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Disorder in the Global Economic Order

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Abstract

The consensus that developed among the governments of all major economies in 2008-09 at the time of the economic depression has dissipated leading to tensions among several of them. These are centered mostly on the issue of the value of their currencies. The replacement of consensus at the series of Group of Twenty (G20) meetings in 2009 with discord at the annual meetings of the International Monetary Fund (IMF) in early October 2010 has produced considerable uncertainty in the markets. The dispute over currency valuation has been exacerbated by political wrangling in the United States (US) leading up to the mid-term elections in November 2010. There is expectation that the G20 summit scheduled to be held in Seoul, South Korea may produce more concrete results than the earlier Washington meeting. At Seoul, some concerns of South Asia – in particular the voice it has in multilateral institutions such as the IMF and the World Bank – may also get addressed.

Crises bring people – and nations – together. When they are over or even when their intensity has diminished, states and citizens return to their old, largely selfish, ways. This is exactly what is happening to the global economy in the final quarter of 2010.

The sudden near-collapse of the global financial system in September 2008, with the demise of Lehman Brothers, one of the storied investment banks in the US, brought global flow of credit to

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a halt and induced panic among policymakers. Six months later the G20 decided to act in unison. The members agreed to stimulate their economies by using their budgets to create domestic demand. The US and China, both with large fiscal stimulus programs, led the way in these efforts.

This was the time-tested Keynesian approach which was adopted at the depth of the Great Depression and saved the battered world economy from slipping into an abyss. The approach worked. The Great Recession of 2008-09 was prevented from becoming the Great Depression of the first decade of the 21st century.

With some comfort having returned to corridors of power in the capitals of major economies, policymakers returned to their old ways. Governments began focusing on what they considered problems to be addressed by domestic policies. They were not too concerned about what the impact of their actions on other nations or the global economy. However, on 8 October 2010, a day before the meeting of the policy-making committee that gives direction to the IMF, unexpectedly weak employment data from the US confirmed the fear that recovery in the US had slowed to the point that the talk of a double-dip recession no longer seemed excessively pessimistic. News that the economy lost 95,000 jobs in September 2010 pushed the US dollar briefly below 82.0 Japanese yen for the first time in 15 years.

Tokyo had already begun adopting measures aimed at weakening the value of its currency. A number of other countries also acted similarly. Brazil, for instance, imposed a tax on capital inflows to reduce the upward pressure on its currency. There were fears of a global currency war. Timothy Geithner, US Treasury Secretary, called for collective action on the eve of the IMF annual meeting in Washington, lamenting progress on lifting domestic demand ‘in countries running external surpluses and by the extent of foreign exchange intervention as countries with undervalued currencies lean against depreciation’. He accused China of setting off a cycle of ‘competitive non-appreciation’ in which countries prevent appreciation of their currencies for helping exports, as Japan, Brazil and South Korea have recently tried. This line of policymaking, according to the US, posed an existential threat to the global economy.[2]

These were strong sentiments expressed by an administration under great pressure because of the domestic political environment. In the run up to the mid-term collections in the US, China had become the poster child of opposition to economic policies of the Obama administration. As one analyst wrote, ‘with many Americans seized about the country’s economic decline, candidates from both parties have suddenly found a new villain to run against: China…At least 29 candidates have recently unveiled advertisements suggesting that their opponents have been too

[2] The quotes from the coverage in Sewell Chan, ‘China’s Central Bank Chief Backs Gradual Rise in Currency’, *The New York Times* (9 October 2010), p.B3.

sympathetic to China and, as a result, Americans have suffered.'[3] There was a move in the US Congress to push legislation that would impose counter-veiling duties on Chinese imports if Beijing did not make revalue its currency vis-à-vis the US dollar.

