UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

GLOBAL IMBALANCES AND EXTERNAL SUSTAINABILITY

UNCTAD contribution to the G20 Mutual Assessment Process (MAP)

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Contents

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In their Declaration at the Seoul Summit, G20 Leaders recognized the need for assessment of the "nature and the root causes of impediments to adjustment as part of the MAP" which are posed by "persistently large imbalances, assessed against indicative guidelines". The G20 Framework Working Group has been asked to consider:

1. **A mechanism to facilitate timely identification of large imbalances that require preventive and corrective action.**
2. **A range of indicators to serve as indicative guidelines for such assessment.**

International organisations have been invited to provide inputs to assist G20 members in this process. UNCTAD offers below some of its observations on the subject, from its vantage point of the integrated treatment of trade, finance and development.

A. GLOBAL IMBALANCES IN PERSPECTIVE

In UNCTAD's view some general observations concerning the nature of global imbalances are crucial to identifying the relevant technical guidelines to assess them:

- *In general, the MAP should consider only those imbalances in the international relations that are directly related to an improper functioning of the international trade and/or finance system. National **public budget deficits are not part** of global imbalances under the (normal) operating circumstances of independent national currencies and national central banks (inside the Euro-zone different political considerations which are not relevant among the G-20 may play a role). In a properly functioning currency system, even countries with very high budget deficits over extended periods of time (and current account deficits resulting from relatively high overall domestic demand growth) would be able to eventually resort to exchange-rate devaluation to stimulate the economy while cutting back on public expenditure or raising tax levels.*

- *Like fiscal disequilibria, imbalances that occur in the form of relatively high national inflation rates or wages growing consistently more in one country than in another (in relation to national productivity advances), are best remedied through exchange rate devaluation if the international currency system were to operate effectively. Preventive or corrective action by institutions dealing with international economic policy is required only when devaluation is not available to correct for the loss of competitiveness of an entire economy. Adjustment mechanisms based on a variety of indicators that are not closely linked to the driving forces of lasting imbalances are counterproductive, since they tend to **focus on the symptoms, rather than the causes,** of imbalances.*

- *Consequently, mutual assessment should concentrate on situations in which the exchange-rate mechanism does not lead to the expected adjustments in the real economy. Such situations occur with increasing frequency as market-determined exchange*

rates no longer reflect the fundamentals but follow short-term speculation on interest rate differentials. This currency carry trade drives exchange rates systematically and over long periods away from fundamentals, thereby creating simultaneously unsustainable imbalances in trade and finance. An assessment of these imbalances needs to account for the deviations of actual exchange rates from a benchmark variable. A suitable benchmark would be a constant real effective exchange rate. The latter would be the norm if nominal exchange rate changes actually did systematically reflect interest rate differentials or price level fundamentals, something that is not the case under present conditions in the international currency system.

- *Due to the increasing malfunctioning of the currency markets over the past decade, global current account imbalances have become a major source of systemic risk to the global economy. As the recent global financial crisis has shown, such current imbalances can have adverse repercussions in the short and long term on both, surplus and deficit economies. This is mainly due to the disruptive effects of a forced sudden adjustment in cases where the financial markets do not expect sufficiently strong corrective action from economic policy and international coordination efforts. A closer look at the components of the current account balance of selected G20 countries highlights **the importance of exchange rates and interest rates as key variables** to avoid unsustainable imbalances (see below).*

- *The interpretation of current account imbalances as a reflection of "excess savings" in surplus countries and "savings shortage" in deficit countries is flawed. It mistakes a macroeconomic accounting identity for a causality and therefore may mislead policy makers. The current account of a country is the outcome of a complex interplay of prices, quantities and policy decisions in many countries and cannot be understood as the result of the voluntary decision of a "representative household". As shown in UNCTAD's **Trade and Development Report 2008**, current account reversals in developing countries, rather than being driven by autonomous saving and investment decisions of domestic agents, tend to be driven by external shocks emerging from goods markets as well as from financial markets.*

B. ASSESSING LARGE GLOBAL IMBALANCES

G-20 leaders acknowledged the need for a co-ordinated multilateral response to trade imbalances by requesting that "indicative guidelines composed of a range of indicators" be designed which "would serve as a mechanism to facilitate timely identification of large imbalances that require preventive and corrective action to be taken"(paragraph 9 of the Seoul Summit Declaration).

