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Dealing with Global Economic Imbalances: The Political Economy of Policy Coordination

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ABSTRACT *Global economic imbalances are not a new phenomenon. However, in the aftermath of the global financial and economic crisis in 2008/2009, they have become a matter of increased concern to the international community as reflected by the IMF and G20. They are seen as having contributed to causing the crisis. What can be done to reduce the imbalances? Attention has focused on the idea of internationally coordinating macroeconomic policy. This article assesses policy coordination from both a technical, but more particularly, a political economy angle. It concludes that the scope for formal and detailed policy coordination is strictly limited because of the underlying political constraints. The article examines alternative ways of dealing with global imbalances and offers a prognosis based on political economy considerations.*

KEY WORDS: International finance; international macroeconomics; policy coordination

1. Introduction

An important feature of international financial systems is the mix between adjustment and external financing that they embody in dealing with global economic imbalances. Generally, the more efficient is the adjustment mechanism the less the need for external financing. If one looks back to the Bretton Woods system, the adjustment mechanism was relatively inefficient, relying mostly, as it did, on the manipulation of domestic aggregate demand rather than changes in exchange rates. Much of the reform debate in the 1960s revolved around augmenting the system's financing capacity. International capital mobility was relatively limited. While, to some extent, this protected pegged exchange rates from speculative attack in the way that the "impossible trinity" implies, it also meant that there was only limited scope for many countries to finance deficits by borrowing from international capital markets. Instead, the IMF played an important role in providing financial support. Beggar-thy-neighbour policies were avoided, but the rule-based coordination of

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macroeconomic policy that was supposedly built into the Bretton Woods system did not work well. Deficit countries were reluctant to sacrifice their domestic targets, and it proved difficult to exert any meaningful pressure on surplus countries to carry a share of the international adjustment burden.

Many themes in international finance recur. In the contemporary environment there are significant global economic imbalances that many argue are unsustainable at their current levels. International adjustment does not seem to be working very well despite the greater flexibility of exchange rates. Within any international monetary system there is the underlying zero sum problem. Balance of payments (BoP) deficits can only be corrected if attempts at correction are accommodated by adjustment in the countries with surpluses. This may mean that a coordinated approach to international adjustment is needed. But what should coordination cover and how is it best organized and achieved? This article addresses these issues.

In principle, the coordination of international policy could apply to both adjustment policies and the provision of international liquidity. It could be organized at either the multilateral or the regional level or both. Not only international financial institutions, and in particular the IMF, but also regional institutions, such as the Eurozone and ASEAN plus three (APT), could be involved. But is it likely that any one form of coordination will be more easily achieved than any other? And can we learn from experience? After all there have been recent attempts to orchestrate coordination involving the IMF and the G20 at the global level and the Eurozone at the regional level, and more distant attempts at coordination under the umbrella of the gold standard and the Bretton Woods international monetary systems.

This paper explores the difficulties involved in organizing a coordinated approach to international adjustment. It not only briefly examines various technical options for putting pressure on countries to follow globally appropriate policies, but also underlines the political economy constraints that are encountered in adopting these options. The paper goes on to claim that it has proved easier (although far from easy) to provide a coordinated approach to the provision of external finance, but it also raises doubts about the extent to which this provides a lasting solution to the problem of global economic imbalances.

The paper is arranged in the following way. Section 2 describes the nature and size of global economic imbalances. Section 3 briefly discusses recent debates about global economic imbalances in the context of a revised Bretton Woods system, so called Bretton Woods II (BWII). Section 4 goes on to assess the extent to which the imbalances constitute a global economic problem. Section 5 examines the role of policy coordination in seeking to reduce the imbalances through appropriate international adjustment. Section 6 looks at the forms that coordination can take and discusses previous attempts at coordination, as well as assessing their degrees of success. The section focuses on the more recent attempts at coordination and on the current initiatives that are being pursued under the auspices of the G20. Section 7 explores the future prospects for policy coordination aimed at reducing global economic imbalances. In the light of the less than sanguine conclusions to which this discussion leads, Section 8 moves on to investigate alternative options to coordinated international adjustment. In a concluding section, the paper offers a summary and prognosis.

2. The nature and size of global economic imbalances

The outward manifestation of global economic imbalances is the pattern and distribution of current account BoP deficits and surpluses. A summary of these in the period 2005–2010 is presented in Tables 1 and 2. The tables not only provide absolute numbers but also express the imbalances in relation to gross domestic product (GDP) as a means of scaling the size of the disequilibria.

However, merely looking at BoP data does not give the whole picture. The more fundamental issue relates to the macroeconomic disequilibria that underlie the observed BoP deficits and surpluses. By analogy, BoP disequilibria are the easily seen "tip of the iceberg". But there are the more substantial macroeconomic disequilibria that lie "beneath the surface". These may be identified by referring to the existing body of BoP theory and may involve a combination of absorption, monetary and structural factors. In the context of the absorption approach, for example, the current account balance reflects the sum of the balance between domestic saving (S) and investment (I) in the private sector and the fiscal balance (the difference between tax revenue, T, and government expenditure, G) in the public sector. In terms of the familiar open economy equation:

$$X - M = (S - I) + (T - G)$$

Using this equation, it may be seen that global economic imbalances reflect imbalances between saving and investment, and/or fiscal imbalances.[1] By contrast,

