The Mismanagement of Global Imbalances: Why Did Multilateralism Fail?

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After all major financial crises, debates about their causes generally continue without resolution for years and even decades. The aftermath of the global financial crisis of 2008-9 is unlikely to be an exception to this rule. As one example, the debate over whether and how much persistent large imbalances in international trade and financial flows contributed to the unsustainable boom that preceded the crisis continues.[1] In this chapter, I largely leave aside the question of whether global imbalances were an important cause of the crisis, although I argue that the lack of agreement on this issue is one factor – but not the most important – contributing to the continuing inability of governments to take measures that would substantially reduce them. One reason for setting aside the debate about the role of global imbalances in causing the crisis is that even if one took the view that they played little role in producing the crisis, there are a variety of other reasons why they should remain high on the agenda of global economic governance. Not least, continuing large payments imbalances raise concerns about the consequences of the growing net indebtedness of the United States, of the continued accumulation of US dollar-denominated government debt by China, and further complicate the already problematic relationship between Washington and Beijing.[2] In many ways, the ability of these two countries and of the institutions of global economic governance more generally to manage the problem of global imbalances can be seen as a litmus test of contemporary multilateralism. Before the crisis, the major countries categorically failed this test. Indeed, the G-20 seemed to accept this in agreeing at the Pittsburgh summit in September 2009 that they had a collective "responsibility to ensure sound macroeconomic policies that serve long-term economic objectives and help avoid unsustainable global imbalances."[3] Despite the renewed impetus provided by the crisis, however, I argue that the likelihood of them achieving their commitment remains low.

What explains this longstanding failure of multilateralism in such a crucial area of global economic governance? One possible reason is the perennial failure within economics and the economic policy community significantly to explore, let alone to understand, the linkages between macroeconomic and financial sector imbalances.[4] With the benefit of hindsight, this weakness played a part in the partial misdiagnosis of the global imbalances problem and its associated focus on the sustainability of net lending by surplus countries to the US. But this intellectual failure cannot fully explain the continued lack of political progress in the aftermath of the crisis, given the heightened attention to macroeconomic-financial linkages. Even before the crisis, conventional analysis implied some fairly frightening possible outcomes, including a collapse of the dollar, rising US interest rates, rising protectionism, and a deep global recession.[5] Such outcomes were sufficiently plausible to policymakers that the major countries conducted a series of bilateral and multilateral policy negotiations to reduce global imbalances after 2004. These efforts went nowhere, suggesting that the failure of multilateralism in this area is not mainly due to the absence of an agreed diagnostic framework.

A second possible explanation for the failure of multilateralism is that the sources of global imbalances increasingly lay in policy choices made outside of the G7 countries, undermining the ability of this key grouping to address the problem. This explanation is less easy to dismiss, in part because it points to an obvious truth (the shift in the balance of economic power away from the G7) and because it links macroeconomic imbalances to financial instability. It became popular in American policymaking circles in particular and has its origins in Ben Bernanke's "global savings glut" analysis, whereby undervaluation of the Chinese renminbi (RMB) led to the accumulation of large foreign exchange reserves mainly in the form of US government debt, keeping long term US interest rates excessively low, fuelling the credit boom.[6] At the end of 2008, US Treasury Secretary Hank Paulson similarly argued that "super-abundant savings from fast-growing emerging nations such as China and oil exporters… put downward pressure on yields and risk spreads everywhere. This…laid the seeds [sic] of a global credit bubble that extended far beyond the US sub-prime mortgage market and has now burst with devastating consequences worldwide."[7] Before the recent crisis began, Fred Bergsten outlined the broader implications of this analysis for multilateral economic governance:

> Inducing China to become a responsible pillar of the global economic system (*as the [US and EU] are*) will be one of the great challenges of coming decades -- particularly since at the moment China seems uninterested in playing such a role…In numerous areas, [China] is pursuing strategies that conflict with existing norms, rules, and institutional arrangements.[8]

In short, Bergsten suggested, Chinese mercantilism undermined a working multilateral system based upon a previously dominant G7 club. A corollary of this argument is the common refrain that China and other important emerging countries must become "responsible stakeholders" in the multilateral system in order for it to resume its effective functioning. There are two main difficulties with this argument. First, as I show below, multilateral efforts to tackle global imbalances long predate the 2000s and were characterized by systematic failure. Multilateralism in the form of the G7 and the IMF were unable to deal with the problem of global imbalances well before China's rise. Second, this diagnosis was attractive in Washington precisely because it shifted blame to China and other emerging market countries, shifting attention away from market failures and poor macroeconomic and financial policy choices in the major countries and above all in the United States.

