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On the (bumpy) road to Seoul

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1. G20 dynamics: is consensus breaking up?

Faced with the threat of global financial meltdown in 2008, G20 countries set aside domestic policy concerns and focused on the shared agenda. But the common front formed at the height of the global financial crisis seems to have crumbled amid escalating currency frictions following the Toronto Summit in June 2010.

With global rebalancing yet to be achieved and countries recovering at very different speeds, there is growing concern that the recent spats on exchange rates may blow up into a currency war. The increasing tensions about undervaluation of emerging market currencies and the ultra-loose monetary policies in the US and other developed countries are driving an edge between emerging and rich world and denting the credibility of the G20 process.

If there is no progress in the upcoming Seoul Summit to mend the cracks in the G20, the group runs the risk of becoming irrelevant. With that in mind, G20 central bank governors and finance ministers met for two days in Gyeongju (South Korea) in late October to prepare the agenda for the Seoul Summit and attempt, with some success, to pull their countries together.

[1] Written with information available until November 3, 2010.

2. The key G20 themes

Behind the lack of consensus among G20 countries on key items of their agenda are not only divergent national interests but also distinct views of the world. Disagreements over exit strategies and the implementation of financial sector reform prevented common action on these fronts at the Toronto Summit. Meanwhile, China's decision to drop the dollar peg and allow more exchange rate flexibility succeeded in keeping the Yuan undervaluation off the table without solving the global imbalances problem—the Yuan has barely moved since then, leading to increasing multilateral pressure on China.

The standoff over the role of exchange rates in unwinding global imbalances gained momentum during last summer and was the hot topic in the Annual Meetings of the IMF and World Bank in early October. Despite intensive debate, little progress was made during the meetings to allay rising concerns that current tensions could lead to a round of competitive devaluations and trade protectionism, and even a 1930-style depression. These themes dominated the discussions during the Gyeongju meetings (October 22-23), together with IMF quota and governance reform, while decisions about financial sector reform were put off until the November Summit.

a. Recovery and global imbalances

The debate on global imbalances has two related dimensions: (i) how to respond to the sluggish growth that has characterized the recovery process in the developed world (and avoid the buildup of asset bubbles in emerging markets); and (ii) how to boost savings in countries with persistent current account deficits and raise consumption in countries with persistent surpluses.

i. 'Austerity vs. stimulus' debate

The general concern is that the recovery in developed countries is losing steam. But despite the shared fear of deflation, there is no agreement among G20 countries on the appropriate policy response, in particular how to achieve fiscal consolidation without undermining the fragile recovery. While G20 leaders endorsed the use of fiscal stimulus to offset lower private demand during the London Summit in April 2009, the Toronto Summit Communiqué (June 2010) called for fiscal consolidation, albeit at different pace among G20 members. The change in mood reflected the sharp market reaction to the Greek crisis in the last spring, but also some evidence of a global recovery, with emerging economies acting as engines of growth.

The issue of austerity vs. stimulus has elicited vigorous and lively debate. However, the numerous attacks and defenses of Keynesian policies proved inconclusive, without tangible progress on developing a more appropriate paradigm to address current challenges. In practice, there is a transatlantic divergence on how to boost growth, with the US continuing to ignore the need for long-term fiscal consolidation, while much of Europe is pushing for instant belt-tightening. Emerging markets, growing at a much faster clip, continue to urge rich countries to avoid premature withdrawal of fiscal stimulus, while firmly opposing their accommodative monetary policies, which risk creating asset bubbles in the emerging world.

ii. Current account imbalances

The US and China are the main protagonists in the dispute about current account imbalances, with emerging markets squeezed in the middle. The key issue here is lack of agreement on the role of exchange rates in rebalancing global demand. In the current fragile economic environment, countries are tempted to use exports as engines of growth, and therefore want to avoid any strengthening of their currencies. The rub, of course, is that it is not possible for all countries to export their way out of the recession, creating the potential for competitive devaluations.