Table 1. BoP on current account (in billions of US $), by regional groupings

	2005	2006	2007	2008	2009	2010	2011[a]
Advanced economies	−410.0	−451.6	−342.2	−491.3	−71.4	−91.0	−131.0
USA	−745.8	−800.6	−710.3	−677.1	−376.6	−470.9	−467.6
Euro Area	38.8	36.4	20.2	−98.6	13.4	34.8	16.8
Japan	165.7	170.4	211.0	157.1	141.8	195.9	147.0
Other advanced economies	131.3	142.1	136.9	127.4	150.0	149.2	172.8
Newly industrialized Asian economies	82.8	99.4	130.9	87.8	128.6	131.5	138.6
Emerging and developing economies	407.9	639.3	628.1	679.8	287.8	422.3	592.3
Central and Eastern Europe	−61.1	−89.0	−137.8	−160.4	−50.0	−80.5	−119.4
Commonwealth of Independent States	87.6	96.3	71.7	107.7	41.3	75.3	113.5
Developing Asia	137.6	268.8	400.3	412.7	291.4	313.2	363.1
Latin America and the Caribbean	36.1	50.2	14.9	−30.5	−24.2	−56.9	−78.7
Middle East and North Africa	211.5	282.2	265.8	349.2	49.9	183.5	306.9
Sub-Saharan Africa	−3.6	30.8	13.1	1.0	−20.7	−12.2	6.9
	2005	2006	2007	2008	2009	2010	2011[a]
Advanced economies	−410.0	−451.6	−342.2	−491.3	−71.4	−91.0	−131.0
USA	−745.8	−800.6	−710.3	−677.1	−376.6	−470.9	−467.6

Source: IMF, World Economic Outlook, September 2011.
[a]Figures are projection.

Table 2. BoP on current account (as% of GDP)

	2005	2006	2007	2008	2009	2010	2011[a]
USA	−5.9	−6.0	−5.1	−4.7	−2.7	−3.2	−3.1
Germany	5.1	6.3	7.5	6.3	5.6	5.7	5
France	−0.5	−0.6	−1.0	−1.7	−1.5	−1.7	−2.7
Italy	−1.7	−2.6	−2.4	−2.9	−2.1	−3.3	−3.5
Spain	−7.4	−9.0	−10.0	−9.6	−5.2	−4.6	−3.8
The Netherlands	7.6	9.7	6.7	4.4	4.9	7.1	7.5
Greece	−7.4	−11.2	−14.4	−14.7	−11.0	−10.5	−8.4
UK	−2.6	−3.4	−2.6	−1.6	−1.7	−3.2	−2.7
Japan	3.6	3.9	4.8	3.2	2.8	3.6	2.5
Russia	11.1	9.5	5.9	6.2	4.1	4.8	5.5
China	5.9	8.6	10.1	9.1	5.2	5.2	5.2
India	−1.3	−1.0	−0.7	−2.0	−2.8	−2.6	−2.2
Thailand	−4.3	1.1	6.3	0.8	8.3	4.6	4.8
Korea	2.2	1.5	2.1	0.3	3.9	2.8	1.5
Argentina	2.6	3.2	2.4	1.5	2.1	0.8	−0.3
Brazil	1.6	1.2	0.1	−1.7	−1.5	−2.3	−2.3
Chile	1.2	4.9	4.5	−1.9	1.6	1.9	0.1
Mexico	−0.6	−0.5	−0.9	−1.5	−0.7	−0.5	−1.0
Saudi Arabia	28.5	27.8	24.3	27.8	5.6	14.9	20.6

Source: IMF, World Economic Outlook, September 2011.
[a]Figures are projection.

and in the context of the monetary approach, the imbalances relate to differences in the state of domestic money markets and to differences in the rates of money supply growth relative to money demand growth. Meanwhile, in the context of the structural approach, the imbalances relate to differences in income elasticities of demand for imports and exports, and differences in productivity growth and in unit labour costs.

We need not explore these dimensions of global economic imbalances in detail here, but it is important to note that the concept of global economic imbalances is much more complex and sophisticated than may be implied by simply looking at BoP data. The complexity becomes important when discussing ways of reducing the size of BoP deficits and surpluses and the nature of the appropriate policy designed to bring this about.

3. Global economic imbalances and the debate about Bretton Woods II

There has been considerable discussion within the literature about the extent to which global imbalances in the 2000s resemble those that were exhibited during the Bretton Woods era. In the 1960s it was Germany and Japan instead of Asia that ran BoP surpluses and acquired dollar-denominated reserves in preference to seeing their nominal exchange rates appreciate. Dooley *et al*. (2003) coined the phrase BWII to emphasize what they argued were similarities between the two eras.

With the marginal productivity of investment staying high in the USA, weak social security systems and ill-developed domestic financial markets remaining a feature of the Chinese economy, and a strong desire amongst holders of dollar-denominated assets not to see the value of the dollar fall, the implication drawn from the BWII approach is that substantial imbalances could continue for a long period of time, and for as long as there is confidence in the dollar. Without such confidence things could change. It was, after all, the dollar crisis and the "confidence problem" that led to the collapse of Bretton Woods I.

Other authors such as Eichengreen (2006) have argued that the similarities between the situation in the 1960s and that in the 2000s are tenuous, claiming that in the latter period there is a greater diversity among the major holders of dollars, an alternative to the dollar in the form of the euro, and a greater understanding of the problems associated with mercantilist policies.

Bird and Willett (2008a) express a view that lies between that of the BWII school and Eichengreen. They argue that it is the political costs of exchange rate appreciation rather more than mercantilist modes of thought that underlie Asian surpluses and reserve accumulation. They claim that, while large dollar holders are wary of the risks of abandoning the dollar, there may be limits on how long this can provide systemic stability. For a time global imbalances may not threaten to disrupt international financial stability, but circumstances can be envisaged where they would.

4. Are global economic imbalances a problem?

The keyword in answering this question is "sustainability". The literature on global economic imbalances offers different assessments, with some authors (see, for example, Corden, 2007) suggesting that the problem of imbalances can be, and has been, severely overstated. Imbalances would not be problematic in circumstances where either they are sustainable or where, even though they are unsustainable at current levels, they tend to be self-correcting (see Bird, 2006). Let us examine these possibilities.

