The G20 Summit – II

The imminence of a crisis does wonders to help concentrate minds! This time around, there was no such backdrop and, naturally, not much could have been expected in any case. The Financial Times post-Summit editorial headline was "*G20 show how not to run the world*". This may be overstating the case, as there are some positive outcomes:

⇒ The threat of a trade war has been averted;

⇒ The dispute over China's exchange rate policy has been papered over, if only for the time being.

Yes, the last five G20 Summits have succeeded in avoiding the mistakes of the 1930s.

In fact, the most imaginative proposal advanced before the meeting came from Timothy Geithner, the U.S. Treasury Secretary: it involved getting the G20 to agree on limits (unstated, but said to be 4% of GDP) on current account surpluses and deficits. The implication is that governments would be expected to take macroeconomic steps to curb imbalances, should they exceed the limit. While in my view 4% is too high, the principle has some very interesting implications, and I am not sure that Mr. Geithner has quite thought them through!

On the issue of exchange rates, the Summit reiterated the wording agreed in the meeting of the G20 Finance Ministers and Central Bank Governors a few weeks earlier – namely a commitment to "*moving toward more market determined exchange rate systems, enhancing exchange rate flexibility to reflect underlying economic fundamentals, and refraining from competitive devaluation of currencies. Advanced economies, including those with reserve currencies, will be vigilant against excess volatility and disorderly movements in exchange rates".*

I had criticized the ill-logic (or should we say “spin”?) in the statement in an earlier article (November 1st). The Summit has compounded the confusing implications by admitting in the accompanying Seoul Summit Document that “*The global financial system came to a sudden halt in 2008 as a result of reckless and irresponsible risk taking by banks and other financial institutions, combined with major failures of regulation and supervision*.” The “failures of regulation and supervision” occurred precisely because of a quasi– religious faith, particularly in the Anglo Saxon regulators, in the efficiency of markets in producing prices which reflect fundamentals. The implication is that any regulatory interference in the market is inherently distortive and hence undesirable. As it happened, this belief was completely mistaken; credit risk was grossly mis-priced by “reckless and irresponsible” banks and their traders. And, they are the very ones who dominate the currency market (it trades 100 times more than the underlying cross-border trade in goods and services) and make huge profits from it. Given this, it is difficult to understand our political masters’ faith in “more market determined exchange rate systems”. In any case, if the market determined external value is to be preferred, by the same logic, why not leave the currency’s internal value (i.e. inflation rate) also to the market? Why does the central bank “manipulate” it? After all, markets are self-correcting, are they not? If prices go too, high, people will stop buying, some may die because they cannot afford to buy food, all of which will bring down the demand, and hence the prices, curing inflation. Surely, in a globalised economy, the external value of a currency is as important as its domestic value to sustainable output, growth and jobs?

To come back to the question of current account imbalances, the Summit Communiqué says that “*We will strengthen multilateral cooperation to promote external sustainability and pursue the full range of policies conducive to reducing excessive imbalances and maintaining current account imbalances at sustainable levels”.* Elaborating on “the full range of policies”, in a speech in Lisbon, President Obama said “*Countries with big surpluses have to figure out how they can expand demand...Countries with significant deficits, we have to* *save more and focus not only on consumption, but also on production and exports….the currency issue plays into this and there's going to be an ongoing debate on making sure that surplus countries are not artificially devaluing their currencies in a way that inhibits not only our growth but world economic growth".* (The Economic Times, November 22). As for production and exports, surely the economics is crucially dependent on the exchange rate? Again, the tone and content of the statement suggest that governments "manipulating" demand, savings, etc is fine. After all, these are variables which directly affect only the real economy; but managing exchange rates in order to curb imbalances is of course a sacrilege – because such an action would directly affect that holy of holies, the financial markets. Strange logic!

The hypotheses that external imbalances are a function only of savings and investment; that these variables and indeed the competitiveness of the economy are independent of the exchange rate so long as it is "fully market-determined"; are completely misplaced. The global economy perhaps needs another crisis to understand that the way to reduce imbalances is to mange the exchange rates; and that, given the "impossible trinity", this will require controls on capital movements.
While, in macro-economic accounting this is so, the fact is that these variables are not independent of the exchange rate

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