

# Policy Brief

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## International Payments Imbalances and Global Governance\*

Eric Helleiner

The world economy is presently characterized by very large payments imbalances. While the United States runs enormous current account deficits, other regions of the world – most notably East Asia and oil producing countries – rack up very large surpluses. We have, of course, been here before. During the late 1960s, the late 1970s and the mid-1980s, the US also experienced very large trade deficits that were associated with rising protectionist pressures, currency instability, and international political tensions. As these phenomena resurface today, the problem of international payments imbalances has once again become an important one for policy makers around the world.

The current global financial crisis has only raised the political profile of this issue. Many analysts argue that global imbalances played a role in contributing to the crisis, and that resolving these imbalances must thus be part of the current international financial reform agenda. There are also concerns about whether global imbalances will continue to be financed smoothly in the context of the present severe international financial instability. If volatile capital flows provoked the need for sudden macroeconomic adjustments and currency fluctuations, the resulting economic upheavals could generate heightened political tensions, both within and between countries.

To tackle this issue effectively, innovations in global governance would be helpful because of three unique features of the current situation: the distinct geography of contemporary imbalances, the dollar's changing position as world currency, and the growing influence of sovereign wealth funds.

\* An earlier version of this paper was prepared as background for the *Modernizing the G8 Summit* meeting (part of the larger CFGS-CIGI "Breaking Global Deadlocks" project) at Bellagio, Italy, from August 18 to 22, 2008. See other project papers at [www.i20.org/libraryitem.php?libraryId=41](http://www.i20.org/libraryitem.php?libraryId=41).



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## The New Geography of International Payments Imbalances

In the past, the G7 countries played the central role in addressing international payments imbalances. Indeed, the emergence and evolution of the G7 as a key entity in global governance was closely connected with the problem of such imbalances. The G7/8 cannot play as useful a role today because of the new geography of payments imbalances. While the US remains the central deficit country, the countries accumulating large surpluses have mostly been non-G8 countries (excepting Japan and Russia).

The most dramatic symbol of the new surpluses has been the explosive growth of China's official reserves. Since the mid-1990s, China's share of international reserves has risen from a mere 5 percent to over 25 percent today, with a total value of over US\$1.9 trillion. Without China's presence, international negotiations to address international economic imbalances are meaningless. Other non-G7/8 countries that have accumulated significant reserves recently include India, Brazil, Saudi Arabia and other members of the Gulf Cooperation Council, as well as a number of other East Asian exporters. To address payments imbalances today, a forum wider than the G7/8 is clearly needed where deficit and surplus countries can discuss issues relating to both the ongoing financing of the imbalances and the adjustments necessary to correct them (particularly given the collective action problems that can plague both of these activities).

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The near-universal membership and overall mandate of the International Monetary Fund make the IMF an obvious possible candidate. But that institution's ability to play a major role in the governance of contemporary international economic imbalances is undermined by distrust of this Western-controlled institution among many "Southern" countries, particularly since the 1997-98 East Asian financial crisis. This distrust is in fact one of the central reasons why many of these countries have been trying to accumulate reserves over the past decade. The institution's advice during the 1997-98 crisis was widely seen as unhelpful, too intrusive, and overly influenced by US policy makers' goals. Policy makers in these countries have preferred to self-insure against balance of payments crises rather than rely on an institution with this record.

A more promising forum might be the G20 grouping of finance ministers and central bankers created in the wake of the East Asian crisis to extend the informal network-based G7/8 form of governance to a wider group of “systemically important” countries. The G20 is fairly well-suited to match the new geography of international imbalances since its membership includes most of the key surplus countries today. Because it is restricted to financial officials, however, the G20 concept is not as effective as it could be if it was extended to include leaders of these countries. To date, the G20 has largely followed the G7 line; distinctive ideas emanating from non-G7 members have had relatively little influence, especially when they might impose costs on G7 governments or firms (Martinez-Diaz, 2007). Convening the G20 at the leaders’ level in the way that US President Bush has for the November 15 summit might give more political weight to the voice of non-G7 members.

A reform of this kind may be particularly important for discussions concerning the financing of, and adjustment to, international payments imbalances. In the past, such discussions have often become closely intertwined with broader political issues that are well outside the jurisdiction of financial officials. These linkages are even more likely to be drawn today since the key imbalances no longer exist exclusively among countries that are bound together by a military alliance, as they were during the 1970s and 1980s. It is difficult for, say, US and Chinese financial officials to insulate their negotiations on imbalances from larger strategic issues in the two countries’ relationship.

Making the “Leaders’G20” a more regular fixture of the international policy making environment is more ambitious than other reforms being touted at the moment, most notably the expansion of the G8 to a G13. It has the greater virtue, however, of including at least one country – Saudi Arabia – from one of the major surplus regions of the world: the Gulf. The “Leaders’ G20” broader membership also enables greater representation for those who are not major deficit or surplus countries but will be vulnerable to the macro-economic impact of decisions addressing global imbalances. This latter goal would be even better served if both the Finance Minister’s and Leaders’ G20 were expanded to include representatives from a “Southern” country grouping such as the G24 (which brings together official developing country viewpoints on monetary and financial issues), much as the G20 already includes a representative from the European Union as one of its 20 members. As I note below, both groupings might also function more effectively if their membership was consolidated along some regional lines.