The imbalances would be sustainable if the countries with BoP deficits have quasi-permanent access to the resources necessary to finance them. Clearly, the running down of owned international reserves does not offer such an option, and sustainability, therefore, relies on the access that deficit countries have to international capital markets and the willingness of surplus countries to provide the finance needed. A problem in assessing sustainability is our rather limited understanding of the factors that affect international capital movements. This makes it difficult to assess their future pattern and size. But there are reasons to believe that a point will arrive where debt accumulation in deficit countries becomes excessive and where international capital markets and surplus countries become unwilling to provide further financial support on the scale required. The difficulty is in calculating when this point will be reached. A common rule of thumb based on previous experience is that current account deficits above about 3.5% of GDP are not sustainable for any protracted period of time.

But even deficits that go beyond this level may not necessarily create problems if there are automatic built-in corrective mechanisms. In principle, there are a number of them. One could operate through flexibility in exchange rates. Thus, where a deficit country experiences a "sudden stop" in capital inflows, the exchange rate of the capital-importing country will depreciate and this will tend to strengthen the current account, thus ameliorating the need for foreign finance and capital inflows.

Another corrective mechanism may exist if international capital markets accurately price risk. In these circumstances they become more and more reluctant to provide the resources necessary to finance fiscal and current account deficits, and the external financing constraint becomes increasingly binding. This forces countries to undertake the necessary fiscal adjustment or real sector reforms that reduce the deficits. As a consequence, the markets impose the discipline necessary to ensure timely international adjustment.

In such a world of automatic built-in adjustment there would be little need for a coordinated approach to any form of interventionist adjustment policy. Indeed, coordination could run the risk of disturbing the automatic mechanisms. The big question, of course, is whether the automatic mechanisms work, or work well enough within a politically acceptable time frame. If they do not, then coordination may still be required.

Exchange rates may not be allowed to move freely and governments may seek to manipulate them in order to gain a competitive advantage.[2] In any case, realigning nominal exchange rates may not always bring about the needed changes in the structure of relative prices. Depreciation leads to an increase in the domestic price level and, in principle, may lead to faster inflation with the result that the change in nominal exchange rates does not bring about an equivalent change in real exchange rates. Furthermore, foreign firms may alter their pricing structures to offset the effects of currency depreciation. Even where relative prices do change, foreign trade price elasticities could, in theory, be too low to bring about BoP correction, certainly in the short term. They may fail to comply with the relevant Marshall–Lerner condition. Altering exchange rates may, therefore, fail to induce the required near-term adjustment, and exchange rates may exhibit a short-term tendency to overshoot.

International capital markets reveal a pattern of instability, moving "too much and too late" (Willett, 2000). For a prolonged period they may underestimate risk but then, quite suddenly, shift to overestimating it. Taken together, automatic corrective mechanisms may encounter the danger of generating excessive volatility and possess a proclivity to cause crises and the serious welfare losses with which these are associated. Greater instability may also be expected to reduce the trend rate of growth of the global economy. In these circumstances a more proactive approach to policy may seem attractive.

5. The need for international policy coordination

There is a substantial literature dealing with the theoretical arguments for and against the international coordination of macroeconomic policy, as well as many studies that attempt to estimate empirically the effects of coordination. This literature is well summarized in most good textbooks.[3] Potentially there are ways in which coordination may be counter-productive. It may lead to appropriate policy reform being postponed as countries look to others to alter their policies. Then there are the bureaucratic delays. But there remains a common-sense appeal to policy coordination. After all, societies see benefit from coordination in other areas of social activity. They establish systems of laws and conventions to regulate people's behaviour. Driving is safer for everyone because drivers are not allowed to do exactly what they please but are encouraged to abide by accepted traffic laws.

In the sphere of economic policy, the principal argument in favour of international coordination is that without it governments will be tempted to pursue policies that are globally sub-optimal. They will fail to take into account the impact of their policies on other countries or the effects of the policies in other countries on them. In short, there will be a failure to internalize the externalities.

Faced with a problem of unemployment and stagnant economic growth, governments may independently be reluctant to adopt expansionary policy for fear of the impact that this will have on the BoP; an impact that would be neutralized if all countries pursued similar policies. On the other hand, unaware of the fact that other countries plan to pursue expansionary policies, governments may opt for domestic policies that result in expansionary overkill, leading to inflation.[4]

The Great Depression of the 1930s is often cited as an example to illustrate the costs of failing to coordinate international macroeconomic policy. Here, competitive beggar-thy-neighbour policies that were pursued independently by countries resulted in losses for all as global unemployment rose, economic activity shrank and world trade declined.[5] Putting it a different way, an uncoordinated approach to economic policy was shown to be Pareto inefficient. The implication that is sometimes drawn from this is that coordination will lead to Pareto efficient gains.[6] However, this may not be technically accurate. Certainly, individual countries may perceive that they would lose from coordination as they are forced to subjugate their own domestic policy preferences in favour of those that are seen as being jointly superior. Moreover, the bargaining position of individual countries in securing a coordinated outcome is unlikely to be equal. Some will be in a stronger position than others, and this will affect the appeal of policy coordination to those involved.

In the global economic environment of 2012, and in the aftermath of the Great Recession, a concern has been that there may be a reversion to some of the types of uncoordinated policies that were a feature of the Great Depression. This has found popular expression in the suggestion that the world is threatened by the outbreak of a currency war and a bout of trade protectionism as countries seek to gain a competitive advantage over others. There is also the claim, as noted above, that governments may individually be reluctant to adopt the fiscal and monetary policies that would assist economic recovery because they fear the BoP consequences. They may suspect that other countries will attempt to take a free ride in the form of export-led economic growth on the back of expansionary policy elsewhere.

