G20 needs to drive the adjustment process
Stephen Grenville
The Australian Financial Review
14 September 2009
P. 20

The global financial crisis has altered the structure of the external imbalances problem, but has not removed the need for policy to assist in the adjustment process. The forthcoming leaders' meeting of the Group of 20 major economies in Pittsburgh provides a chance to take the issues forward.

Before the crisis, the problem was seen largely in bilateral terms. America's huge external deficit (reflecting a household saving rate of close to zero) was juxtaposed against China's counterpart surplus (reflecting excess saving and an export-promoting exchange rate policy). China's de facto fixed exchange was blamed, with the strong suggestion that a 15-25 per cent appreciation in its currency was both necessary and probably sufficient to fix the problem.

Now the US external deficit is running at half its peak rate and is forecast to go lower. With US consumption no longer spurred on by the euphoria of asset price increases, households have dramatically altered their saving behaviour, returning the saving rate close to traditional levels.

This doesn't mean the problem has gone away. Rather, it has changed form. America's principal imbalance is now a domestic one: its budget deficit is running at 12 per cent of gross domestic product. This huge deficit is needed to maintain macro balance and avoid an even larger rise in unemployment, already close to 10 per cent.

Such a deficit is unsustainable because it relies on foreign capital to fund the growing stock of government debt. If foreign investors become nervous about their holdings of US government debt, the bond market will administer a sharp rise in interest rates to a weak economy.

This presents an acute problem of transition. Central to a longer-term solution will be a redeployment of US production towards net exports (either exports or import substitution).

A substantial shift in international competitiveness would help bring this about. But to do this through a fall in the exchange rate risks scaring foreign investors who are vital to the near-term funding of the external and internal deficits (current account and budget).

To make things worse, some of these foreign investors will be wary about US inflation, knowing that historically governments are tempted to use inflation to erode the sort of big official debt burden that awaits the US.

The safe path of adjustment is a narrow one. The US has to maintain its budget deficit while retaining confidence in the bond market by promising to reduce the deficit. It needs a lower (more competitive) exchange rate, but it doesn't want a falling currency to spook foreign investors, still vital to fund the twin deficits and maintain their existing debt holdings.

In theory, financial markets should be able to bring about this sort of adjustment smoothly. But the past year has shaken faith in the market's ability to do this.

It might be time to return to a policy approach neglected for more than two decades: some modest international policy co-ordination.

Last time the US went through a similar external adjustment in the mid-1980s, one element of the approach was the Plaza Accord (1985) and Louvre Accord (1987), both aimed at smoothly steering the dollar to a more competitive level.

The contemporary counterpart to these old agreements could be more ambitious. Instead of the head-butting bilateral discussions of recent years to try to persuade the Chinese to appreciate the yuan, the more productive approach might be to craft a package of measures that can offer net advantages to each of the main players. For the US, a key benefit might be international support for a smooth adjustment path for its exchange rate (which involves assuring continued funding of its twin deficits). To persuade China to co-operate, the carrot might be some protection against heavy capital losses on its foreign exchange reserves held in US dollars.

A more balanced debate would put less emphasis on dismantling China's hugely successful export-oriented strategies and more emphasis on reaping further gains from globalisation. External surpluses can be reduced by expanding imports rather than discouraging exports. China's surplus savings, currently flowing "uphill" to the mature investment markets of the US, could over time be channelled to the potentially higher-return investment opportunities in other East Asian countries if the financial infrastructure were more developed. The international institutions (World Bank, International Monetary Fund and Asian Development Bank) could facilitate this.

Such a package could have more broadly based political-economy components. China has a legitimate claim to much more influence in international discussions (it now has the same voting rights in the IMF as Belgium).

Almost all of the old Group of Seven countries are facing serious structural financial problems which will take years to resolve and sap growth in the meantime. The result will be a two-speed world, with many of the emerging countries ready to go forward at their normal energetic pace. China will be in the forefront of this group of countries, looking for recognition that power is shifting away from a US-dominated unipolar world.

The G20 leaders' meeting (itself a product of the global financial crisis) is a good place to discuss these issues. At the London G20 meeting in April, China showed its willingness to engage in discussion of external imbalances and even exchange rates.

Much more will be required to put together a package of measures that offer a balance of advantages for the main participants (especially the US, with its reputation for disliking multilateral policy co-ordination). Multilateral discussions can do no more than articulate some broad objectives, sharpen the analytical issues and set out the menu of policy measures. Specific implementation requires bilateral negotiation away from the glare of publicity.

But the starting point is to recognise the vulnerability of the current economic conjuncture. There are enough dangers in an unmanaged market-driven adjustment process to justify making this a key agenda item at G20.

Stephen Grenville is a visiting fellow at the Lowy Institute for International Policy and a former deputy governor at the Reserve Bank of Australia. The full paper is available on the Lowy Institute website.