

INTERNATIONAL FINANCIAL IMBALANCES AND GLOBAL GOVERNANCE

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The world economy is presently characterized by very large payments imbalances. While the US runs enormous current account deficits, other regions of the world – most notably East Asia and oil producing countries – rack up very large surpluses.

We have been here before. During the late 1960s, the late 1970s and the mid-1980s, the US also experienced very large trade deficits that were associated with rising protectionist pressures, currency instability, and international political tensions. As these phenomena resurface today, the problem of international financial imbalances has once again become a central one for policymakers around the world.

To tackle this issue today, innovations in global governance will be required because of three unique features of the current situation: the distinct geography of contemporary imbalances, the fragility of the dollar's position as world currency, and the growing influence of sovereign wealth funds. The most promising innovations at this moment would be the following:

- a widening of the G8
- the creation of a substitution account to ease the selling of official dollar reserves
- greater recognition of the role of regions in global financial governance
- new multilateral rules for investment flows

The New Geography of International Financial Imbalances

In the past, the G7 countries played the central role in addressing international financial imbalances. Indeed, the emergence and evolution of the G7 as a key entity in global governance was closely connected with the problem of such imbalances. The G7/8 cannot play a useful role today because of the new geography of international financial imbalances. While the US remains the central deficit country, the countries accumulating large surpluses have mostly been non-G8 countries (excepting Japan and Russia).

The most dramatic symbol of the new surpluses has been the explosive growth of China's official reserves. Since the mid-1990s, China's share of international reserves has risen from a mere 5% to over 25% today, with a total value of over \$1.8 trillion. Without China's presence, international negotiations to address international financial imbalances are meaningless. Other non-G8 countries that have accumulated significant reserves recently include India, Brazil, Saudi Arabia and other members of the Gulf Cooperation Council, as well as a number of other East Asian exporters such as Hong Kong, Singapore, South Korea, and Taiwan. To address financial imbalances today, a forum wider than the G8 is clearly needed where deficit and surplus countries can discuss issues relating to both the ongoing financing of the imbalances and the adjustments necessary to correct them (particularly given the collective action problems that can plague both of these activities).

The IMF's near-universal membership and overall mandate make it an obvious possible candidate. But that institution's ability to play a major role in the governance of contemporary international financial imbalances is undermined by distrust of this Western-controlled institution among many "Southern" countries, particularly since the 1997-98 East Asian financial crisis. This distrust is in fact one of the central reasons why many of these countries – especially in East Asia and Latin America - have been trying to accumulate reserves over the past decade. The institution's advice during the 1997-98 crisis was widely seen as unhelpful, too intrusive, and overly influenced by US policymakers' goals. Policymakers in these countries have preferred to self-insure against balance of payments crises rather than rely on an institution with this record.

A more promising forum might be the G20 grouping of finance ministers and central bankers which was created in the wake of the East Asian crisis to extend the informal network-based G7/8 form of governance to a wider group of "systemically important" countries. The G20 is fairly well suited to match the new geography of international financial imbalances since its membership includes most of the key surplus countries today. Because it is restricted to financial officials, however, the G20 concept is not as effective as it could be if it was extended to include leaders of these countries. To date, the G20 has largely followed the G7 line; distinctive ideas emanating from non-G7 members have had relatively little influence, especially when they might impose costs on G7 governments or firms. Integrating the G20 with a broader L20 leaders meeting might give more political weight to the voice of non-G7 members.

A reform of this kind may be particularly important for discussions concerning the financing of, and adjustment to, international financial imbalances. In the past, such discussions have often become closely intertwined with broader political - even military - issues that are well outside the jurisdiction of financial officials. These linkages to high politics are even more likely to be drawn today since the key imbalances no longer exist exclusively among countries that are bound together by a military alliance, as they were during the 1970s and 1980s. It is difficult for, say, US and Chinese financial officials to insulate their negotiations on imbalances from larger strategic issues in the two countries' relationship.

The L20 proposal is more ambitious than other reforms being touted at the moment, most notably the expansion of the G8 to a G13. It has the greater virtue, however, of including at least one country – Saudi Arabia – from one of the major surplus regions of the world: the Gulf. The L20's broader membership also enables greater representation for those who are not major deficit or surplus countries but will be vulnerable to the macroeconomic impact of decisions addressing global imbalances. This latter goal would be even better served if both the G20 and L20 were expanded to include representatives from a "Southern" country grouping such as the G24 (which brings together official developing country viewpoints on monetary and financial issues), much as the G20 already includes a representative from the European Union as one of its twenty members. As I will note below, both groupings might also function more effectively if their membership was consolidated along some regional lines.