There is a growing consensus that correcting global economic imbalances requires a rebalancing of economic growth, with BoP deficit countries switching away from consumption-led growth to export-led growth, and surplus countries switching in the opposite direction. How likely is such a rebalancing in the absence of an internationally coordinated approach? Without it, there is the danger that all countries will attempt to base economic growth on foreign demand, and this will be an unattainable goal. Relevant in this regard is the long-standing acknowledgement that global BoP adjustment is "zero sum" in nature. Deficits and surpluses cancel each other out, and policies aimed at reducing current account deficits will only be effective if they are simultaneously accommodated by appropriate policies in countries with current account surpluses. The recognition that BoP correction is a zero sum game carries with it the implication that it will require a measure of international policy coordination, or at least a measure of consistency and compatibility. But recognizing that it is needed is far removed from achieving it. Moreover, there is the issue of whether it will happen without some formal agreement.

6. Forms of international policy coordination and the record so far

International policy coordination may basically take two forms; it can be rule-based or discretion-based. Most general examples of attempts to coordinate behaviour seem to favour rule-based coordination. Discretion-based coordination seems only to be superior when there are exceptional events that have not been anticipated and with which the existing set of rules cannot cope. The general superiority of rules over discretion may be observed in the codes of conduct that seek to constrain social behaviour. Societies live by laws and regulations. All sports (or games) have their rule books. Taking our earlier example of driving, it would be inefficient to have to decide, on a discretionary basis, which driver has the right of way each time a junction is approached. It is much easier to have an established and accepted set of rules with which drivers comply; this coordinates their behaviour.

However, this analogy helps us anticipate the conditions necessary for coordination to work. The rules have to be relatively straightforward, agreed, known and accepted by all. There has to be a mechanism for monitoring compliance with the rules. And there has to be a system of penalties that provides an incentive for people to abide by them. In the case of driving, there are highway codes, driving tests, closed circuit television cameras and police officers monitoring compliance, as well as systems of fines, driving bans and even imprisonment that are used to incentivize compliance. The question is whether a similar set of arrangements can be envisaged for the coordination of international macroeconomic policy? The preliminary answer would appear to be both "yes" and "no". "Yes" in the sense that it is possible in theory to design a system with these sorts of features, although it may be much harder in practice to agree on what constitutes an appropriate set of rules, and of course countries could only be "sent to jail" metaphorically. But "no" in the sense that there will be political impediments to implementing such a system – we examine them in more detail later in the paper.

The world's experiences with attempting to orchestrate an internationally coordinated approach to macroeconomic policy do not offer a record of great success. Problems have arisen in terms of each of the issues mentioned above. It has proved difficult, if not impossible, to get agreement on the rules, to monitor compliance and to penalize non-compliance in an effective way. Let us briefly take a few examples drawn from the history of the international monetary system to illustrate the difficulties.

The gold standard broke down because governments were reluctant to play by the "rules of the game" that required them to allow the state of the BoP to have its full and un-moderated impact on the domestic money supply. As things turned out, rather than penalising countries for failing to abide by the rules, the game was abandoned. A similar fate awaited the Bretton Woods system. Even though this system was designed to incorporate a rule-based approach to policy coordination, with the rule being to defend par values provided they were close to their equilibrium levels, in practice it proved impossible to put sufficient pressure on surplus countries to share the burden of adjustment. Although a mechanism for exerting such pressure in the form of the "scarce currency clause" was incorporated into the Articles of Agreement of the IMF, and was in principle available to be used, it has never been invoked. The Stability and Growth Pact (SGP), which forms a part of the European Monetary System, was designed to provide a set of rules for organizing a coordinated approach to macroeconomic policy within Europe. In this case the rule book was thicker than it had been for the Bretton Woods system and covered fiscal deficits and debt. However, the record of this attempt at coordination hardly needs elaboration in the light of events in Europe in 2010–2012 and the crisis in the Eurozone. The SGP has failed to induce a coordinated approach to macro policy. Not all countries have abided by the rules and there has been no effective mechanism for deterring non-compliance.

Meanwhile the IMF's attempt at co-ordinating macroeconomic policies under its "multilateral consultations" initiative in the mid-2000s also failed because there was no incentive for individual countries to follow the IMF's advice where this meant deviating from policies that they saw as being in their own national best interests (see Bird and Willett, 2007, for a critical examination of the Fund's experiment with multilateral surveillance and consultations).

Confronted with the exceptional global economic and financial crisis of 2008/2009, there was an attempt to organize discretion-based coordination (covering both trade and macroeconomic policy) at the London summit of the G20 in April 2009. But, the motivation for a coordinated approach dissipated in the months that followed as disagreements arose about the causes of the crisis and the appropriate cures. To use the jargon of the relevant theory, there was an increasing degree of model uncertainty (see Bird, 2009, 2011, for a discussion of the G20's involvement in the formation of global macroeconomic policy).

Perhaps in the light of its experience with discretion-based coordination, in 2010/2011 the G20 embarked on a plan to deal with global imbalances based on using "indicative guidelines". The plan involves a number of reasonably conventional elements. At the time of writing in early 2012 the details of the scheme remain to be fully formulated but the broad direction may be fairly easily discerned. The idea is to use a set of "indicative guidelines" to measure the potential risks to the global economy as a result of national economic policies among the G20 nations. Countries accounting for more than 5 per cent of G20 output are to be subjected to a more detailed monitoring process than the rest of the G20 members since there is "greater potential for spill-over effects from larger economies" (G20 communiqué). The indicators are intended to cover public debts and deficits, as well as private debts and savings rates. Fiscal and monetary policies in addition to exchange rates will also be "considered". Imbalances in individual countries are to be examined relative to contemporary country-specific economic fundamentals, historical experience, and imbalances elsewhere within the G20. Those countries assessed as having persistently large imbalances are to be examined "in depth" to determine the causes of the imbalances and the "impediments to adjustment".

