



Building a global monetary system: the door opens for new ideas

Proposals to avert exchange rate chaos and to reshape the international monetary system have received new impetus recently. For the first time since the end of the Bretton Woods system, a proposal has been tabled to resolve unsustainable global trade imbalances through a multilateral solution. The initiatives under discussion by the G-20 to ensure greater order in international monetary affairs are an implicit recognition that the market cannot solve a major problem that has been blocking the smooth integration of all countries into the globalized economy. UNCTAD research supports this view. Indeed, UNCTAD has consistently shown that without a multilateral approach, it will neither be possible to reap the benefits of an intensified global division of labour, nor to avoid devastating international financial crises of the kind that have been seen in the last two decades.

Avoiding competitive devaluations: new paths to global economic governance

The outbreak of the financial crisis in 2008 – and its global ramifications since – propelled the group of 20 developed and developing countries to centre stage to lead a coordinated international response. Just as the crisis has continually revealed new regional and structural effects, so has the G-20 agenda advanced. G-20 finance ministers last month highlighted the need to assess the persistently large global imbalances and the prerequisites for rebalancing. Concern is increasingly being focused on addressing internal structural balances, fiscal policy and currency alignment, within a common policy package to weather the next stage of the crisis. This welcome dose of inclusive multilateralism and new thinking on interdependence, a foundational principle of UNCTAD, has come at the right time, as exchange rate management seizes the foreground of the policy debate.

G-20 leaders will discuss this week new proposals for monitoring, assessing and redressing global trade imbalances, as well as the structural, fiscal and exchange rate constraints that have aggravated them in recent years. This debate opens new paths to improve global economic governance. It acknowledges that the mantra of “leaving currencies to the market” has lost its persuasive power. The contradiction between expecting market forces to do their job, and hoping for a realignment of currencies according to fundamental determinants of competitiveness, has become glaringly obvious. This was revealed yet again in recent weeks as a major deficit developing country, Brazil, was faced with having to fend off the huge capital inflows that caused an unsustainable appreciation of its currency.

This should not come as a surprise – the world has been in a similar situation before. In 1985, the market’s inability to resolve long-standing trade imbalances between Japan and the United States was finally resolved by the historic Plaza Accord. After all other approaches had failed, coordinated intervention between G-5 members achieved a 50 per cent

devaluation of the United States dollar. Today the need for coordination is greater, but achieving it is more difficult. Globalization means that virtually all of the world’s economies are affected, rather than just the leading few. Also, by comparison, the magnitude of the trade and capital flows involved is immense.

With open markets for capital, short-term speculators trying to obtain arbitrage profits from interest rate differentials – the so-called carry trade – are driving exchange rates against the fundamentals of the targeted countries, in contrast to what economic theory would expect. Speculative capital flowing into countries that have relatively high interest and inflation rates causes an appreciation of their currencies that dramatically endangers the competitiveness of their economies and distorts trade flows. This eventually leads to a loss of market share, lasting current account deficits, and the kind of financial crisis that sooner or later forces a broader economic crisis.

Current account imbalances: fallacies and flaws

In order to monitor global trade imbalances and progress towards external sustainability as part of a mutual assessment process, the G-20 will consider technical guidelines to indicate when the overall scale of imbalances is moving away from sustainable positions. One suggestion has been to focus on the size of a country’s current account deficit or surplus, as a percentage of gross domestic product (GDP). Other viewpoints favour looking at a range of indicators that contribute to imbalances and to inconsistent fiscal, monetary and exchange rate policies.

This renewed impetus for multilateral cooperation to resolve long-standing imbalances, and tabling of concrete proposals for mechanisms to reduce global monetary and financial volatility, is timely. But it would be a mistake to use the current account as the indicator of choice when measuring the “sustainability” of large imbalances.

To do so would be to focus on a symptom of global imbalances rather than on its cause. As described in the Trade and Development Report 2006, this focus



on the current account stems from a widely held view that current account surpluses or deficits are mainly the result of an excess of savings in the surplus country and a lack of savings in the deficit country. This view is based on the simple national accounting identity between savings on the one hand, and investment and the current account balance on the other. But this is just an identity, not an explanation: it says nothing about the causality of changes in these macroeconomic variables. For example, misalignment of the real exchange rate distorts the international competitiveness of countries, with the ensuing capital flows (“foreign savings”) from surplus to deficit countries being the apparent result.