The Fragility of the Dollar's Position as World Currency

Although the G7 played a role in addressing large international financial imbalances during the

1970s and 1980s, the dominant actor was the United States. The dollar's role as world currency provided the US with a unique power in macroeconomic diplomacy. It enabled the US to delay adjustments as foreigners financed its current account deficit through dollar holdings. Then, when adjustments were required, a falling dollar allowed the US to deflect much of the adjustment burden to other countries. International financial imbalances were governed, in other words, as much – if not more – by US hegemony than the networked forms of governance embodied in the G7 process.

The dollar's position as the dominant world currency today is more precarious than at any time in the postwar period. The creation of the euro has provided foreigners with an alternative currency in which to hold their assets and conduct their international business. Although scholars debate how quickly the euro will become a major international currency, few disagree with the view that the dollar's preeminent position will be diminished, at least somewhat, by the euro in coming years.

Foreign confidence in the dollar has been shaken by the growth of US current account deficits and external debt, the currency's rapid depreciation vis-à-vis the euro since 2002, and the recent severe instability in US financial markets. As private investors have reduced their support for the dollar, foreign monetary authorities have filled the gap, but their support is far from secure. Foreign governments have become increasingly frustrated with the losses they are experiencing on dollar holdings. The lowering of US interest rates in the context of 2007-08 financial crisis has also lessened the attractiveness of US Treasury bills as a reserve asset, while at the same time bolstering the risk of imported inflation for countries whose currencies are linked to the dollar. If foreign holding of dollars has been driven – as some suggest - by a desire to secure access to the US market, this benefit is diminishing with the US economic slowdown, changing trade patterns, and US protectionist pressures.

In this context, the dollar's status as the dominant world currency has become less secure. International currencies are sustained in part by a kind of inertia; people continue to use a specific currency because other people use it. If there was a sudden change of market and/or official expectations, a 'tipping point' could be reached where foreign support for the dollar's international role unraveled quite quickly. Dollar crises in the past – recall 1971, 1978-9, 1987 - have been associated with worldwide instability. The risk of a repeat on an even larger scale must be taken seriously.

To minimize this risk, it would be helpful if a mechanism could be developed to enable foreign governments to diversify their reserves away from dollars without generating a major dollar crisis. Precisely such a mechanism was negotiated in 1978-80 by top G5 policymakers, with the strong support of top US and IMF officials. Under this proposal, foreign governments would have been allowed to deposit dollars in a special "substitution account" at the IMF and be credited in certificates denominated in the IMF's currency: SDRs (whose value is made up of a weighted basket of the world's leading currencies). Because this exchange was off-market, foreign governments would have been able to diversify their assets without undermining the value of the US dollar.

Of course, there would have been some costs. Although SDRs could be used by foreign governments to pay for future balance of payments deficits or transfer to other governments, assets denominated in this currency are less liquid than those in dollars. The account also risked losing money if the dollar fell since its liabilities were denominated in SDRs whereas its assets were dollar-denominated US Treasury bills. US efforts to shift this exchange rate risk to the IMF – by asking the Fund to back the account with its gold holdings – ultimately complicated the negotiations. When the dollar rose sharply after US monetary policy tightened dramatically in 1979, the issue left the global public policy agenda.

Proposals for a substitution account deserve to be considered again today. Prominent US economists such as Fred Bergsten (who was involved in the 1978-80 discussions) have raised the idea and some analysts suggest that large foreign dollar holders such as China might be open to discussing it. Given the lack of enthusiasm for the IMF among many dollar-holding governments today, a less ambitious version might stand a better chance of being implemented at this moment.

As Peter Kenen has suggested, the European Central Bank (ECB) could create a special facility that bought dollars from other central banks in exchange for newly-issued, off-market, *euro* instruments. This proposal would enable the ECB to minimize the risk of a dollar sell off generating a further appreciation of the euro, while boosting the euro's international role. The proposal might be more attractive to European officials if they could negotiate with the US to share the exchange rate risk involved by exchanging some portion of the US Treasury bills they purchase for special euro-denominated US T-bills. As the economists Pietro Alessandrini and Michele Fratianni have recently argued, other variations on this idea could involve the creation of a joint facility by the ECB and US Federal Reserve to issue a new supranational bank money.

These proposals would facilitate a more orderly shift away from the dollar-centred international monetary order. Equally important are reforms that enable macroeconomic diplomacy to function more effectively in the more decentralized monetary environment being ushered in. A top priority should be the task of consolidating the external representation of the eurozone. As the euro becomes a more important international currency, the eurozone's finance ministers need to give more authority to the informal "eurogroup" and its president to speak for the region in the G8, IMF and elsewhere. This reform might enable the eurozone to diminish the ambiguity over euro exchange rate policy, a policy that is formally shared between finance ministers (who are supposed to set its general orientation) and the ECB (which conducts currency intervention). By accepting one seat in the IMF, the eurozone would also support efforts to reform the IMF's governance to be more inclusive of emerging economies.