1. Current account imbalances: fallacies and flaws

In their request, the G-20 Leaders have opened new paths to improve global economic governance. This imparts renewed impetus for multilateral cooperation to resolve long-standing imbalances, and the tabling of concrete proposals for mechanisms to reduce global monetary and financial volatility is timely. But in UNCTAD's view, it would be mistaken to focus on the current account balance as the main indicator to be assessed when measuring the sustainability of large imbalances.

The new G-20 position acknowledges that leaving current accounts and exchange rate developments entirely to the market does not always generate acceptable macroeconomic outcomes. 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 obvious. This is revealed yet again as Brazil, a major emerging-market economy running a current-account deficit, has been faced with huge capital inflows that are threatening to cause an unsustainable appreciation of its currency.

The world economy has been in similar situations 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. 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 with a generation ago, the magnitude of the trade and capital flows involved is immense.

With open markets for capital, short-term speculators carry currencies across borders to obtain arbitrage profits from interest rate differentials that follow from different national monetary policies. These speculative capital flows continue to dominate the market quantitatively and drive exchange rates against the fundamentals of the targeted countries – exactly 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 all internationally exposed companies and distorts trade flows. This eventually leads to a loss of market share, lasting current account deficits, and to the kind of financial crisis that very often triggers a broader economic crisis. In a situation of fragile global recovery, such risks cannot be underestimated.

In monitoring global trade imbalances and progress towards external sustainability it might seem logical to focus on the size of a country's current account deficit or surplus, as a percentage of its gross domestic product (GDP) to indicate when the overall scale of imbalances is moving away from sustainable positions. Other viewpoints favor looking at a range of indicators that contribute to imbalances and to consistency between fiscal, monetary and exchange rate policies.

However, relying on current account imbalances as a core indicator does not provide an appropriate guide for decisions about macroeconomic adjustment. There are many good reasons why a current account may be in deficit or surplus at any point in time. One reason is that domestic demand in an economy may be growing faster than in its trading partners, causing imports to rise more than exports (e.g. the United States over much of the past 20 years). Another is that a country may depend on the import of a primary commodity the price of which tends to rise time 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 the potential to import comparable quantities due to the relative poverty of large parts of the population (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 always indicative of a systemic problem that**

needs coordinated intervention. But current account deficits certainly signal a systemic problem when they are the outcome of a general loss of competitiveness. Such losses are actually reflected in the appreciation of the real exchange rate (RER), and the resulting deficit is unsustainable.