At this relatively early stage, the G20 initiative for dealing with global economic imbalances falls a long way short of what is normally implied by the concept of "policy coordination". Indeed the G20 communiqué announcing the proposals avoids the word "coordination" altogether and refers instead to a "mutual assessment process to promote external sustainability''. As things stand, the rules are not agreed. Indeed, there is strong opposition to having any ''rules'' at all; hence the more positive word ''targets'' was avoided and the much softer word ''guidelines'' was used in the communiqué. Moreover, there is no agreement about the details of how the guidelines, once formulated, will be monitored and how the globally desirable changes in policy will be implemented. There appears to be no mechanism for putting pressure on countries that fail to comply with the guidelines to correct the situation, and there is apparently no system that is likely to be effective in penalizing countries that fail to comply with them.

A recurring theme of the contemporary media reports on the G20's deliberations related to the wide and substantial degree of disagreement within the G20 membership. This could only be accommodated by using vague and imprecise language and by making sure that the guidelines were presented as non-binding. Individual countries have opposing views about the design of macro policy and have shown themselves to be unwilling to impose any binding constraint on their future policy options. On this basis, it seems probable that in the fullness of time the G20 initiative will provide yet another example of failure in terms of policy coordination.

In the following section we examine more completely the sources of difficulty in designing effective mechanisms for co-ordinating international adjustment policy and the consequences that follow on from this.

7. Future prospects for coordinating international adjustment policy

In assessing the future prospects for coordinating international adjustment policy there are two groups of considerations. The first relates to whether there are insurmountable technical difficulties in designing a system that would include the features cited earlier and, in particular, whether the necessary structure of incentives that is needed to encourage countries to modify their domestic policies in a way that would facilitate reducing global economic imbalances can be devised. The second relates to whether such a system is ever likely to command the degree of political support that would be needed for it to be adopted. The first question deals with the principles of policy coordination. The second question deals with the political realities.

It may be anticipated that the latter group of considerations is likely to impose the greater constraint on the future evolution of policy coordination, although as of early 2012 there would be substantial disagreement about what policies are needed to deal with global imbalances. In particular, the consensus that appeared to exist in 2009 around expansionary fiscal policy and quantitative easing has broken apart, meaning that there is sharp disagreement about the type of coordinated policies that should be pursued.

7.1. Technical issues

A long-standing issue in international macroeconomics is how to put pressure on surplus countries to adjust. More broadly, the issue may be extended to examine how pressure may be exerted not only on surplus countries but also on deficit countries that find it relatively easy to finance their current account deficits by international borrowing. These countries will not be looking for loans from the IMF and are, therefore, exempt from IMF conditionality.[7] Article IV consultations that the IMF conducts with all member countries are widely believed to be a relatively ineffective way of exerting policy pressure.

Under the gold standard, adjustment was designed to be symmetrical as between deficit and surplus countries, since deficit countries would experience monetary contraction, a falling price level and enhanced competitiveness, while surplus countries would experience monetary expansion, an increasing price level and weakening competitiveness. In seeking to come up with an international monetary system to replace it, and as part of his plan for international monetary reform, Keynes suggested that surplus countries accumulating increasing amounts of a new reserve asset (bancor) at a newly established International Clearing Union (ICU) would, in effect, be taxed on their excessive accumulations, thereby creating an incentive for them to reduce their surpluses (see the Keynes Plan, reproduced in Moggridge, 1980). Deficit countries would have access to an overdraft facility at the ICU but at a penalty rate. As noted earlier, and in a much softer form, the IMF's Articles of Agreement incorporated a "scarce currency clause" that, if invoked, allowed trade sanctions to be imposed against persistent surplus countries once their currencies were declared "scarce in the Fund". The USA, anticipating a strong BoP in the post-war period, had opposed any scheme that directly sought to tax reserve accumulations.

Following the breakdown of the Bretton Woods system and the move over to generalized exchange rate flexibility, it might have been imagined that the problem of asymmetrical adjustment would disappear. The idea was that the exchange rates of surplus countries would appreciate and those of deficit countries would depreciate. However, not all countries have adopted a flexible exchange rate and the existence of large global economic imbalances revealed in Tables 1 and 2 demonstrates that this mechanism has, in any case, not worked in exactly the way the simple textbook model suggests. Much of the contemporary debate implies that some strategically important surplus countries, and most notoriously China, have been unwilling to allow their exchange rates to appreciate sufficiently to reduce global imbalances to sustainable levels. As a result, the question of how to put pressure on surplus countries to adjust has once again come into prominence.

A number of schemes have been proposed and are well described and analysed in detail by Williamson (2011).[8] At a basic level, however, these proposals share many of the features that were present in the older proposals alluded to above. They seek to penalize excessive accumulations of reserves, or to set targets for current account surpluses that, if exceeded, are then penalized in some way, or they allow trade sanctions to be imposed (possibly under the umbrella of the World Trade Organization) if there is evidence of currency manipulation designed to maintain undervalued exchange rates. They may opt to orchestrate intervention in foreign exchange markets by those countries that are adversely affected in order to push up the currency values of surplus countries. Alternatively a scheme could be devised that combines elements of all these proposals.[9]

There are devils to be found in the details of all the schemes, and there are undoubtedly important issues that would need to be resolved. These include determining when reserve accumulation becomes "excessive", or when surpluses are "excessive", or when currencies are being "manipulated", which in turn requires fundamental equilibrium exchange rates to be calculated.[10] However, it seems likely that the effective constraint on introducing a system that coerces, or at least encourages countries to pursue policies that are deemed to be globally desirable does not arise from the technical side of things. It is in terms of political economy that policy coordination encounters its most insurmountable difficulties.

7.2. Political economy issues

Many things influence a government's choice of policy. But an internationally coordinated approach implies that they will make concessions in terms of what policies they pursue. Coordination would have little purpose if countries merely ended up following the same policies as they would have done in any case.

The underlying difficulty is that governments may perceive little reason to coordinate policy unless it allows them to persuade other countries to change their policies in a way that is perceived to be beneficial. The benefits associated with getting other governments to alter their policies need to be seen as exceeding the costs of making domestic concessions. Governments will have to be convinced that the benefits of a coordinated approach, through its effects on other countries and related feedback effects, outweigh the costs of abandoning what was the previously preferred domestic macroeconomic strategy. This, having been said, the preferred domestic strategy will also depend on the policies pursued elsewhere and may, therefore, change where there is effective coordination.

