



Global monetary chaos: Systemic failures need bold multilateral responses

Amidst continued financial crisis, the question of the global trade imbalances is back high on the international agenda. A procession of prominent economists, editorialists and politicians have taken it upon themselves to “remind” the surplus countries, and in particular the country with the biggest surplus, China, of their responsibility for a sound and balanced global recovery. The generally shared view is that this means permitting the value of the renminbi to be set freely by the “markets”, so that the country will export less and import and consume more, hence allowing the rest of the world to do the opposite. But is it reasonable to put the burden of rebalancing the global economy on a single country and its currency? This policy brief contends that the decision to leave currencies to the vagaries of the market will not help rebalance the global economy. It argues that the problem lies in systemic failures, and as such, requires comprehensive and inclusive multilateral action.

The international community has allowed global monetary incoherence to reign before and after the crisis. Indeed, “markets” were permitted to manipulate currencies in a way that made some sovereign governments and central banks look like penniless orphans. The need for a new approach to global macro-economic governance is more urgent than ever, because today’s currency chaos has become a threat to international trade and could be used as an alibi by major trading countries for resorting to protectionist measures.

An unbalanced way to rebalance international trade

In fact, the calm after the storm of the recent financial meltdown did not last for long. Institutional “investors” are back in business in global currency markets. With their resurgence, countries are again facing huge inflows of hot money that cannot be put to any productive use, but which create severe price misalignments and trade distortions. The global “casino”, nearly empty a year ago, is crowded again, and many new bets are on the table. However, the recovery in the real economy is modest at best. In fact, the rebound of stocks, commodity futures and currency trade in several emerging and developing economies since March 2009 displays the makings of highly correlated big new bubbles and the threat of a new round of financial crisis. Of even greater concern is that the crisis notwithstanding, faith in “market fundamentalism” is unswerving. That faith continues to sustain the naïve belief that a solution to misalignment may be found by leaving the determination of exchange rates to unregulated financial markets.

The effects of the new exuberance on financial markets are adverse for countries with once-fragile currencies, such as Brazil, Hungary and Turkey. Exploiting the differentials between interest rates, the so-called currency carry trade in these countries and in the big financial markets of the North has become even easier today. Rates in the North are generally close to zero, whereas maintaining “confidence” in countries with weaker currencies – under the aegis of IMF programmes since the onset of the crisis – has called for higher rates than before. The first results of the new “confidence” in weak currencies are ominous. An appreciation of the Brazilian *real* and the Hungarian *forint* has forestalled urgently needed gains in competitiveness and could again lead to severe overvaluation, a dramatic distortion of trade patterns and new imbalances.

Recent actions taken by some developing economies, such as Brazil, to intervene in foreign exchange markets have to be evaluated in light of the dramatic failure of the currency markets to get the prices right. Re-imposing a 2% tax on purchases by foreign investors of real-denominated fixed-income securities and stocks, for example, is not a market-unfriendly policy. Rather, such measures serve to safeguard the efficiency of markets for goods and services by protecting their prices from becoming a punching ball of financial market prices, which are driven by an undifferentiated (if not irrational) appetite for risk. In the brave new world of liberalized global trade and finance, the treasuries of sovereign governments of the largest developing economies – and even some developed countries – can be seriously challenged by the power of financial flows. And in the absence of a truly multilateral exchange rate system, each country naturally pursues whatever works best in the circumstances.



In fact, as a response to the current global crisis that originated elsewhere, China has done more than any other emerging economy to stimulate domestic demand, and as a result its import volume has expanded significantly. Private consumption is rising at breakneck speed. According to several estimates, Chinese private consumption increased by 9% in 2009 in real terms, dwarfing all the other major countries' attempts to revive their domestic markets. But even in the preceding decade, real private consumption, at an average 8% growth rate, was an important driver of growth, backed by wage and salary increases in the two-digit range and strong productivity growth. Unit labour costs (nominal compensation divided by productivity) are rising more there than elsewhere, resulting in a continuous loss in competitive power even with a fixed exchange rate. Expecting that China will leave its exchange rate to the mercy of totally unreliable markets and risk a Japan-like appreciation shock ignores the importance of its domestic and external stability for the region and for the globe.