Multilateralism has failed to manage global imbalances, I suggest, for two other related and deeply political reasons. First, it stemmed from a persistent unwillingness among all major countries, not just China, to accept the domestic political costs of adjustment and a related shift to different models of economic growth. I argue below that China is indeed an outlier among the G-4 (consisting of the US, EU, Japan, and China), but only because it is relatively poor, unusually open, and has opted for exchange rate targeting rather than inflation targeting. It does indeed resist external policy constraint, but in this regard it is little different to other major countries. Second, it stemmed from the weakness of the multilateral policy surveillance framework inherited from the era of western dominance. This framework was poorly suited to facilitate the negotiation of the necessary domestic and international political bargains, particularly as regards policy areas that the major countries viewed as too politically sensitive. In order for multilateralism to become more effective in the future, these flaws would need to be resolved, but there are few signs that major governments will accept the constraints on domestic policy choices that this requires.

The rest of this chapter proceeds by placing the recent failure of the global institutional framework to manage global imbalances effectively in a broader historical and political context. The first section briefly outlines the evolution of the multilateral framework for macroeconomic policy coordination since 1944. The second section addresses the question of whether China has refused to play by the established rules in the 2000s and if so, why. The focus on China is motivated by the consideration that China is now widely seen (at least in the West) as presenting the major challenge to the Western multilateral economic order established at the end of World War II. The third section addresses the state of the multilateral regime on macroeconomic policy coordination on the eve of the recent global crisis and shows that China was far from unusual in resisting multilateral constraint on domestic policy choices – for this reason, China is not the 'critical test' of multilateralism that it is often seen to be. The conclusion assesses the potential for recent changes in the shape of global economic governance to make multilateralism more effective in this area in the future.

1 The multilateral framework for macroeconomic policy coordination

Under the Bretton Woods rules as agreed in 1944, the main focus of multilateral policy constraint was firmly on member countries' exchange rate policies, not fiscal and monetary policies. Reflecting the negative interwar experience with floating exchange rates, countries were obliged to avoid beggar-thy-neighbour exchange rate policies and to consult with the Fund on any significant change in their currency's par value. This focus was retained after the breakdown of the pegged exchange rate system in the early 1970s, when the major countries agreed to expand some aspects of the IMF's macroeconomic policy surveillance function. These modifications were driven primarily by the US concern that major surplus countries, particularly West Germany and Japan, were continuing to resist the appreciation of their currencies that Washington saw as necessary to reduce growing global payments imbalances.

The Second Amendment of the IMF Articles of Agreement (1977) modified Article IV to give the IMF responsibility to oversee the international monetary system to ensure its effective operation ("multilateral surveillance") and to monitor each member country's compliance with its policy obligations ("bilateral surveillance"). The amendment specified that "The Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." The Second Amendment also obliged IMF members not to "manipulate" their exchange rate: "A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."[9] However, this clause was rather general and implied the need to demonstrate intent on the part of the country to gain an unfair advantage.

Pauly argues that these revisions reflected a persistent underlying norm that countries were mutually responsible for the external effects of their macroeconomic policy choices.[10] But the regime was narrower than this, since the formal rules continued to focus almost entirely on exchange rates. Member countries had no obligation to coordinate their fiscal and monetary policies. Fiscal policy choices have never been constrained by this multilateral regime, a reflection of the domestic political sensitivity of taxation and spending decisions. Under the pegged exchange rate system, countries were free to adopt capital controls precisely in order to permit them to make independent monetary policy choices. The country at the centre of the pegged exchange rate system, the United States, had no exchange rate policy target and accepted no multilateral constraint on the Federal Reserve's monetary policy choices. As growing capital mobility gradually eroded monetary policy independence on the part of other countries, floating exchange rates became seen by the early 1970s as a means of restoring national monetary policy autonomy.

Thus, the IMF surveillance regime has always reflected a rough compromise between two key norms: the norm that countries should take into account the negative external consequences of domestic policy choices, and the norm that countries should be largely free to manage their own domestic business cycle. As Ruggie pointed out, this embedded liberal compromise entailed only limited and specific external constraints on national policy choices, whilst according substantial national autonomy over fiscal and monetary policy.[11] This reflected the dominant preference of the major western countries in the postwar period, above all those of the United States.