Governments will have to accept that it is worth constraining their choice of policy in order to impose constraints on the policy choices of others, and that this net gain is likely to remain positive. They will need to feel that the change in policy direction will not create insurmountable domestic political problems for them. Perhaps the design of existing domestic policy reflects the outcome of a complex domestic political bargain that will be disrupted by policy change; governments will be concerned about whether they can survive such disruption. In any event, the stage of the political cycle or the need for parliamentary approval may limit an incumbent government's room for manoeuvre. In short, countries may be expected to be (very) reluctant to relinquish national sovereignty over the design of the key tools of macroeconomic policy as would happen with international policy coordination.

This is exactly what we see. Thus, China has been reluctant to allow the value of the yuan to rise because of the likely implications for its export-led growth strategy and because of the political consequences that would follow on from this.[11] In the context of the crisis in the Eurozone in 2010–2012, Germany has been unwilling to relax fiscal policy because of the perceived dangers of inflation. It was also reluctant to modify its interest rate policy during the crisis in the Exchange Rate Mechanism of the European Monetary System in 1992 for similar reasons. Brazil did not modify its decision to devalue the *real* at the end of the 1990s in spite of the likely adverse implications that this might have been expected to have for its fellow members of the Latin American Mercosur trade agreement. The list goes on. What is the conclusion that follows?

If it requires governments to pursue policies that they do not perceive as being in their own best interests, and if this perception cannot be altered, policy coordination is unlikely to happen. But given that it may also be politically awkward to stridently take such an official line, the likelihood is that there will be a great deal of international discussion about policy coordination, agreement to collect information and monitor developments, and acknowledgement of the interdependences that exist. There will be an emphasis on cooperation rather than coordination. However, there will not be a lot beyond this. This is what history reveals.[12] If the political realities are unlikely to change, then the prospects for meaningful progress are not good. In these circumstances the question is whether there are other options available that could be helpful, and that have a greater chance of being implemented.

8. Other options for dealing with global economic imbalances

8.1. Global governance and multilateralism, or enhanced regionalism

If there are problems associated with internationally coordinating adjustment policy, is there a better chance that something useful could be achieved at either the *global level* or at the *regional level*?

At the global level, this might ultimately involve a form of global governance, with a single global money, global monetary and fiscal policy and global institutions appropriately designed to implement such policies.

Although there is an interesting intellectual debate to be had on the subject, this idea appears to be politically unrealistic given the observed reluctance of governments to cede control over macroeconomic policy. However, although when taken to extremes, the idea is a non-starter, it could make a contribution in a more limited form. Thus, when faced with concerns about shortages of international liquidity, the G20 and IMF in 2009 endorsed additional allocations of Special Drawing Rights (SDRs). In one sense, this is a type of global monetary policy. Movement in the direction of increasing the role of the SDR in the international monetary system would in turn increase the scope for further developing the idea of global monetary policy. Global fiscal policy seems less likely, given the strong opposition there has been to proposals to introduce a tax on international currency transactions (the Tobin or Robin Hood tax).

An argument has sometimes been made that policy coordination at the *regional* level will escape some of the problems that are encountered at the international one. The key claim is that countries will be more willing to cede a degree of national sovereignty over the design of macroeconomic policy to a group made up of regional neighbours than to an international institution such as the IMF. There is a superficial appeal to this claim. Is there not likely to be a greater degree of friendship with geographical neighbours and a higher probability that there will be less disagreement over the design of appropriate macroeconomic policy, either because they are exposed to similar shocks and there is greater economic synchronization between them, or because they share a common view about the specification of their social welfare functions?

Further consideration raises serious doubts about this. One does not need to look much further than the trials and tribulations of the Eurozone in 2010–2012 to see that coordinating policy across regional neighbours is far from easy. As noted earlier, the SGP failed to ensure that coordination occurred. Germany, as the main surplus country in the region, has not been prepared to relax fiscal policy and has instead continued to encourage deficit countries to make the necessary fiscal and labour market adjustments. The economies in the Eurozone have not been in step economically and do not seem to share views in common about the optimal location on any old fashioned Phillips curve that maps out the menu of choices between inflation and unemployment. Moreover, while the crisis has highlighted the deficiencies of the Eurozone in terms of fiscal coordination and has spawned a series of pronouncements about the need for it to be improved in the future, there is as yet still no clear indication that closer fiscal coordination lies ahead. Europe's new fiscal compact is hardly a good example of coordination (Bird & Mandilaras, 2012). It may be a better example of fiscal coercion. Opposition to "fiscal federalism" within Europe remains strong. Indeed, faced with the possibility that the Eurozone will only survive if such fiscal coordination is effectively organized, the option of breaking up the zone has received increasing attention (Bird, 2012).

There seems little reason to believe that regional neighbours will necessarily enjoy a greater degree of fiscal, or indeed political, harmony. After all, it may be that it is with regional neighbours that hostilities have historically been most severe. Some commentators have suggested that other regional groupings such as APT will exhibit similar constraints on policy coordination as those revealed in the Eurozone, but to an even greater extent given the lack of equivalent motivation for closer political unity.[13]

Experience suggests that, rather than regional arrangements fostering fiscal coordination that allows imbalances to be corrected, they are more likely to foster an approach that attempts to finance the imbalances. This takes the form of encouraging the countries with BoP surpluses or with relatively strong economies to provide finance to those countries in deficit or with weaker economies. The argument is not that such financing arrangements will be easily put together. Indeed, the Eurozone example shows just how difficult it will often be to gain agreement on such financing packages, as political resistance both within and between countries has exerted a powerful influence limiting progress. But nonetheless, they may prove less difficult to set up than fiscal coordination would be. It is not coincidental that, in the pursuit of economic integration in Europe, the path followed involved trade reform first and monetary integration second (Bird & Rajan, 2007). It largely left fiscal integration to one side, other than in the ineffective form of the SGP. In the same fashion, regional integration in Asia has involved trade reform and the mutual financial support provided by the Chiang Mai Initiative (CMI) rather than fiscal coordination.[14]