The value of its currency was not the only concern of developed countries with reference to China's economic policies. They also wanted China to change the orientation of its policies; to give up, in fact, the model of export-led growth it had used with such success to climb the economic ladder. The senior Chinese leaders who came to the IMF meeting did not seem to disagree with this notion. On the eve of the Washington meeting, the Chinese officials did not contest the finding that their currency needed to appreciate. But they argued that the upward adjustment needed to be gradual, not abrupt and certainly not by something like 20 per cent that was being informally proposed. Such a major adjustment would bankrupt a number of export industries in the country and increase the level of unemployment. What they called the 'equilibrium exchange rate' should come into play over a few years.

China also indicated that they needed more than an exchange rate adjustment to balance their economy. Speaking at a forum sponsored by the IMF and the British Broadcasting Corporation, Zhou Xiaochuan, the governor of the People's Bank of China, the country's central bank, said that 'the Chinese government was committed to doing its part by encouraging the growth of the service sector, which would lessen its dependence on the export-oriented manufacturing sector; by improving its health care and retirement pension systems, which would allow Chinese consumers to save less; and by spending more on rural development to lessen the economy's dependence on rapidly urbanising global areas'.[4] Revaluation of the currency would help reorient growth away from exports and coastal manufacturing areas and move it more towards domestic demand and poor regions in the country's interior. Some of these areas had become politically restive in recent years. Greater emphasis on developing social safety sets would ultimately result in reducing domestic savings and increasing consumption. The assumption was that if China begins consuming a larger proportion of its national product, it would export less and thus help in balancing the global economy.

While Geithner was pointing his finger at Beijing, the Europeans included the US among the culprits attempting to manipulate currencies for building exports. Jean-Claude Juncker, chairman of the group of Eurozone finance ministers, complained about the weakness of the US dollar as

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3 David D. Chen, 'China emerges as a scapegoat in campaign ads', *The New York Times* (10 October 2101), pp. A1 and A19.

4 Sewell Chan, 'China's Central Bank Chief Backs Gradual Rise in Currency', *The New York Times* (9 October 2010), p.B3.

well the undervaluation of the Chinese currency. 'The euro is too strong today', he said. 'I don't think the dollar is in line with the underlying fundamentals'.[5]

While accepting some of the criticisms, the Chinese also had their own complaints. According to them, the global imbalance threatening the world economy and affecting its recovery was also due to the inability of the US to curb its fiscal deficit and reduce government debt. They also emphasised that liberal monetary policies of central banks of large economies had contributed to global imbalances. They further pointed out that the decision by the Federal Reserve (Fed) in the US, to use 'quantitative easing' to stimulate demand would end in further lowering the value of the US dollar. Quantitative easing, or QE, is used by the Federal Reserve to pump new money into the economy and keep interest rates low by buying assets from the private sector. This was done by the Fed in 2009; the new effort has been labeled QEII and can be launched if the US economy shows signs of weakening further.

The minutes of the meeting of the Federal Open Market Committee (FOMC), which sets interest rates and held on 21 September 2010, showed that many participants felt that more monetary easing is necessary for kick-starting the sluggish US economy. 'Many participants noted that if economic growth remained too slow to make satisfactory progress towards reducing the unemployment rate, or if inflation continued to come in below levels consistent with the FOMC's dual mandate, it would be appropriate to provide additional policy accommodation.'[6] The QEII decision may come as early as 3 November 2010, when the FOMC is scheduled to meet again. As Dominic Wilson of Goldman Sachs points out, 'quantitative easing is potentially a very stimulative policy for the global economy if it compels other central banks to follow suit on pain of seeing their currencies rise and policy stances tighten'.[7] The effect of this policy will be significant for a country such as India that has been tightening money supply on inflationary concerns.

It is not surprising that the IMF meeting produced at best a tepid response, which did little to calm the markets. No pressure was exerted to get China to revalue its currency. Instead the communiqué issued after the deliberations recognised that 'economic recovery is proceeding, but remains fragile and uneven across the membership'. The members pledged to 'continue working collaboratively to secure strong sustainable and balanced growth, and to refrain from policy actions that would detract from these shared goals'. They also promised 'to work towards a more balanced pattern of global growth, recognising the responsibilities of surplus and deficit

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5 Chris Giles and Alan Beattie, 'Global clash over economy', *Financial Times* (11 October 2010), p.1.