From fairly early on, the difficulty with this compromise was that when the United States wanted to place pressure on other countries to adjust their monetary and fiscal policies, the multilateral framework provided it with little leverage. In part for this reason, negotiations of this kind were often pursued outside of the formal multilateral framework provided by the IMF. In the 1960s, such discussions occurred in Working Party 3 of the OECD and from the mid-1970s in the newly formed G7. In addition, the United States increasingly resorted to bilateral negotiations with key partners, notably Japan from the late 1970s. Since many of the other major economies were also political allies of the United States, these other forums permitted Washington a unique degree of leverage, further reducing the incentive to undertake substantive reforms of the multilateral framework itself.[12]

From the mid-1990s, there was a sharp deterioration of the US current account deficit (figure 1). The size of this deficit, and the corresponding size of the collective current surplus of the rest of the world, also became much larger in proportion to the size of the global economy. The absolute value of current account imbalances reached about 6% of global GDP, up from 2% in the early 1980s and 1990s and even less during the Bretton Woods period.[13] Although Washington was complacent about this development during the 1990s boom, concerns grew in the early 2000s as the external deficit continued to rise and as the composition of the rest of the world's surplus changed. By the mid-2000s, Japan and Germany remained important surplus countries but China and the Middle East (collectively) had emerged as even more important. Particularly as regards China, the usual negotiating mechanisms open to Washington were less likely to bear fruit than in the case of important US allies. Growing concerns about China's economic rise, fuelled by the large and growing US bilateral trade deficit with China, prompted Washington to push for a further modification of the multilateral surveillance framework.

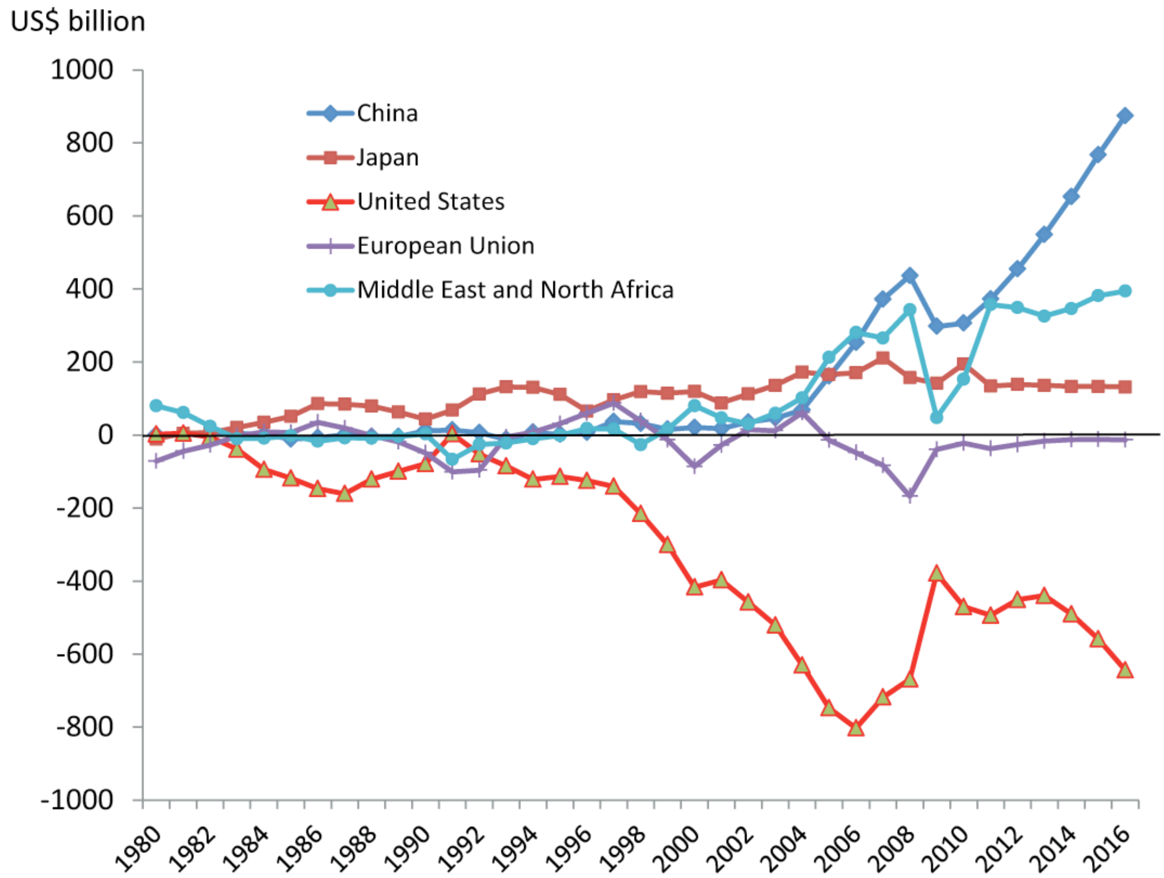

Figure 1. Current account balances, major countries/regions, 1980-2016, US$ billions (estimates from 2010-2016).