8.2. External financing rather than international adjustment

The above discussion suggests that although there are likely to be insurmountable political economy impediments to the introduction of policy coordination designed to bring about international adjustment, there may be fewer impediments to introducing an internationally coordinated approach to international financing. This could take the form of creating additional SDRs or increasing the lending capacity of the IMF. Experience shows that this form of international policy coordination can be achieved at some levels and in certain circumstances. When, during the 1960s, the Bretton Woods system exhibited problems in terms of achieving international adjustment to reduce global economic imbalances, reform focused on increasing the amount of international liquidity through increasing the IMF's resources, developing a system of bilateral swaps and eventually introducing the

SDR. In the aftermath of the global economic and financial crisis in 2008/2009 the global economic community followed a similar reform path.

Greater financing capacity allows the world economy to survive for a time with a relatively inefficient adjustment mechanism. Thus, the reforms of the 1960s may have postponed the collapse of the Bretton Woods system. But they did not prevent it. Enhanced financing creates an opportunity for adjustment to occur at a slower speed than would otherwise be the case. However, there are two problems with it. First, there is the well-rehearsed moral hazard problem. With greater access to external finance, countries may be more inclined to try and avoid necessary adjustment. Second, increased financing means that, although in principle there is more time to undertake adjustment, the amount of adjustment will eventually need to be greater because external financing will have involved further debt accumulation.

These observations imply that, while enhanced global financing capacity may buy the world time to design a better way of achieving international adjustment, it will not avoid the need to adjust. And, as already noted, there are serious underlying problems in designing and, more particularly, in implementing policies of international adjustment. So what does the future hold for global imbalances and policy coordination aimed at dealing with them?

9. Concluding Remarks: A Prognosis

While it is unsafe to make predictions about the future evolution of global economic imbalances and about the policy reaction to them, it is possible to assess some of the underlying probabilities. The projections made by the IMF at the end of 2011 in its *World Economic Survey* suggest that global imbalances will, in some respects, narrow in the period up to 2016. In the case of the USA, for example, the Fund projects that its current account deficit will be less than 3% of GDP by 2016. If these projections turn out to be accurate, the implication is that, on the basis of previous experience, imbalances may become more sustainable than appeared to be the situation in the mid-2000s when the USA deficit exceeded 6% of GDP. It may be that economic recovery in the USA, combined with a narrowing current account deficit relative to GDP, will enable the USA to continue to attract foreign capital in the amounts required to sustain its current account deficits.

Global imbalances may also be expected to narrow if world economic growth is rebalanced in the way described earlier in this article and if exchange rate misalignment is corrected. Indeed, the latter would contribute to the former. Without such rebalancing, global economic growth could make the imbalances worse (Bird, 2008). The issue at stake is whether these developments will occur in the absence of a proactive, relatively detailed and sophisticated approach to policy coordination.

There have been some indications that the appropriate movements have been occurring without the need for formal coordination of macroeconomic policy. The US dollar depreciated and the yuan appreciated in nominal terms in the period between 2005 and 2011. *The Economist* magazine claimed that "China's real exchange rate with America has strengthened by almost 50 per cent since 2005" (4 November 2010). Recent calculations of fundamental equilibrium exchange rates made by Cline and Williamson (2011) suggest that, although currency misalignments still exist, they may be somewhat less than is sometimes supposed. However, they also conclude that further substantial realignment between the US dollar and the Chinese yuan is needed.[15]

Improved monitoring of their underlying determinants, combined with enhanced moral suasion based on better information relating to currency misalignment, and organized under the auspices of the IMF and G20, may make a significant contribution to reducing global imbalances. Furthermore, if international reserves in surplus countries are perceived by them as already meeting their precautionary needs, and if the risks of further near-term economic crises recede, and if referral to the IMF is made less unattractive to potential users by the reforms already put in place that have been intended to make its conditionality appear "softer", the incentive to run current account surpluses may weaken. This may then contribute to the rebalancing of global economic growth that reduces the payments imbalances. The important question is the extent to which such changes will occur and over what period of time. How quickly will they work? Will there be a hard or a soft landing when it comes to bringing imbalances down to sustainable levels?

This paper has argued that although the technical issues involved in designing a more aggressive approach to policy coordination create serious challenges, the challenges are not insurmountable. The most fundamental problems lie elsewhere. It seems highly unlikely that the political economy of coordination will support any move that is viewed by potential participants as a step in the direction of coercing them to pursue policies that they do not immediately perceive as being in the own best interests. This implies that the roles of the IMF and the G20 in terms of policy coordination will remain limited. Any claim that the initiatives being pursued by the G20 in early 2012 will culminate in "grand design" reform involving policy coordination that carries with it tightly defined rules and a punitive set of effective penalties on non-compliers is surely misplaced.

While they may often be only very reluctantly approved because of the moral hazard dangers, it seems more likely that initiatives aimed at providing enhanced amounts of external finance will be mounted to cushion the process of transition towards sustainable imbalances. The transition will continue to be encouraged by using moral suasion to entice surplus countries with undervalued currencies to allow their exchange rates to appreciate. Financing initiatives seem likely to be pursued at both the regional and international levels. But again it seems improbable that this will reflect a well-designed and fully thought out global strategy that is agreed upon and endorsed by the world community well in advance of it being implemented. Instead, it seems more likely that global imbalances will be dealt with in a relatively ad hoc and piecemeal way. Muddling through seems more likely than strategic vision.

