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Global macroeconomic imbalances: G20 leaders must back up their rhetoric with deeds

October 13, 2009 10:03am by FT

By Eswar Prasad

The financial crisis has taught us a painful lesson that global macroeconomic imbalances can wreak enormous damage on the world economy. Indeed, the centrepiece of the recent G20 Summit in Pittsburgh was agreement on a framework for balanced and sustainable growth to forestall a resurgence of imbalances as the economic recovery gets underway. At the recent IMF-World Bank annual meetings, G20 leaders gave the IMF a mandate to manage this framework by providing hard-nosed evaluations of their countries' macroeconomic policies.

Experience suggests that grand promises to implement policies that are in the collective global interest can't be taken seriously without an effective enforcement mechanism. After all, we have seen how quickly these same leaders' firm pledges to forswear trade protectionism bit the dust. The IMF has no real levers when it comes to the leading G20 economies, especially since they are the major shareholders in the institution. Moral suasion and name-to-shame approaches don't work well as the large economies tend to simply brush off external criticism of their policies.

There is a simple approach that has real consequences, would be straightforward to implement and allows G20 countries to make enforceable policy commitments. It involves Special Drawing Rights, essentially an artificial currency created at the IMF and distributed to countries in rough proportion to their economic size. The total stock of SDRs is now close to $300bn, a sizable chunk of money.

The scheme would work as follows. The G20, in consultation with the IMF, develops a simple and transparent set of rules for governments on policies that could contribute to global imbalances - for instance, that government budget deficits and current account balances (deficits or surpluses) should be kept below 3 per cent of national GDP. Each country posts a commitment bond amounting to a minimum of 25 per cent of its SDR holdings to back up its commitments to those objectives.

Since it is not easy, even with the best of policies, to turn around the factors underlying imbalances within a short period, commitments to policy objectives would be made over a five year horizon. Intermediate targets could be set over a three year horizon. Failure to meet the targets would mean a forfeiture of the bond (or a part of the bond for missing interim targets). The actual cost would not be large. China, for instance, now has an allocation of 7bn SDRs and 25 per cent of that would amount to less than $3bn. Still, the symbolic effect of being levied an SDR penalty for running bad economic policies would be huge.

By posting larger shares of their SDR holdings, countries could signal stronger commitments to their policy pledges to the international community. This would be a perfect setup for the US to lead by example in bolstering the framework it initiated - by posting a large bond as a commitment to sharply reduce its budget deficit. Given the limited and uncertain tenure of some governments, such a commitment bond would also be a good way of binding future governments to sound policies.

This approach would shift the discussion from contentious arguments about current policies to a focus on outcomes. For instance, China has consistently maintained that its current account surplus reflects structural problems in its economy and has nothing to do with its exchange rate policy. Who could quibble with methods so long as China commits to reducing its current account surplus and succeeds in putting its economy on a trajectory to get it below 3 per cent of GDP in the next 5 years (perhaps with an interim target of 5 per cent of GDP in the next 2-3 years)?

What happens to SDRs that get docked if countries don't hit their targets? These SDRs would be distributed among low income countries. To get incentives right, only those low-income countries that meet minimum standards in terms of their macro policies would be eligible for this redistribution. This way, the IMF could finally offer carrots to poor countries for good policies rather than just sticks for bad policies. Any SDR redistributions to small poor economies resulting from this scheme would be morally justified - instability caused by bad policies in the larger and richer economies tends to hurt these vulnerable and innocent bystanders disproportionately.

The G20 commitment to tackling global macroeconomic imbalances is laudable. G20 leaders must now be willing to back up their rhetoric with deeds and be ready to pay the price for breaking their commitments.

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October 13, 2009 10:03am in Capitalism, Economists | Comment

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