Focusing on current account imbalances alone is also flawed, owing to the difficulty of quantifying appropriate bands outside which imbalances are truly unsustainable – not to mention all the circumstances under which exceptions might be tolerated. There are many good reasons why a current account may be in deficit or surplus at any given point in time. One reason is that the domestic economy may be growing faster than that of its trade partners, causing imports to rise more than exports (e.g. the United States). Another is that a country may be a major importer of a commodity whose price tends to rise again and again, increasing the import bill without there being any compensation through higher levels of export (e.g. the group of “low-income, food deficit countries”). Still another reason is that a country may serve as a hub for foreign firms to produce manufactures on a large scale, but may not yet have enough high-income members of the population to consume the level of imports that would equilibrate exports (e.g. China).

In all such cases, the short-term buffer of net capital inflows or outflows is needed to allow for a smooth functioning of the international trading system. In other words, imbalances in the current account are not in themselves indicative of a systemic problem that needs coordinated intervention. Moreover, what is important is not so much the current account position of any one country – some commodity exporters can rely on maintaining their surpluses indefinitely (eg. Saudi Arabia). What does matter is a loss of competitiveness in aggregate that may be at the origin of a current account deficit.

The only current account imbalances that are clearly unsustainable are those that originate from a loss of competitiveness of the economy as a whole. Such losses are reflected in the appreciation of the real exchange rate (RER) vis-à-vis the nominal exchange rate, and also in the widening aggregate current account imbalances that began to emerge 10 years after 1985’s Plaza Accord, as shown in the chart.

The RER between two currencies is simply the nominal exchange rate adjusted for inflation, or for other economic fundamentals that differ between the countries such as changes in export prices, or the rate of increase of unit labour costs. A general overvaluation of a country’s currency means that the nominal exchange rate of its currency has appreciated against other currencies more than is warranted in terms of the difference between the domestic price level and that in comparator economies.

The fact that exchange rates play a pivotal role is supported by empirical evidence analysing the factors influencing current account reversals. The Trade and Development Report 2008 showed that rather than being driven by the autonomous savings and investment decisions of domestic and foreign agents, current account reversals tend to be driven by external shocks emerging from both goods markets and financial markets. In particular, improvements in the current account were usually accompanied either by positive terms-of-trade shocks, by a real exchange rate depreciation, or by panic in the international capital markets followed by sudden stops in capital flows.

Multilateral currency coordination is the key to resolving global imbalances

Exchange rate management must be at the centre of the package to avoid unsustainable imbalances, notwithstanding other policy measures that will be needed.

To sum up, the right approach to the twin problems of global trade imbalances and destabilizing short-term capital flows is straightforward: it entails adjustment of the nominal exchange rate in line with the constant real exchange rate rule (CRER – see the Trade and Development Report 2009 and UNCTAD Policy Brief 12). This rule would firstly be enforceable by multilateral agreement on the pattern of optimal or reasonable exchange rates. Secondly, concerted central bank action would maintain this pattern and would also help to remove the incentive for short-term currency speculation that has so aggravated global imbalances.

Financial market participants would quickly understand that challenging such a multilateral policy framework would be impossible. This is because the stabilization of the system would call for the active participation of the central banks – not only those of countries whose currencies have a tendency to depreciate (and thus require the sale of foreign exchange reserves for their stabilization). Also, the central banks of countries whose currencies are under pressure to appreciate beyond the generally accepted rule would have to stand ready to stem the speculative tide by intervening through sales of their own currency. Their reach is always greater than that of the market, because they can print all the currency they need.

Of course, such a scheme raises a number of technical problems. One central issue is determining the level and range of nominal exchange rates at which to introduce the CRER. Another is identifying the right indicator to be used as a basis for RER calculations in the future. But these are not insurmountable (see forthcoming UNCTAD Policy Brief).

What is needed now is a thorough discussion about the deviation between nominal and real exchange rates, so as to launch an inclusive, substantive discourse about the multilateral trading system and its shortcomings. This should encompass discussions about the fundamental sources of competitiveness (including labour market developments) and the effects of financial markets. Given the risks of competitive devaluations, this debate should be high on the agenda of the G-20 and of other international forums.

The proposal to limit current account deficits and surpluses may not be the best indicator to focus on, because they are affected by too many variables. Nonetheless, this bold embrace of multilateral remedies to address systemic crises opens the door for establishing order in global monetary affairs and making trade effective.