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Notes

[1] Data from the IMF's *World Economic Survey* show that very many countries run fiscal deficits and only rather few have fiscal surpluses. This implies that the current account balance depends crucially on

whether private sector saving exceeds or falls short of investment and the size of this balance relative to the size of the fiscal deficit.

[2] Bird and Willett (2008b), for example, discuss the reasons why governments may be reluctant to devalue or revalue even in circumstances where there is substantial evidence that currency values are misaligned.

[3] Bird (2007a), for example, provides a brief summary of the main issues involved, whereas Pilbeam (2006) offers a more comprehensive review of the literature covering both the theory of macroeconomic policy coordination and empirical estimations of the benefits and costs.

[4] Some of the key studies that examine the theory of macroeconomic policy coordination include Oudiz and Sachs (1984, 1985), who argue that coordination may improve welfare when foreign exchange markets are forward looking, Rogoff (1985), who argues that it is important to take into account the reaction of private agents to cooperation, a reaction that may mean that it carries costs, and Frankel and Rockett (1988), who argue that coordination may be inferior to non-coordination where there is uncertainty pertaining to the correct economic model, such that the wrong model is assumed.

[5] Many empirical studies have sought to estimate the gains and losses associated with macroeconomic policy coordination. The studies have generally been based on simulation estimations, see, for example, Frankel and Rockett (1988), Holtham and Hughes-Hallett (1987), Oudiz and Sachs (1984, 1985) and McKibben and Sachs (1991). A fairly wide range of potential outcomes is reported. Interestingly in the light of what follows, Miller and Salmon (1985) conclude that "what gains there may be from coordination must come . . . in choosing the path towards equilibrium and not the final equilibrium" However, it may be that studies published in the 1980s and based on data when there was a lower degree of economic integration than there is in 2012, may underestimate the gains from coordination. More recent analyses of coordination using a new open economy macroeconomic model (NOEM) reveal the sensitivity of results to the choice of parameter values and the details of model specification, but some of them continue to conclude that the gains from coordinating monetary policy are "negligible" (Obstfeld and Rogoff, 2002).

[6] The scope for achieving these gains is conventionally illustrated by using the so-called "Hamada diagram" (Hamada, 1976, 1985), which shows how a cooperative solution will be superior to the Nash equilibrium that might result from non-cooperation.

[7] There is, in any case, some evidence to suggest that IMF conditionality is not particularly effective at bringing about adjustment in the deficit countries that borrow from the Fund. For a review of the evidence on the effectiveness of conditionality see Bird (2007b).

[8] Williamson explains and critically assesses proposals put forward by Goldstein (2010), Mattoo and Subramanian (2008), Bergsten (2010), Giethner (as cited in Williamson, 2011), Yi Gang (2010), Gros (2010) and Hufbauer (2010).

[9] Williamson (2011) favours a plan that would involve the IMF examining the policies of any country with a surplus in excess of some benchmark level, expressed relative to GDP, and would then allow action to be initiated under the auspices of the WTO to reduce excessive surpluses in circumstances where the surplus countries are themselves unwilling to correct the underlying macroeconomic disequilibria that the surplus reflects. The relevant polices would depend on whether or not the countries belonged to a monetary union that constrains their ability to use exchange rate and monetary policy.

[10] For a number of years, Cline and Williamson, based at the Peterson Institute for International Economics, have been calculating fundamental equilibrium exchange rates (FEERs) and using their results to establish the extent to which currencies are misaligned (see, for example, Cline and Williamson, 2011). They have also used their calculations to determine, in broad terms, the appropriate combination of macroeconomic policies in individual countries (see Cline and Williamson, 2010). This is also the direction in which the IMF seems to be moving.

[11] Cline (2010) has calculated that an appropriate appreciation in the yuan would contribute significantly to correcting the current account imbalance between China and the USA. His calculations imply a relatively high export price elasticity, and his regression results indicate that "a 1 per cent rise in the renminbi yields a 0.45 per cent of GDP fall in the current account" (Cline, 2010, p. 2). See also, IMF (2007) for calculations of the extent to which exchange rate changes would contribute to reducing global imbalances.

[12] Note that the more modest benefits associated with the collection and sharing of information should not be underestimated. For example, the sharing of information about BoP targets will help identify incompatibilities between them.

[13] Cohen (2010) provides a full and detailed examination of the development of Asian economic cooperation in the form of APT. He also concludes that the binding constraint on regional policy coordination is to be found in the underlying politics of the region, maintaining that the economics of integration, based on optimum area criteria, are no less strong, and possibly even stronger, in Asia than in Europe. Cohen argues that the APT, however, fails to comply with the political conditions for closer integration, exhibiting neither a broad consensus of opinion nor a natural and strong leader.

[14] Again, Cohen (2010) provides a useful analysis of the evolution of the CMI that illustrates the difficulties involved and the limited progress achieved. See also Bird and Rajan (2002) and Henning (2002) for a discussion of the CMI and the proposal to form an Asian Monetary Fund. Casual observation also reveals the limited progress achieved in Latin America under the umbrella of the Latin American Reserve Fund (Fondo Latino Americano de Reservas, FLAR). It is relevant to note that a requirement for financial support under the CMI and its successor has been the inclusion of IMF conditionality. This suggests that the idea that policy reform is more easily organized at the regional level is misplaced. The example of IMF involvement in the Eurozone crisis seems to imply a similar conclusion. More generally, while a regional approach to the provision of finance may have logic in the sense that spillovers are particularly significant regionally, this may be at odds with another requirement of schemes of reserve pooling, namely that there needs to be a low degree of co-variance across the participants.

[15] Cline and Williamson (2011) claim that:

> most currencies appear to have been reasonably close to their FEERs in April, 2011. The most important exceptions are China, on the weak side, and the United States, on the strong side. The countries that need to seek weaker effective rates are those with large current account deficits: Australia and New Zealand, South Africa, Turkey, Poland and Hungary, and the United States and Brazil.

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