## The Dollar’s Changing Position as World Currency

Although the G7 played a role in addressing large international payments imbalances during the 1970s and 1980s, the dominant actor was the United States. The dollar’s role as world currency provided the US with unique power in macroeconomic diplomacy. It allowed the US to delay adjustments as foreigners financed its current account deficit through dollar holdings. Then, when adjustments were required, a falling dollar enabled the US to



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deflect much of the adjustment burden to other countries. International payments imbalances were governed, in other words, as much – if not more – by US hegemony than the networked forms of governance embodied in the G7 process.

The dollar's position as the dominant world currency today is facing a more serious challenge than at any time in the postwar period. The creation of the euro has provided foreigners with an alternative currency in which to hold their assets and conduct their international business. Although scholars debate how quickly the euro will become a major international currency, few disagree with the view that the dollar's pre-eminent position will be diminished, at least somewhat, by the euro in coming years.

This shift is likely to reflect not just changing market preferences but also those of foreign governments. In recent years, foreign official holdings of dollar reserves have played an increasingly important role in supporting the dollar. But many foreign governments have become increasingly frustrated with the losses they experienced on their holdings as the dollar depreciated vis-à-vis the euro in the last few years (before the very recent spike in value). The dramatic loosening of US monetary policy during the 2007-08 financial crisis has also raised the prospect for countries whose currencies are linked to the dollar of importing inflation. If foreign holding of dollars has been driven – as some suggest – by a desire to secure access to the US market, this benefit is also diminishing with the US economic slowdown and changing trade patterns. More generally, the 2007-08 crisis appears to have generated renewed interest in Europe and East Asia in the promotion of a more multipolar monetary and financial order.

In this context, the dollar's status as the dominant world currency has become less secure. To be sure, the 2008 financial crisis has demonstrated the dollar's enduring international role as its value has strengthened with the scramble for liquidity and safety. But when the panic subsides, questions about the dollar's future are likely to resurface. International currencies are sustained in part by a kind of inertia; people continue to use a specific currency because other people use it. If there was a sudden change of market and/or official expectations, a "tipping point" could be reached where foreign support for the dollar's international role could unravel quite quickly. Dollar crises in the past – recall 1971, 1978-79, 1987 – have been associated with worldwide instability. The risk of a repeat on an even larger scale must be taken seriously (Helleiner and Kirshner, forthcoming).

To minimize this risk, it would be helpful if a mechanism could be developed to enable foreign governments to diversify their reserves away from dollars without generating a major dollar crisis. Precisely such a mechanism was negotiated in 1978-80 by top G5 policy makers, with the strong support of US and IMF officials (Gowa, 1984). Under this proposal, foreign governments would have been allowed to deposit dollars in a special "substitution account" at the IMF and be credited in certificates denominated in the IMF's currency: SDRs (whose value is made up of a weighted basket of the world's leading currencies). Because this exchange was off-market, foreign governments would have been able to diversify their assets without undermining the value of the US dollar.

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Of course, there would have been some costs. Although SDRs could be used by foreign governments to pay for future balance of payments deficits or transfers to other governments, assets denominated in this currency are less liquid than those in dollars. The account also risked losing money if the dollar fell, since its liabilities were denominated in SDRs whereas its assets were dollar-denominated US Treasury bills. Efforts to shift this exchange rate risk to the IMF – by asking the Fund to back the account with its gold holdings – ultimately complicated the negotiations. When the dollar rose sharply after US monetary policy tightened dramatically in 1979, the issue left the global public policy agenda.

Proposals for a substitution account deserve to be considered again today. Prominent US economists such as Fred Bergsten (2007) – who was involved in the 1978-80 discussions – have raised the idea and some analysts suggest that large foreign dollar holders such as China might be open to discussing it (Reuters 2008). Given the lack of enthusiasm for the IMF among many dollar-holding governments today, a less ambitious version might stand a better chance of being implemented at this moment. Peter Kenen (2005) has suggested that the European Central Bank (ECB) could create a special facility that bought dollars from other central banks in exchange for newly-issued, off-market, euro instruments. This proposal would enable the ECB to minimize the risk of a dollar sell-off that would generate a further appreciation of the euro. One way in which US and European officials could share the exchange rate risk involved would be if the Europeans were to exchange some portion of the US Treasury bills they purchase for special euro-denominated US T-bills.

These proposals would facilitate a more orderly shift away from the dollar-centred international monetary order. Equally important are reforms that would enable macroeconomic diplomacy to function more effectively in the more decentralized monetary environment being ushered in. A top priority should be the task of consolidating the external representation of the euro

zone. As the euro becomes a more important international currency, the euro zone's finance ministers need to give more authority to the informal "eurogroup" and its president to speak for the region in the G8, IMF and elsewhere. This reform might enable the euro zone to diminish the ambiguity over euro exchange rate policy, a policy that is formally shared between finance ministers (who are supposed to set its general orientation) and the ECB (which conducts currency intervention). By accepting one seat in the IMF, the euro zone would also support efforts to reform the IMF's governance to be more inclusive of emerging economies.

