance analysts and international institutions. The IMF (2010),

5 See Dooley, Folkerts-Landau, and Garber (2004) for the term "Bretton Woods II". On the US fiscal deficits, they note that "as USA debts cumulate, US willingness to repay both Asia and Europe comes more naturally onto the radar screen, so the system that was previously stable could run into trouble."

6 For further discussion, see, for example, Bergsten (2009).

seconded by the OECD (2010), stresses the need for fiscal consolidation in advanced nations and openness to capital inflows and exchange rate appreciations in emerging ones. The ECB (2010) sternly warns imbalances "pose a key risk for global macroeconomic and financial stability."

Making the framework work

The task for the G20 is to see the Framework through against this challenging backdrop. Needed are cuts in US budget deficit, commitment by Asians and Germany to stimulate domestic demand, and an end to China's currency mercantilism. The future of the G20 is at stake: how the group deals with the imbalances will be a key barometer of its performance and relevance. Unlike the other items on its agenda – financial regulations, IMF reform, global trade liberalisation, and so on – that will ultimately be dealt with in other forums, the imbalances are and have been the core competence of the G system since its founding in 1973. The collaboration, while grudging, had its successes, most notably the historic Plaza Accord of 1985 among the G5.[7]

Factors behind Plaza are again present: uncertain American demand, sour US trade politics, and a forum that encompasses all actors required for a solution. Positively, a more systematic process than in the 1980s for addressing the issue is in place. Further, besides the US, other main deficit nations should be keen to tackle the issue, and dozens of nations want to see changes in China's trade and currency policies. The G20 agenda is broad enough to provide for bargaining across issues. And unlike just half a decade ago, the US now has a complementary forum, the Strategic and Economic Dialogue, for addressing the issue bilaterally with China, the necessary partner in the balancing act.

However, the surplus nations are unwilling to budge, and Washington's carrots and sticks are in shorter supply than in the past. The surplus nations are not as concerned about the specter of US protectionism as Japan was in the 1980s, and Japan and Germany are perhaps less dependent on US security umbrella than in the past. G20 and the Strategic and Economic Dialogue are hostage to the precarious health of US-China relations. Politics jeopardise the Framework. China is loathe to offer detailed multi-year projections due to the domestic expectations they place on the government, and not all governments

7 The United States was to reign in the budget, Japan to boost private demand through tax reform, and Germany to cut taxes to stimulate its economy. All five were also to intervene in foreign exchange markets to bring down the value of the dollar. To be sure, Germany – Bundesbank in particular – resisted, and Plaza entailed practically no changes to German fiscal or monetary policies. Plaza had an immediate effect. The following day, the dollar fell 4.3 percent against other major currencies; in the next several months, it dropped by more than 30 percent, both thanks to Plaza and because of lower oil prices and flickers of growth in Japan and Europe. See Funabashi (1989), Henning (1994), Meyer et al. (2002), and Cline (2005). Kelin et al. (1991) show that it was indeed Plaza rather than some other factor that compelled governments to adopt policies that changed trade balances.

will necessarily interpret "sustainable" like Washington does – current account deficit no higher than 3.5% of GDP.[8]

To be sure, policy can go only so far.Even the best efforts to tackle the imbalances could be overwhelmed by factors beyond governments' immediate control, such as commodity shocks or exchange rate instability. Conversely, some trends could create an appearance that the Framework worked. For example, low growth in the US and rapid growth in Asia could reduce the imbalances, but such a situation would be sub-optimal for everyone. Concurrent policies, such as stringent financial regulations, could help, but only in the longer-term.

That policy has its limitations does not mean it should not be pursued. The issue and its implications are global, and common responses are required. If each nation instead blindly pursues its own short-term interest, everyone loses at the end. Pushing exports at all costs, the surplus nations could send off rounds of trade protection and only perpetuate the imbalances. Trade barriers and fiscal deficits in the US would be similarly short-sighted and self-defeating.

The Framework is not a tool for shrinking US fiscal gap or changing the surplus nations' political economy equilibria. Nor is it a means to a coordinated exchange rate adjustment. Reforms will inherently have to be made unilaterally. However, by requiring all players to show their hand simultaneously and by implying they synchronise policies, the Framework does lower informational costs and collective action problems. It is a coordination device to overcome a Prisoner's Dilemma in international economic relations.