6 Quoted in James Politi and Robin Harding, 'Fresh Fed boost more likely', *Financial Times* (13 October 2010), p.1.

7 Quoted in Alan Beattie, 'G20 currency fighters set for rumble in Seoul concrete jungle', *Financial Times* (12 October), p.2.

countries'[8]. The message was largely meant for China, with huge trade and foreign exchange surpluses, and the US with equally large deficits. The IMF policymaking committee also vowed to 'address the challenges of large and volatile capital movements which can be disruptive'.[9] This had reference to the large inflows of capital in emerging market economies such as Brazil and India, where higher returns were available due to monetary tightening.

The other important issue before the IMF during the annual meeting was to change the rules of governance, which would have given greater voice to larger emerging market economies. This would have resulted in reduction in the number of seats held by Europe in the 24-member IMF board of directors. The Europeans were not prepared to make major adjustments and suggested only minor changes that were not acceptable to the US and other large emerging market economies.

Weak words do not produce strong policy actions. 'The language is ineffective. The language is not going to change things. Policy has to be adapted', said Dominique Strauss-Kahn, IMF managing director, expressing his discontent at the outcome of the meeting. Many experts feared that the lack of substantive agreements and brinksmanship on proposed reforms to the IMF is likely to exacerbate currency volatility in run-up to the Seoul G20 summit.[10] According to Mohamed El-Erian, chief executive of PIMCO (Pacific Investment Management Company, LLC), the world's largest bond investor, 'a once promising global response has now been replaced by inadequately coordinated national economic policies and growing friction among countries'.[11] Paul Martin, the former Canadian prime minister who helped create the G20 after the 1997-98 Asian financial crisis, said the dispute among the major global players was overshadowing issues of international cooperation such as the Basel III capital accords and the newly expanded Financial Stabilty Board. 'The exchange rate issue is important but it would be tragedy if the Seoul G20 were to be hijacked by currencies as these meetings were', he said after the conclusion of the meetings.[12]

With the world's attention trained on the value of the global currencies and recovery from the Great Recession of 2008-09, South Asia's concerns were hardly discussed at Washington. India expressed concern about capital inflows becoming larger than what can be absorbed without difficulty and affecting the value of the rupee. Pakistan used the meetings to drum up support for

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8 International Monetary Fund, 'Communiqué of the Twenty-Second matting of the International Monetary and Financial of the Board of Governors of the International Monetary Fund', *Press Release No. 10/379*, 9 (October 2010), Washington DC.

9 Ibid.

10 Chris Giles and Alan Beattie, 'Global clash over economy', *Financial Times* (11 October 2010), p.1

11 Ibid.

12 Alan Beattie and Chris Giles, 'IMF meeting dashes hopes for cooperation', *Financial Times (*11 October 2010), p.2.

its efforts to revive the economy after the 2010 floods that had caused severe economic distress. Even after India's impressive economic performance over the last quarter century, the South Asian presence in the global economy is not strongly felt. That said, there are issues on which South Asia, India in particular, would like the international community to focus. The most important among these is the voice of the region in the IMF and the World Bank. The region is not heard when important international economic issues are debated at international forums. India figures in the boards of the IMF and the World Bank but unlike China, it is not a permanent member and has other South Asian countries such as Pakistan in its constituency. It, therefore, does not fully represent South Asia since Pakistan is included in the Iran/Arab constituencies in the two boards. Unfortunately, while demanding changes in the voting structures of these institutions, South Asia is not working together.

Many of the causes for the disorder in the global economic system and the structure of the international system remain unaddressed in Washington. The can has been kicked down the road with the expectation that the G20 meeting in Seoul in November, with fewer people sitting around the table than at the IMF annual meeting at Washington, may be more productive. Seoul may be able to take some decisions that were avoided in the Washington meeting.

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