

## DEPARTMENT OF ECONOMIC ANALYSIS AND POLICY

### **No Melodrama, Please, We're Central Bankers: Article in International Herald Tribune, February 9, 2005**

The above mentioned article analyses the recent speech given by Mervyn King, Governor, Bank of England on the International Monetary System on February 4, 2005. The speech covers issues relating to current imbalances in the global economy and the adjustments required by the US, the Euro area and the Asian economies. Mr. King highlights that the current global imbalances are the natural result of policy decisions by all three blocs (the dollar, the euro, and an Asian bloc of currencies). It is therefore meaningless to try to identify the culprit, and blame any one bloc's woes on another. The choice of exchange rate regime by any one bloc both depends on and affects the choices of the others. The salient points covered in the speech are listed below:

- Since the breakdown of the Bretton Woods arrangements and with developments of the international financial markets, there has been a general movement to flexible exchange rates supported by credible domestic monetary policies. Two exceptions to the flexible exchange rate regimes have been the gradual fixing of the exchange rates between members of the European Union and the more or less formal policies of the newly industrialised Asian countries and Japan to keep the value of their currencies stable against the dollar. As a result, the Asian central banks have been accumulating large dollar reserves.
- The counterpart to the Asian bloc's current account surpluses and acquisition of dollar reserves has been large current account deficits in the US, reflecting the use of financial markets to allocate savings from around the world to the most profitable investment opportunities.
- But there is likely to be a limit to the amount of debt that one country can issue as a result of *persistent* deficits before investors start to worry about its ability or willingness to repay. When the country in question is also the issuer of the reserve currency, the rapid build-up in the assets denominated in the reserve currency contributes to the potential instability of the international monetary system.

- Mr. King identifies three challenges for the future. First, do we still need a reserve currency as a source of global liquidity? Second, given that each bloc's policy choices reflect domestic objectives, what could be achieved through international meetings? Third, how might we arrive at such a common analysis? He argues that the G-7 arose out of an earlier episode of concern about exchange rate movements in the 1980s. It is important to expand the group of countries that discuss these issues beyond the G-7 to include those, such as China and India, whose actions increasingly have global economic consequences.
- The main conclusion that he arrives at is that the international monetary system should be seen not as a series of bilateral relationships, but as a multilateral arrangement, albeit one where a small number of the key players can usefully communicate with each other. He argues that there is a need to rethink the role of the IMF in the international monetary system. The Fund should articulate a positive vision for the management of the international monetary system in its forthcoming strategic review.

### **Prof. Mundell's View**

The debate on the global imbalance and its solution is continuing. Recently, Mundell viewed that economic superpowers do not want international currency since their own currency is world currency. In the past there has been a general neglect on issues relating to currency. He felt that the move towards flexible exchange rate regime in the mid-1970s was without study of its implications. Flexible exchange regime (as compared to gold standard) gave rise to high inflation in many countries and though not high inflation but high exchange rate volatility for major industrialised countries such as US, EU and Japan. Given the deficiencies of the current currency system in the world the following suggestions can be considered:

- A 3 to 5 basket of currencies can be adopted as world currency.
- 3 currency agents of the day – Dollar, Euro and Yen (DEY) – can be adopted by the IMF, which would contain 50 per cent DEY and 50 per cent gold. This would give rise to a stable exchange rate regime.
- Quotas of the IMF have to be recalculated. Vote of US would go down and that of EU would go up.
- Multiple currency monetary union would be the order of the day.
- Individual countries would anchor their currencies against DEY.

## **The Issue of Global Imbalance**

The issue of global imbalance essentially hinges on an interdependent cycle:

- The high and increasing current account deficit of US finances the widening domestic saving-investment gap which, in turn, generates demand from the rest of the world resulting in current account surpluses in emerging market economies and raises their foreign exchange reserves.
- The Central banks of the EMEs, including Japan, in turn, invest their reserves into US assets which helps them to manage their exchange rate and export competitiveness, on the one hand, while on the other, such investments help the US to finance its current account deficit at low interest rates and also hold down the interest rate in the US which support consumer spending and imports.
- The investments in US assets have been mainly facilitated by the interventions made by Japan and EMEs like China and India to maintain exchange rate stability by EMEs, than the attractiveness of the US asset's relative rate of return. As a corollary, such a mechanism raises the apprehension that at some point of time, the EMEs may loose their appetite for US Government debt resulting in an abrupt adjustment. More importantly, the increasing pressure on the US dollar may encourage speculators to take a 'one way bet' on the US dollar, which would aggravate the pains of such an adjustment.