The stage is set for confrontation and stalemate. The main culprit in the global scene is China and its unwillingness to let the Yuan appreciate. At the same time, the US is increasingly relying on lax monetary policy to boost domestic demand, in what can be viewed as an indirect manipulation of the dollar. The excess liquidity generated in the process is flowing into emerging markets in search of higher yields, putting downward pressure in their currencies. Emerging markets have responded to these destabilizing inflows with currency intervention and capital controls. These currency tensions intensified when trade data for August showed a rising US deficit (with a surge in imports from China) and the US Federal Reserve signaled its intention to engage in another round of quantitative easing (printing money to buy long-term government bonds).

G20 countries tend to frame the global imbalances problem differently, according to their own interests:

- The US blames the artificially undervalued Yuan for its current account deficit, pointing out that China's exchange rate policy is leading to competitive non-appreciation and excessive (i.e., non-precautionary) reserve accumulation in other emerging countries. The US strategy has shifted from direct confrontation to attempts to escalate international pressure on China to take on its global responsibilities (as the world's second largest economy) and avoid creating global distortions. With US unemployment rate stubbornly high, pressure for adopting legislation targeting the Yuan has risen in Congress, but the US recently avoided—once again—labeling China a currency manipulator.[2]

- With the Yuan's weakness threatening European recovery, EU countries have joined the US chorus in calling for Yuan appreciation, stepping up pressure on China.

[2] A bill allowing US firms to request countervailing tariffs in cases of undervalued currencies passed the House of Representatives in mid-September.

- China blames the US and other rich countries for running an ultra-loose monetary policy and causing distortions in emerging markets. At the same time, it accuses the US congress of being politically motivated in its attempts to impose currency import tariffs on Chinese goods, pointing out that what's behind the gaping US current account and fiscal deficits are expansionary fiscal/monetary policies, not the undervalued Yuan. More generally, China continues to signal preference for a gradual revaluation, claiming that a large appreciation would cause severe job losses and lead to social upheaval, as the small profit margins of Chinese exports would get wiped out.

- Emerging markets are caught in the tug-of-war between the US and China, blaming both for their loss of competitiveness and for the flood of foreign exchange swamping their economies. In an effort to curb destabilizing capital inflows, Brazil, Thailand, and Indonesia have introduced capital controls recently, signaling a lack of confidence in a multilateral resolution for ongoing currency tensions.

The IMF is urging increased cooperation to avoid derailing the recovery process, pointing out that global rebalancing involves more than a free float of the Yuan. Shrinking the current trade imbalances requires a broad set of policy measures both in countries running large and persistent surpluses and those running large and persistent deficits. Given policy spillovers, rebalancing of global demand requires a cooperative effort.

Fearing the consequences of the growing doubts about the group's ability to deal effectively with global economic issues, G20 finance ministers agreed in Gyeongju that a currency coordination framework was needed to prevent currency disputes from escalating into trade wars. While they settled on the overall objective, there was no agreement on how to move forward, notwithstanding US attempts to establish more concrete targets on the underlying factors behind undervalued exchange rates.

In a change of tactics, the US proposed setting a numerical cap (4 percent of GDP) on countries' current account balance (deficit or surplus), beyond which policy action would be required. This move shifted the debate away from exchange rates adjustments and toward the broader set of policies needed for rebalancing. Although the proposal injected some momentum into the discussions, it was met with resistance from major exporters such as Germany and Japan, and a non-commital attitude from China. In the event, in their final communiqué, G20 ministers only pledged to "move towards more market determined exchange rate systems that reflect underlying economic fundamentals and refrain from competitive devaluation of currencies".[3] The quantitative guidelines to assess the persistently large imbalances would need to be agreed at a later stage, and should take into account country-specific circumstances, in particular the needs of large commodity exporters.[4]

The IMF was given a central role in monitoring whether G20 countries meet their commitments. As part of its contribution to the Mutual Assessment Process, the IMF was tasked with monitoring progress with assessments of sustainability and of the consistency of policies. The G20 also endorsed the IMF's proposal of strengthening surveillance through the monitoring of policy spillovers of major systemic countries. Since the IMF (much as the G20 itself) lacks binding authority, there is some skepticism about the chances of success of the new initiative, especially since past attempts at multilateral coordination have failed.