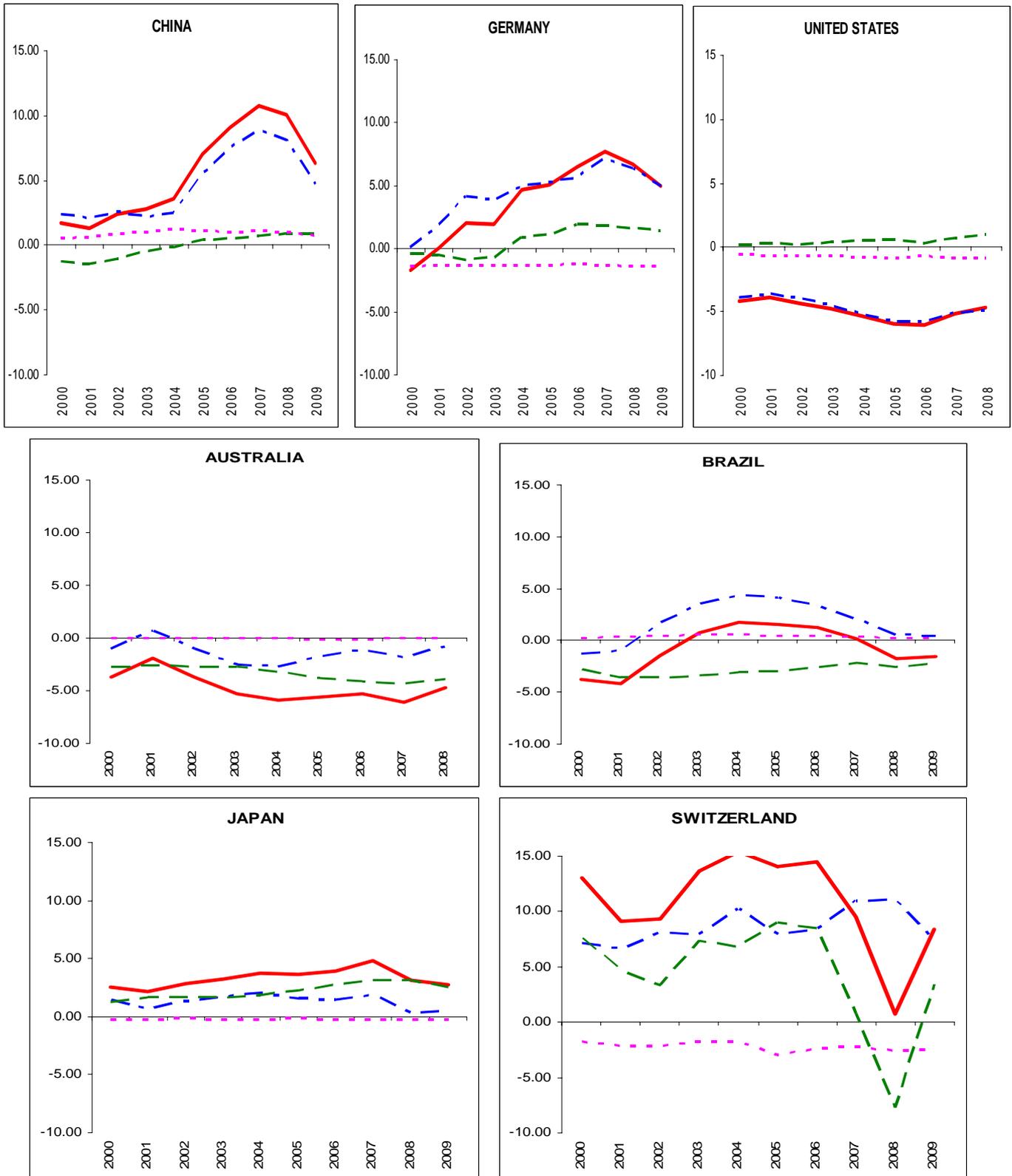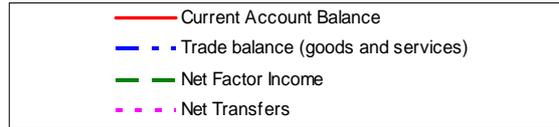## 2. Trade balances do not determine the current account in all cases

The main components of the current account show that beyond trade flows, currency carry trade has played an important role in the built up of the visible imbalances.

By definition, the current account balance is composed of the **balance of t rade** (net earnings on exports – payments for imports), **factor income** (earnings on foreign investments – payments made to foreign investors) and **net transfers**, including remittances. An analysis of the components of the current account balance of selected G20 economies during the period 2000-2009, yields some interesting results:

1. *For Germany, China and the US, trade flows are the major component in the evolution of their current account balances.*
2. *However, for Australia, Brazil, Japan and Switzerland, net factor income is a key component in the evolution of their current account balance*
3. *Countries with currencies that are investment currencies for carry trade strategies, as the Australian Dollar and the Brazil Real, experience a net factor income deficit. In the case of Australia, factor income is dominated by income from portfolio investment and interest paid on debt. The persistent factor income deficit leads to a current account deficit. In the case of Brazil, the trade surplus is dwarfed by a rising factor income deficit.*
4. *Countries with currencies that are funding currencies for carry trade strategies, as the Swiss Franc and Japanese Yen, the income on debt determines a large part of total factor income (chart 1).*
5. *In Japan this part of factor income dominates the dynamics of factor income whereas in Switzerland other factors are dominant*

This underlines that the focus on trade account imbalances alone is insufficient and a consistent framework including exchange rates and interest rates as the most important variables is warranted.