Europe is not the only part of the world where regionalization trends in the monetary and financial realm are accelerating. The countries of Gulf Cooperation Council are planning a monetary union by 2010. East Asian countries have been multilateralizing the system of bilateral swap arrangements they have been building since 2000, while at the same time developing an Asian currency unit and Asian Bond Fund in order to reduce dependence on the dollar and US financial markets. South American countries are also strengthening the regional provision of balance of payments financing. As these initiatives accelerate, efforts should be made to incorporate representatives from these emerging regions within global financial governance structures.

These regionalization initiatives also strengthen the case for greater pluralism and decentralization in international financial and monetary governance. The development of policy that is distinct from the universalistic claims of the Washington Consensus is a central objective of many of the initiatives. This objective extends beyond issues relating to international financial imbalances, as Japan's recent proposal for an Asian version of the Financial Stability Forum suggests. This trend also bolsters the case for greater representation of regions within global financial governance.

The New Influence of Sovereign Wealth Funds

The governance of international financial imbalances must adjust to one further change in the global economic landscape: the rapid growth of sovereign wealth funds (SWFs). In the past, payments surpluses were usually recycled to deficit countries via private financial flows or official purchases of safe, highly liquid international reserve assets. In the last few years, in order to earn higher returns, many surplus countries have begun to move some of their reserves into funds which invest much more aggressively in higher risk assets, ranging from equities to real estate.

These sovereign wealth funds have now become significant players in world financial markets, with assets of approximately \$3 trillion (up from \$500 billion in 1990). This sum is larger than the entire hedge fund industry and their size is projected to continue to grow rapidly in the coming years. The largest funds are those of Abu Dhabi, Kuwait, Singapore, Norway, Russia and China, but over three dozen other funds now exist and more are being created each year.

As SWFs have invested in strategic sectors such as banking and high technology, concerns have been raised in "Northern" countries receiving these investments. Many Northern analysts and policymakers have wondered whether these investments might be designed to bolster the national champions or the political and strategic goals of these governments. These concerns have generated protectionist calls for restrictions on SWF investments, restrictions that would not just antagonize surplus countries but also inhibit the role that SWFs play in recycling of payments surpluses.

In order to minimize such political reactions, analysts Michael Bordo and Harold James have wondered whether the IMF should take on the role of an active asset manager, investing funds on behalf of SWFs. This proposal would require a rebalancing of votes in the Fund; they suggest that as much as 50% of IMF votes could be determined by the size of reserve assets placed in the IMF for this kind of active management. If surplus countries had misgivings about the IMF, they could also consider the creation of a new international institution to perform a similar function.

Most attention at the moment, however, has focused on the creation of a set of multilateral rules to govern international investment flows involving SWFs that might ease the concerns both the countries with SWFs and those hosting SWF investments. Reaching consensus on effective rules will be a difficult task; past initiatives to create worldwide rules for investment flows involving countries of both North and South have failed. While Northern governments pressed for provisions relating to national treatment and non-

discrimination for their multinational firms, Southern governments raised concerns about sovereignty and sought tougher regulations over the activities of those same multinationals. The deadlock at the multilateral level has left investment flows governed by an uneven patchwork of unilateral, bilateral and regional rules.

Initial IMF-led discussions concerning rules for SWF investments have revealed North-South divisions once again. But the roles are now reversed. Northern governments are raising the concerns about sovereignty and seeking to force greater transparency on the activities of SWFs. Southern governments, by contrast, are pushing for guarantees that the investments of their SWFs remain unrestricted and treated in a non-discriminatory manner. The result will most likely be a toothless voluntary code of conduct.

The impasse brings to mind US President Eisenhower's advice: if a problem cannot be solved, enlarge it. Given the role reversals, the most promising way to reach an effective multilateral agreement on SWF investments might be to widen the negotiation to address international investment rules more generally. The room for tradeoffs should be considerable.

The negotiation of such multilateral rules could also be used as an opportunity to promote global priorities in creative ways. SWFs could be encouraged to embrace international codes of conduct relating to social and environmental responsibility in their investing, just as many large multinational corporations have been asked to do. SWFs could also be requested to invest a small portion of their funds – World Bank President Robert Zoellick has suggested 1% - in projects relating to development or other global goals, again echoing some recent calls vis-à-vis major multinational corporations.

Concerns about their global public image may encourage SWFs to embrace these kinds of commitments. But these initiatives could also be promoted on the ground that the accumulation of large balance of payments surpluses should be accompanied by certain international responsibilities – a principle that Keynes tried to implement, albeit in a different way, at Bretton Woods.