[3] See Gyeongju Communiqué (http://www.treas.gov/press/releases/tg919.htm).
[4] The US proposal would make an exception for "structurally large exporters of raw materials", which in practice meant the 4 percent cap would apply to Germany and China, which would be expected to take action to boost demand in order to reduce their surpluses.

b. IMF Reform

A critical agreement on IMF quota and governance reform was finally reached (somewhat surprisingly) during the Gyeongju meetings. The breakthrough followed months of foot-dragging and an impasse over IMF Board composition in the run-up to the Annual Meetings.

During the Pittsburg Summit in September 2009, the G20 agreed to bolster the IMF's legitimacy by increasing the voice and representation of developing and emerging countries. The specific commitment was to shift the quota distribution from developed to emerging/developing countries by at least 5 percentage points. For months, the US had been pressing European countries to give up some of their seats at the IMF Executive Board in order to make room for emerging countries. Finally, to force a move by the Europeans, the US used a procedural maneuver last August, blocking a vote needed to maintain the IMF Board in its current 24-seat form.

The impasse persisted until the Gyeongju meetings, when finance ministers agreed on a set of reform proposals to overhaul the IMF governance structure. According to the proposals:

- The IMF's $340bn quotas will be doubled;
- Over 6 percent of IMF voting power will be transferred to emerging market and developing countries, while Europe will give up two seats (and the US will retain its veto power);
- The Executive Board will keep its current size, with all 24 directors elected rather than appointed.[5]

[5] Currently, the countries with five largest quotas (US, Japan, Germany, France, and the UK) have permanent seats (and appointed directors), while the remaining 19 chairs are elected by constituencies of countries.

This better-than-expected result ensures that the so-called “dynamic emerging market countries”, including Brazil, China, India, and Russia, will be among the top 10 shareholders of the IMF. The European concession has been interpreted as the price to pay to reach a deal on IMF’s reform and thus meet China’s key condition for moving toward a more flexible exchange rate system.[6] After Executive Board reshuffling, China will hold the third largest quota share.

The changes to IMF governance structure, hailed as ‘historic’ by the IMF, still need to be ratified by the Executive Board, and will become effective only around the time of the 2012 Annual Meetings. Not until then will it become clear which advanced European countries will lose their seat.

[6] See Oxford Analytica brief: “G20 Boosts IMF Global Stability Role” (October 26, 2010).

3. Agenda for Seoul Summit (November 11-12)

As confidence in multilateral solutions to global imbalances decline, the G20 has called for renewed efforts at cooperation ahead of the Seoul Summit. The agenda for the heads of state meeting is expected to focus on global policy coordination and financial sector reform, but also cover the Korean initiative on global safety nets. And the proposals for IMF quota and governance reform will need to be endorsed.

Global imbalances

While G20 representatives were able to display a show of unity during the Gyeongju meetings, they failed to deliver on concrete policy actions to rein in the imbalances. There is clearly a lot of work to do to bring China and other emerging countries onboard to support global rebalancing. On the other hand, the impact of US monetary policy on emerging markets, already flagged in the Gyeongju communiqué, will also need to be tackled, following a string of unilateral actions by the affected countries that put the credibility of the G20 process at risk.

Financial sector reform

During the Seoul Summit, G20 leaders are expected to endorse a revamped regulatory system—one of the pillars of the financial sector reform agenda. It is generally agreed that the new bank capital and liquidity standards developed by the Basel Committee, known as Basel III, represent an improvement in the quality and quantity of bank capital. However, critics have claimed that Basel III rules have been watered down significantly since the draft phase, following intense bank lobbying. One of the criticisms of the new rules is that they allow a long phase-in period for some of the requirements. For example, the short-term liquidity requirements will not kick in completely until 2015, while the new

capital requirements will become fully effective by 2019. In addition, since the new requirements only apply to a subset of the financial system, they may not be sufficient to prevent another financial crisis.