Chart 1
CURRENT ACCOUNT BALANCE BY COMPONENT, selected G20 economies, 2000-2009
(Per cent of GDP)

Sources: UNCTAD secretariat calculations, based on UNCTAD GLOBstat and IMF Balance of Payments Database.

C. MULTILATERAL EXCHANGE RATE COORDINATION IS THE KEY

A promising approach to deal with the twin problems of global trade imbalances and destabilizing short-term capital flows entails adjustment of nominal exchange rates in line with the fundamentals. Such **a rule to k eep the real exchange rate c onstant** would be enforceable by multilateral agreement and concerted central bank action. It would restore the fundamental conditions required for free trade and remove the incentive for short-term currency speculation that has aggravated global imbalances and the attendant financial crisis whose impact continues to encompass advanced and major developing economies alike.

The use of the Real Effective Exchange Rate (REER) as a practical and effective indicator to differentiate between sustainable and unsustainable trade imbalances leads to a simple and viable approach to averting exchange rate mis-alignments and for preventing carry trade with currencies at the same time. The REER 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 labor 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.

In the event of such an approach being integrated into the monitoring of 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 symmetric action of the central banks of both countries whose currencies are under pressure to depreciate and countries whose currencies are under pressure to appreciate. The latter 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.
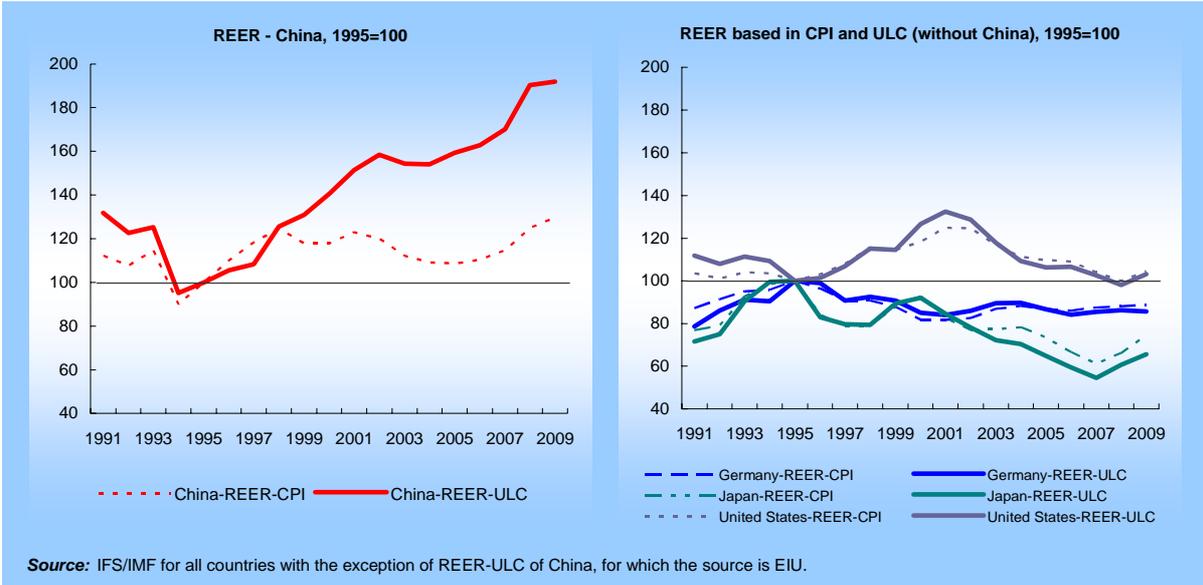
1. Technical problems can be solved

At least two important technical problems need to be addressed in order to implement such a scheme. Obviously, a central challenge is the determination of the level and range of nominal exchange rates on which such a mechanism would be based. Finding the appropriate "original equilibrium exchange rate", requires a detailed investigation into the absolute purchasing power of all currencies, a subject that UNCTAD will examine and on which it will make policy proposals in due course. The second problem - identifying the right indicator to be used as basis for the real exchange rate calculation – is equally important.