Thus, with its rising budget deficit and ballooning current imbalance, US is running up a foreign debt of such high proportions that could threaten the financial stability of the global economy. Given the well-established adverse impact of current account corrections on the growth in the deficit country and the central role of US in world output growth, even an orderly adjustment in US current account deficit may suppress the global output growth.

## **Sharing the Burden of Adjustment**

The issue of sharing the burden of adjustment of the current global imbalance is to be seen in right perspective. Mr. King rightly points out that "...it is meaningless to try to identify the culprit, and blame any one bloc's woes on another." Necessary adjustments have to be taken by all the three blocs to correct the current

global imbalance. Thus, there is an imperative need for a coordinated and cooperative approach. Key elements of this coordinated approach should include different policy responses in different countries/regions:

- In the US, there is need to curb household and government borrowings and strengthen national savings. However, US policies would need to delicately balance a gradual withdrawal of fiscal stimulus without hurting the recovery and, at the same time, without disruptive adjustment of the US dollar.
- The Euro area, which continues to depend largely on external demand, needs to pursue some structural reforms, especially labour policies, to boost domestic demand and broad-base the recovery. Japan needs to continue to take some concrete measures to strengthen its financial system, restructure the corporate sector, and reduce large fiscal imbalances.
- There is a growing perception that flexibility in exchange rate policies in emerging market economies (EMEs) in Asia is worth considering on pragmatic grounds but as appropriate to each country's circumstances.
- As the recovery gains further momentum, interest rates which are at historically lows, may have a tendency to firm up. The transition to higher interest rates would have to be managed carefully, particularly in countries with high household indebtedness and exposure to housing and mortgage markets.
- There is need for bold leadership in resolving some of the issues confronting the international community. Despite the fact that past episodes of crises have exposed various deficiencies of the international financial system, progress towards developing a sound system has been slow. Concrete steps need to be initiated in right earnest to redesign the international financial architecture. Accumulation of foreign exchange reserves by several Asian countries seems to be not only linked to the exchange rate policies and the related trade as well as employment implications but also, to the lack of confidence of these countries in the existing architecture (Reddy, 2003).
- There is also a need to move swiftly in reviving trade talks. The protectionist postures by industrialised countries need to be shed, particularly in agriculture and textiles sectors, especially when developing countries have started, at last, to get out of their protectionist mindsets. Developing countries are increasingly realising that trade is, after all, not a zero sum game but a win-win proposition for both the trading partners. In this context, as presented eloquently by most eminent policy-makers in industrialized countries, the recent protectionist measures by some countries against business process outsourcing misses out not only the efficiency

gains from such outsourcing but also the employment gains from resources saved in the process and deployed in other employment generating sectors.

It may be pointed out that the concerns about sharing of the burden of adjustment on account of the corrections of the US dollar need to be judged in the right perspective. Although, the US dollar has depreciated notably over the recent past, it did not have abrupt repercussions on the major currency parities as well as the global capital flows. Thus, the burden of adjustment has been reasonably shared amongst the global partners.

### **Adjustments Required by the EMEs**

The EMEs could play an important role in correcting the global imbalance. It is advocated that these countries could allow higher exchange rate flexibility, which at this stage, would imply large appreciation in their exchange rate on the back of capital flows searching for higher return in these economies. It would imply that China should revalue its currency (if it remains at the fixed exchange rate regime) or let the Yuan appreciate (if it adopts a flexible exchange rate, the possibility of which is less in near future) and India should allow rupee to appreciate against the US dollar. Similarly, other EMEs should also accept higher flexibility in terms of appreciation in their exchange rates. Higher flexibility in the exchange rate of EMEs, in turn, would have following implications:

- The decline in the US dollar against euro and yen could slow down or even get reversed as the US dollar depreciates against the currencies of Asian EMEs.
- With the appreciation of the currencies of the Asian EMEs, the foreign investors in these countries would book their capital gain and then could divert their assets to the industrialised countries as the EMEs would become less price competitive due to appreciation of their exchange rates.
- The accumulation of reserves in the EMEs would slow down and the current account surplus in most of these economies could be reversed.

- With the depreciation of US dollar against the currencies of the EMEs, the US current account position could improve and the global imbalance could be abetted to a certain extent.