As part of post-crisis effort to impose worldwide rules to reduce risk, the Financial Stability Board had been tasked by the G20 to come up with a plan to tighten supervision of systematically important financial institutions. This additional pillar of the G20 agenda involved the creation of a global mechanism to wind down financial institutions deemed 'too big to fail' without the disruption caused by Lehman Brothers' collapse in 2008. However, divisions among European and US regulators on how to design the new package of capital surcharges and other safety measures have marred the conclusion of the discussions. While G20 leaders had hoped to endorse the final package during the Seoul Summit, it is now clear that international financial regulators will not provide a concrete set of recommendations until mid-2011. This delay is yet another disappointment on the feasibility of multilateral solutions, and increases the risk of unilateral initiatives that could lead to regulatory arbitrage.

Global financial safety net

South Korea is keen on discussing the creation of a global financial safety net, coordinated by the IMF. The new framework would pull together global and regional funds with a view to avoiding the need for the accumulation of large foreign exchange reserves by emerging economies. The expectation is that this would ensure that future crises are better managed, reducing the need for emergency responses.

4. The challenges for the BICs (Brazil, India, and China)

The BICs continue to face multiple challenges as they assert their positions in a changing world. While leading the global recovery, they face growing risks of overheating as they try to unwind their crisis-related fiscal stimulus and struggle to manage increasing capital inflows.

When it comes to the key G20 themes, the three countries are united in pressing for reform of quotas, voice, and governance at the IMF, but split in their views on the role of exchange rate policy in curbing global imbalances. This is consistent with their different circumstances within the G20 group. While all three countries are clear winners of the IMF reform, their divergent current account positions place them in opposite sides of the currency debate. According to a recent IMF classification of G20 countries ahead of the Seoul Summit, Brazil and India belong to the same group (emerging deficit countries), while China is classified as an emerging market with a current account surplus.

The persistent depreciation of the US dollar has added to the growing international pressure on China to take action to help rebalance the global economy. China's commitment to boost domestic demand in its latest draft 5-year plan is a positive step in this direction. Moreover, after a muted reaction in Gyeongju, China seems to have warmed up to the US proposal for the adoption of numerical targets on current account balances. But while the broadening of the debate away from a narrow focus on the Yuan has increased the probability of securing China's support for some version of the US proposal, it is far from clear that the Summit will produce concrete guidelines.

India tends to watch the current tensions from the sidelines, but has recently called for renewed G20 efforts to bridge the worrisome gap between developed and developing worlds. Finding common ground with China continues to be a

challenge, however, as the world's largest democracy seems troubled with China's increasing assertiveness in South-east Asia. The two Asian giants have still to settle ongoing disputes over borders in the Himalayan region and over their current trade imbalances—with hefty surpluses in China's favor. Although India's task to balance the competing objectives of curbing inflation and managing the exchange rate is increasingly difficult, it does not support the imposition of numerical targets on current account surpluses and deficits to rebalance trade.

Brazil has also been deeply affected by China's undervalued currency and the depreciating dollar. To mitigate the impact of destabilizing inflows, the central bank of Brazil has intervened in the foreign exchange market and raised the tax on foreign investments in fixed-income securities twice recently. As other emerging markets, Brazil is braced for a fresh inflow of capital following the recent decision by the FED to engage on another round of quantitative easing, and has become more vocal in arguing for action from both China and the US. To inject more transparency into the forthcoming debate in Seoul, Brazil is considering proposing the adoption of a "currency manipulation index". The index, to be designed by the IMF, would provide a measure of currency undervaluation that could be eventually used to support sanctions by the World Trade Organization.