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THE GLOBAL ECONOMY: FINDING COMMON GROUND BETWEEN NATIONAL INTERESTS AND GLOBAL STABILITY

DANIEL SCHWANEN

KEY POINTS

- Global economic rebalancing cannot just be about adjusting the value of one currency — countries must make deeper structural commitments.
- While there is significant overlap between the domestic long-term interests of the G20 countries and the good of the global economy, implementing necessary long-term reform in each country is difficult — the G20 could support each other through this reform process.
- Important commitments can and should be taken now by the G20, but a framework for understanding interdependencies is required to identify when cooperation is needed and when it requires actual policy coordination.

With the G20 in agreement that fiscal stimulus will shift to fiscal consolidation over the medium term, the question of how to address the risk of another downturn in global demand will be on everyone's mind during the G20 summit in Seoul.

In this context, there has been a recent focus on the risk that currency market swings could result in competitive devaluations and protectionist measures. Such actions could deal a serious blow to the hope for a strengthening global economy. In response, many commentators have again called on China to revalue its currency by allowing for more exchange rate flexibility.

Others point to the likelihood that the United States will undertake additional monetary stimulus by engaging in further quantitative easing — printing money to buy securities — which, by its nature, injects a significant amount of US dollars into the global economy, thereby putting downward pressure on the US dollar. With the yuan still effectively tied to the US dollar, this translates into upward pressure on the currencies of many other countries. These countries, in turn, worry about the negative impact on their competitiveness.

The less-than-successful results of past attempts at "rebalancing" trade and capital flows through exchange rate intervention, such as the Plaza and Louvre accords of 1985 and 1987, rather than by better recognizing and addressing the fundamental reasons for growth-threatening imbalances, should afford a considerable note of caution about any single-minded focus on the nominal exchange rate values of the yuan or the dollar at the G20 summit.

This history underscores the essential need, which G20 finance ministers and central bank governors affirmed in October, for cooperation in addressing the continued

Daniel Schwanen is special advisor, programs, to the executive director at CIGI.

fragility of the global economy because of the high degree of interdependence among economies. It also makes clear that the G20 needs to look well beyond nominal exchange rate misalignments if it is to achieve its goals under the G20 Framework for Strong, Sustainable and Balanced Growth, established at the Pittsburgh summit.

In the absence of a clear and accepted analytical framework for understanding the nature of interdependencies and spillovers, we do not know when cooperation, which can range from informal arrangements such as consultation and exchange of information to more formal mechanisms such as the G20 mutual assessments, needs to evolve into more formal coordination of policies. Effective cooperation and coordination of policies must be based on a better understanding of policy interactions, if a mutually determined set of multilateral objectives is to be realized. Mechanisms to follow-up on commitments are also needed.

Even with the current absence of an agreed and comprehensive analytical framework, there is still a great deal that G20 countries can do to assume their responsibility, agreed to in Pittsburgh, for the health of the global economy. This is because national interests often coincide with the collective interest, something the G20 needs to emphasize and exploit more strongly in Seoul.

For example, given the circumstances today, there is little disagreement about the fact that monetary policy in both the US and Japan needs to keep the threat of deflation at bay, while China needs to prevent inflationary bubbles and pressures more generally. These priorities would normally result in market pressures towards an appreciation of the yuan vis-à-vis the dollar and the yen.

Countering these pressures by limiting the flexibility of the yuan, Chinese authorities will either gradually import what they do not want — reflationary US monetary policy — or continue to aggressively accumulate assets (notably US dollars) which will likely decline in value. The question is whether this policy is good for China, and the answer is that, in the long run, it surely is not — just as Europe's misreading of imbalances within its currency union and unsustainable US and Japanese fiscal deficits also hurt their respective growth prospects.

Structural policy changes are often the most difficult, because they typically require demanding adjustments on the part of significant segments of the population who rely on unsustainable policies to support their income. Yet, these policy changes are required to achieve the balanced, sustainable growth desired by the G20.

As G20 leaders in Seoul consider the Action Plan submitted to them by their finance ministers and central bankers in fulfillment of the Pittsburgh Framework, what can the leaders undertake to instill confidence that this Framework will provide meaningful sustainable and balanced global growth going forward? The key is for countries to agree to politically credible commitments, where national interests are seen as coinciding with the collective interest.

At the end of the day, the policy mix that needs to emerge from Seoul should be one that sees countries taking measures understood to be both in their own best interest and the best interest of the global economy. The G20 can provide the forum and framework within which nations encourage and commit themselves, in a very public way, to vigorously pursue such measures.