Neither floating nor pegged: reforming global exchange rate governance

It is time to break with a sterile polemic that ignores the increasing evidence from a range of experiences showing that both absolutely fixed/pegged and fully flexible/floating exchange rate systems are suboptimal. These so-called "corner solutions" have added to volatility and uncertainty and aggravated the global imbalances. With this as a starting point, the debate can move forward to explore new common formulas for exchange rate management that increase consistency between trade and financial flows in a globalized economy.

In order to address global imbalances coherently, governments need to act in the same spirit of multilateralism that characterized the international fiscal response to the crisis at its most critical moments in 2008. A coherent approach to restoring balanced trade calls for policies that address and prevent currency speculation at the global level. Even those who criticize governments for stabilizing exchange rates and intervening in financial markets generally recognize that a viable long-term solution to the problem of massive trade distortions and global imbalances cannot be expected from individual central banks trying to find a unilateral solution to a multilateral problem like the exchange rate.

The World Trade Organization was established to help countries coordinate and manage the multilateral trading system, and the Basle Accords set global standards for banking. But the global monetary system has no such agreed regulatory system for enabling trading partners to avoid distortions stemming from financial shocks and, most importantly, exchange rate misalignments. Such a framework for limiting the degree of exchange rate deviations from the fundamentals would provide the missing link in dealing with the crucial but neglected source of imbalance and instability in the globalized economy. In the meantime, countries should be able to retain the policy space needed to limit the speed and change the direction of capital flows when the collateral damage threatens to become unbearable.

How do we get there?

As proposed by UNCTAD in its *Trade and Development Report 2009*, a number of crucial targets aimed at governing global trade and finance can be met through one measure: a "constant real exchange rate rule". Since the real exchange rate is defined as the nominal exchange rate adjusted for inflation differentials between countries, a constant real exchange rate (CRER) can be maintained if nominal exchange rates strictly follow inflation differentials. With a CRER rule, higher inflation is automatically offset by the devaluation of the nominal exchange rate.

A constant real exchange rate can help achieve several main targets. It:

1. *Curbs excessive currency speculation of the carry trade type*, because the interest rate differentials reflect the inflation differentials.
2. *Prevents unsustainable current account deficits and currency crises* by excluding long-lasting currency overvaluation as a policy option.
3. *Helps to avoid unsustainable debt* by removing the tendency for countries to move deeper into unsustainable current account deficits based on the erroneous perception that they have earned the "confidence" of financial markets and rating agencies.
4. *Avoids the imposition by creditors of unwarranted pro-cyclical conditionality in case of crisis*, because the support needed to ward off speculation against a currency would come automatically from the revaluing of partner currencies, given the systemic intervention obligations.
5. *Minimizes the need to hold international reserves*, because with symmetric obligations under the CRER rule no country has to hold reserves to defend its currency but only to compensate for potential volatility of export returns.

Needless to say, introducing the CRER rule would call for major political commitments and be fraught with technical difficulties that would have to be hammered out. To get such a scheme off the ground, in-depth analysis would be needed to identify the level at which real exchange rates could be fixed with the least possible friction. This is, however, feasible if the political will exists to put international trade on a rational basis. Such a rule could include giving more flexibility and exemptions to LDCs in the case of idiosyncratic shocks and lasting structural weaknesses. In conclusion, the CRER rule goes further than instruments that focus on national taxation of capital flows, on the unconditional provision of international support in times of crisis, or on simply throwing sand on the "greasy" wheels of the financial system to decelerate the pace of speculation. With an explicit exchange rate rule, the problem is dealt with at source by removing the incentives for speculation.

Most important: Through a multilateral framework such as this, mutual recrimination over exchange-rate management and the threat of trade wars will give way to a more balanced and coherent discussion of the problems of an interdependent, and indeed very much "coupled", world economy.