The resistance of the EMEs, in particular, China to revalue its currency can be traced to various factors

- The revaluation of Yuan would reduce the competitiveness of the Chinese economy and thereby seriously undermine the export led growth performance of the economy.
- The financial sector of China, in spite of taking significant strides in recent years, is still in an early stage of development so as to withstand the volatilities associated with sharp exchange rate movements. Currently, the stable exchange rate regime is providing an anchor to the monetary and financial system of the country and the Chinese authorities are reluctant to change the status quo.
- The revaluation of Yuan could give rise to market expectations of further rise in the external value of Yuan which could lead to sharp inflows of speculative capital, eventually resulting in a currency crisis.

In view of the above, it is unlikely that the Chinese authorities would allow a significant revaluation of Yuan in near future.

### **Repercussions of Shift in Investment Pattern of EMEs**

In the absence of the flexibility in the exchange rate of the Asian EMEs and the continued decline in the external value of US dollar against euro and yen, there is a possibility of realignment in the deployment pattern of the foreign exchange reserves of the EMEs. Any shift in the overall portfolio of the EMEs Central Banks away from US Dollar denominated assets can have serious repercussions on the 'gradual' process of adjustment. The impact of a shift of the composition of reserves of the EMEs (especially Asian EMEs) and also Japan away from US dollar is likely to have the following impacts:

- The process of depreciation off US dollar would get substantially accelerated due to over supply of dollar assets and stronger demand for other major currencies. This may not altogether undermine the position of US dollar as reserve currency, which could lead to a situation of multiple reserve currencies.
- With decreased appetite for dollar assets or large scale sell-off of dollar assets, the value of such assets would decrease substantially, leading to rise in the interest rates in the US. At the same time, Central Banks with large dollar assets would book substantial decline in their asset value. It has been argued that the possibilities of such large capital losses have compelled the EME and Japanese Central Banks to keep buying dollar assets to ensure that prices of such assets do not go down sharply.
- Rising interest rate would have direct adverse impact on investment spending in the country. This would also increase the already high interest expenditure by the US households. Decreased asset prices would also have unfavourable wealth effect. The net result would be decline in consumer spending. There may also be a need to cut government spending as well, which would also have adverse impact on the growth rate in the US.
- With sharp depreciation and depressed domestic demand, US exports would increase while imports would go down. While these developments would reduce the current account deficit, given the large imbalance at the current juncture, it is unlikely that the deficit can be altogether reversed in the medium-term. It is likely that sharp depreciation in US dollar could feed into inflationary expectations in the long run.
- Rising interest rate and reduced appetite of the foreign Central Banks for US assets would put serious pressures on the government finances. However, if the economic slowdown is substantial, the government may have to increase expenditure/cut tax to boost economic activities. Therefore, even if there is partial decline, government deficit is likely to remain substantial even in the longer-term future.
- During the 1990s, the US provided the major impetus to the global growth rate. Even in the last two years (2003 and 2004), spurt in economic activities in the US helped revival of the global growth rate. Therefore, a strong slowdown of the US economy would seriously undermine the global growth rate.
- In a bid to cut losses, private investors may also shift their portfolio from dollar assets. This along with possibilities of arbitrage and carry trade may

result in sharp rise in inflows in the major EMEs like China and India, with their connected problems in terms of managing these inflows.

- Sharp depreciation in US dollar may result in serious volatility in the foreign exchange markets and disorderly corrections in exchange rates across the world. The exchange rate of the EMEs would have to bear some burden of adjustment in terms of being more flexible, which would imply, appreciation in their exchange rates.
- With appreciation in the exchange rate of the EMEs, it is likely that their export competitiveness would decline, implying reduction in their current account surplus and slowdown in accretion of reserves. It is also likely that with appreciating currency in the EMEs, the impact of rising oil prices would be dampened.

### **Concluding Observations**

The issue of global imbalance is gaining in importance as the cost of the adjustments required by global players may become higher as the days pass by and the adjustment is postponed for the future. The adjustments and market reaction to the global imbalance and in particular the twin deficit in the US has so far been orderly but these continue to be the major risk factors as sharp adjustment would be severely disruptive. These cannot be solved through independent or unilateral action. Hence, relatively coordinated medium-term action is called for among the major economies of the world. The US, the euro area and the Asian economies like China and India have major role to play in correcting these imbalances.