The Framework is up against a familiar dilemma in international financial affairs: while a binding pact would have bite, the specter of enforcement would preclude countries' buy-in in such a pact to begin with. The odds of the Framework can, however, be fortified through four measures:

- The first is continuity. Rebalancing must be an on-going process rather than a result of agonised, ad hoc Plaza-like watersheds. The G20 leaders and finance ministers need to dedicate a regular time to the imbalances, issue bold language to single out laggards, and provide the IMF adequate resources for its assigned task. Sustained focus is particularly critical in the years ahead, as the G20 agenda is bound to broaden to issues of interest to its diverse membership.
- Progress needs to be measured and lack of it to automatically induce action. The G20 could adopt a "rebalancing trigger", a threshold that if surpassed, would set off concerted action, such as a special finance ministerial or IMF consultation. One such threshold indicator could be six months of US current account deficits: if consistently above 3.5%, it would trigger action. Or, the trigger could be based on a set of indicators that includes the US trade balance.
- The end goal must be structural changes in the surplus economies. Large imbalances will cease no sooner than their leading cause is terminated.

8 The Canada Summit will start providing answers to further pending and potentially problematic questions – whether all G20 members will submit their plans to the IMF, and whether they will dutifully break down their growth projections into the various sub-components (domestic savings, governments spending, investment, and international trade) that allow the Fund to assess the prospects for rebalancing.

Asia's industry mix needs to change and policy bias against services end. While the deficit nations hold little sway over the politics of Chinese industry, they can encourage investment in Asian services industries.[9] Such measures should be met by an Asian quid pro quo: greater market access in the region to US goods, capital, and services. For Asia, adjustment does to need to be economically painful: IMF (2010) finds that countries that have enacted policies to end their current account surpluses have not lost any growth or exports, but gained in employment, capital, and imports.

- Given the global unhappiness with undervalued Chinese and Asian currency policies, exchange rates, even if they are arguably contingent on structural changes, need to be part of the Framework process lest they cloud it. The approach should be multilateralised so as to address the Asian nations that peg their currencies to the renminbi: not only will their actions affect China's policies; a coordinated adjustment across Asia would reduce exports from the region twice as much as an adjustment by China alone (Thorbecke and Smith 2010). A multilateral approach would also help avoid negative fallout on US-China relations.

US Policy

Critically, Washington needs to play by its initiative. Beijing's currency policy has tempted Congress and Paul Krugman (2010) to irresponsibly advocate tariffs against China. Protectionism would be counter-productive. Implying that the US sidesteps the Framework process it has promoted, trade barriers would only undermine the Framework, as well as damage the multilateral trading system America has championed for decades – and so right when steep trade deficits are feared to propel protectionism globally. Instead, the currency issue needs to be handled at the G20, IMF, and Strategic and Economic Dialogue and, if necessary, WTO dispute settlement body.

US fiscal discipline is another pre-requisite to progress. It is necessary for surplus nations' buy-in: fiscal stringency would signal US preparedness to do its share for the Framework, not shift the adjustment burden abroad or exclusively pursue the Obama Administration's export agenda. It would compel others to act: few motivators are as powerful for the surplus nations to re-examine their growth models as a saving America.

Self-restraint is also the simplest means for Washington to counter the loosened fiscal constraint entailed by foreign lending, and provide other nations assurances of US economic health. Cutting the fiscal deficits by 2 percentage points is estimated to lower current account deficits by only 0.6 percentage points (Bartolini and Lahiri 2006). However, fiscal discipline is crucial for fueling private

9 While greater social security benefits could disincentivize Chinese to save, an efficient services sector would incentivize them to spend. The impact could be powerful if combined with financial development. If Chinese savers had access to safe instruments guaranteeing higher rates of return, they would be likelier to spend a larger share of their incomes.

savings, which have rebounded to 5% of US incomes on the back of the past two years of deleveraging. The trade-offs are meager. Any negative effects from reduced public and private spending are consistently offset by greater availability of capital investment (Thornton 2009). Historically, robust investment and economic growth have been sustainable only on the back of domestic saving.

In the past, taxes and spending cuts have been used simultaneously to rein in deficits. Taxes must not curb growth, already because tax revenue hinges on robust growth.[10] Containing the rising cost of health care and reforming Social Security are critical, as are pay-go rules and government exit from the marketplace. President Obama's commission on national debt must think bigger and for the longer haul than stopping at advocating a value added tax.

Conclusion

The challenge to the G20 is the very same one that has confronted each G from the G4 to G5, G7, G8 and, now, G20: implementing internationally agreed macroeconomic policy changes even when they clash with domestic political imperatives. The litmus test for the group's effectiveness in meeting its goals will come as global growth rebounds and the salience of crisis-induced cooperation dissipates. The Framework process needs to be bolstered in order for nations to stick to it also in good times. Imbalances need to be addressed regularly, not only when they grow too large and political to be undone only by a good crisis. Much of the work has to be done at home. Washington's goals must be fiscal policies that ensure US economic resilience and compel others to adjust. China needs to be both pressured and co-opted through institutions – G20, Strategic and Economic Dialogue, and IMF. For its part, Beijing must see that cultivating new sources of growth is in its economic and political self-interest. The magnitude of the potential problem requires nothing less.

10 For a discussion on optimal taxation, see Mankiw et al (2009).

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