The charts (chart 2) below show that there can be significant differences in the measurement of the real exchange rate, depending on whether it is calculated on the traditional basis of changes in the consumer price index (CPI) or on changes in unit labour costs (ULC). The charts depict these two indicators for the four biggest countries in terms of economic power as measured by GDP, with 1995 (a year with rather low trade imbalances among the G 20) as the base year. On both counts, the real exchange rates of both Japan and Germany indicate a significant gain of competitiveness compared to the base year. Despite the persistent surpluses of these two economies and despite the recent nominal appreciation of the Japanese Yen their

real exchange rates do not undergo a significant appreciation in the subsequent years. On the other hand, the US Dollar appreciated sharply in real terms between 1995 and 2001 along with high and further rising current account deficits and, although the United States has since been on a path to recover competitiveness, the level of 1995 was reached only in 2008. For these three countries the two measures move more or less in tandem, indicating urgent policy action to reduce imbalances by realigning nominal exchange rates better than in the past to domestic cost levels.

Chart 2

REER - China, 1995=100

REER based in CPI and ULC (without China), 1995=100

· · · · · China-REER-CPI ——— China-REER-ULC

— — — Germany-REER-CPI   ——— Germany-REER-ULC
— · — · Japan-REER-CPI   ——— Japan-REER-ULC
· · · · · United States-REER-CPI   ——— United States-REER-ULC

Source: IFS/IMF for all countries with the exception of REER-ULC of China, for which the source is EIU.

For China, however, the situation is totally different. China experiences a widening deviation between the two measures. The ULC-based REER has been appreciating sharply since 1994. It rises consistently and strongly between 2000 and 2010, indicating an overall loss of competitiveness of some 40 percent in these years only. By contrast, the CPI-based REER rises much less and remains more or less constant since the end of the 1990s, interrupted by a phase of depreciation in the mid-1990s. Even though the data used for this exercise do not cover the whole Chinese labour force, there are strong indications that economy-wide wages have been rising very quickly during the last years. The most important of them is a booming private consumption, which would not be possible without strongly rising nominal and real wages.

2. FDI and the real appreciation of emerging market currencies

The discrepancy between the two indicators has to be fully understood before China is held to account for "undervaluation". Based on the ULC-REER China is the only country among the four mentioned where the rising surplus on the current account coincides with the expected loss of competitiveness. This discrepancy is much less surprising when the particularities of China's economic development over the past two decades are carefully considered.

China is the only country among this small group where activities based on foreign direct investment (FDI) dominate export and import behaviour. More than 60 per cent of all Chinese exports emanate from affiliates of foreign firms. Most of them use China as host location because production there allows combining technology incorporating high labour productivity with still very low absolute wages. This combination allows for very high profit margins or strengthens the reach of companies using this production hub to conquer global markets by means of lower costs and prices. In either case, even if nominal and real wages and the ULC rise strongly, as they did in China during the last ten years, there is a significantly larger margin to keep prices low to gain market shares for foreign producers than for firms using the same technology but located in developed, higher-wage economies. This is probably why the higher labour costs are reflected to a much smaller extent in price increases than in other economies (see for a more detailed explanation: *UNCTAD Policy Brief No. 19*).

D. CONCLUSION

The proposal to limit unsustainable current account deficits and surpluses has yet to translate into identifying a set of optimal indicator(s), but this bold embrace of multilateral remedies to address systemic crises opens the door for establishing greater order in global monetary affairs and making trade more effective for development. Indeed, to "find a mechanism to facilitate timely identification of large imbalances that require preventive and corrective action" is crucial for the future of world trade. Trade cannot be made an effective tool to foster growth and reduce poverty if the global community fails to find the sources of imbalances and to institutionalize instruments to prevent them.

The real effective exchange rate based on unit labour costs appears as the most useful benchmark against which distortions on trade flows and capital flows can be measured at the same time. The ULC-based REER provides the only reliable information on the country's competitiveness even under the special circumstances of some emerging markets as a hub of manufacturing production. If labour costs increase sharply in relation to productivity the effect will show up in either a loss of market shares or a loss of profitability compared to the past. On both accounts, competitiveness is reduced in relation to producers in other countries with a lower increase in labour costs.