Europe is not the only part of the world where regionalization trends in the monetary and financial realm are accelerating. The countries of the Gulf Cooperation Council are planning to achieve a monetary union by 2010. East Asian countries have recently committed to multilateralize the system of bilateral swap arrangements that they have been building since 2000, and they have also been developing an Asian bond fund and discussing an Asian currency unit in order to reduce dependence on the dollar and US financial markets. South American countries are also strengthening the regional provision of balance of payments financing. If these initiatives accelerate, efforts should be made to incorporate representatives from these emerging regions within global financial governance.

These regionalization initiatives also strengthen the case for greater pluralism and decentralization in international financial and monetary governance. The development of policy that is distinct from the universalistic claims of the "Washington Consensus" is an important objective of many of the initiatives. This objective extends beyond issues relating to international imbalances, as Japan's recent initiative, supported now by South Korea and China, for an Asian version of the Financial Stability Forum suggests (Daily Yomiuri, 2008). This trend also bolsters the case for greater representation of regions within global financial governance.

## The New Influence of Sovereign Wealth Funds

The governance of international payments imbalances must adjust to one further change in the global economic landscape: the rapid growth of sovereign wealth funds (SWFs). In the past, payments surpluses were usually recycled to deficit countries via private financial flows or official purchases of safe, highly liquid international reserve assets. In the last few years, in order to earn higher returns, many surplus countries have begun to move some of their reserves into funds which invest much more aggressively in higher-risk assets, ranging from equities to real estate.

These sovereign wealth funds have now become significant players in world financial markets, with assets of approximately US\$3 trillion (up from US\$500 billion in 1990). This sum is larger than the entire hedge fund industry and their size is projected to continue to grow rapidly in the coming years. The largest funds are those of Abu Dhabi, Kuwait, Singapore, Norway, Russia and China, but over three dozen other funds now exist and more are being created each year.

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As SWFs have invested in strategic sectors such as banking and high technology, concerns have been raised in “Northern” countries receiving these investments. Some Northern analysts and policy makers have worried whether these investments might be designed to bolster the national champions or the strategic goals of these governments. These concerns have generated protectionist calls for restrictions on SWF investments, restrictions that would not just antagonize surplus countries but also inhibit the role that SWFs can play in recycling of payments surpluses.

In order to minimize such political reactions, analysts Michael Bordo and Harold James have wondered whether the IMF should take on the role of an active asset manager, investing funds on behalf of SWFs (Bordo and James, 2008). This proposal would require a rebalancing of votes in the Fund; they suggest that as much as 50 percent of IMF votes could be determined by the size of reserve assets placed in the IMF for this kind of active management. If surplus countries had misgivings about the IMF, they could also consider the creation of a new international institution to perform a similar function.

Most attention at the moment, however, has focused on the creation of a set of international rules to govern international investment flows involving SWFs that might ease the concerns of both the countries with SWFs and those hosting SWF investments. Some progress has been made (for example, the October 2008 “Santiago Principles” embraced by 26 SWFs), but more ambitious and substantial agreement between both sides will be difficult to reach. After all, past initiatives to create worldwide rules for investment flows involving countries of both North and South have failed. While Northern governments pressed for provisions relating to national treatment and

non-discrimination for their multinational firms, Southern governments raised concerns about sovereignty and sought tougher regulations over the activities of those same multinationals. The deadlock at the multilateral level has left investment flows governed by an uneven patchwork of unilateral, bilateral and regional rules.

The initial discussions concerning rules for SWF investments have revealed North-South divisions once again. But the roles are now reversed. Northern governments are raising the concerns about sovereignty and seeking to force greater transparency on the activities of SWFs. Southern governments, by contrast, are pushing for guarantees that the investments of their SWFs remain unrestricted and treated in a non-discriminatory manner.

The impasse brings to mind US President Eisenhower's advice: if a problem cannot be solved, enlarge it. Given the role reversals, the most promising way to reach an effective multilateral agreement on SWF investments might be to widen the negotiation to address international investment rules more generally. The room for trade-offs should be considerable.

The negotiation of such multilateral rules could also be used as an opportunity to promote global priorities in creative ways. SWFs could be encouraged to embrace international codes of conduct relating to social and environmental responsibility in their investing, just as many large multinational corporations have been asked to do. SWFs could also be requested to invest a small portion of their funds – World Bank President Robert Zoellick has suggested 1 percent – in projects relating to development or other global goals, again echoing some recent calls vis-à-vis major multinational corporations (Guha, 2008).

Concerns about their global public image may encourage SWFs to embrace these kinds of commitments. But these initiatives could also be promoted on the ground that the accumulation of large balance of payments surpluses should be accompanied by certain international responsibilities – a principle that Keynes tried to implement, albeit in a different way, at Bretton Woods.



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Le CIGI a été fondé en 2002 par Jim Balsillie, co-chef de la direction de RIM (Research In Motion). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario. Le CIGI exprime sa reconnaissance envers le gouvernement du Canada pour sa contribution à son Fonds de dotation.

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