Source: IMF, *World Economic Outlook* database, August 2011.

In June 2007, the IMF's Executive Board approved its Decision on Bilateral Surveillance which specified that the Fund should focus on the extent to which each member country's policies were consistent with "external stability." This was defined as "a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements."[14] The Decision elaborated that "exchange rate policies will always be the subject of the Fund's bilateral surveillance with respect to each member, as will monetary, fiscal, and financial sector policies" (*Ibid*: I.A.5). However, it was primarily exchange rate obligations that were tightened; in fact, the Decision explicitly stated that "the Fund will not require a member that is complying with Article IV, Sections 1(i) and (ii) to change its domestic policies in the interests of external stability."[15] As for exchange rate obligations, the Decision specified that a member would be "acting inconsistently with Article IV, Section 1 (iii)," if the Fund determined it was both engaging in policies that are targeted at – and actually affect – the level of the exchange rate, which could mean either causing the exchange rate to move or preventing it from moving; and doing so "for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate" in order "to increase net exports."[16]

Thus, the primary implication of the 2007 Decision was to give greater specificity to the currency manipulation clause of the 1977 Amendment and to increase pressure on persistent large surplus countries with managed exchange rates to accept policy adjustment. The US Treasury (2009: Appendix 2) claimed that "[t]he 2007 Decision restored exchange rate surveillance's position at the core of the IMF's mandate." Beijing's view, unsurprisingly, was different, seeing the Decision as targeted at and stigmatizing China and in an unusual step it voted against the proposal.[17]

In summary, multilateral rules on macroeconomic policy have always focused primarily on currency policy and have become progressively stronger in their implied prohibition on currency "manipulation," but do not and are not intended seriously to constrain national monetary and fiscal policy autonomy. This asymmetry is largely consistent with the preferences of the governments of the major developed countries who still dominate the IMF's Executive Board and thus reflects power, or the legacy of past power, in the global political economy. Given the continuing rise in capital mobility since the 1970s, the regime therefore also favours those countries and blocs who in most circumstances prefer macroeconomic policy autonomy to exchange rate targeting – that is, the US, EU and, to a lesser extent, Japan. By contrast, the revealed preference of many emerging and developing countries is for exchange rate targeting – presumably because of their increasing focus on ensuring export growth as a key source of development.[18] This puts them at much greater risk of falling foul of existing multilateral rules. This is especially true for China given its unusual size and importance in the global political economy.

2 Has China refused to play by the rules? If so, why?

Having briefly sketched the evolution of the multilateral framework on macroeconomic policy surveillance, to what extent has China been in breach of them? Since the time that China joined the IMF in April 1980 it broadly accepted its position as a rule-taker on monetary and financial issues.[19] It was eager to be seen to be playing by the rules for two main reasons. First, this was consistent with its broader goal of being accepted in the western-dominated global system and in the major multilateral institutions, which Beijing saw as providing it with substantial economic benefits. For example, China has never objected in principle to the IMF's bilateral surveillance process in the form of annual Article IV consultations and has been highly sensitive to suggestions that it does not accept and play by multilateral rules. Second, the Chinese government's willingness to accept multilateral rules, standards and norms in principle has also been driven by the desire to provide clear and challenging reform and competitiveness benchmarks for domestic actors of various kinds.[20]

This convergence strategy contains elements of contradiction of which Beijing is well aware. Despite its positive general orientation towards multilateral rules and institutions, China would prefer not to remain indefinitely in a rule-taking position even if this is necessary as an interim strategy. This tension has increased since the 2008-9 crisis, as reflected in China's growing willingness to demand openly an increased weight and voice in the IMF and World Bank, reform of the international monetary system, and increased multilateral constraints on US policy.[21] Well before this, the Asian crisis of the late 1990s had demonstrated to Beijing that IMF policy advice could be destructive as well as beneficial to national economic and political stability, even though China's relationship with the IMF remained cordial. IMF borrowing has long been very unlikely for China itself, but China's growing influence in and dependence upon the Asian region gives it a growing interest in IMF governance and policy conditionality.

Relations with the Fund became more strained in the middle of the last decade, with the growing focus on China's large current account surplus, its unprecedented reserve accumulation, and the role played by China's exchange rate policies. By 2005, pressure on China to revalue the RMB from the United States, the G7 and the IMF reached a crescendo. After permitting the RMB to appreciate in a gradual and controlled fashion after July 2005, Beijing became increasingly annoyed that this foreign criticism did not cease. In their 2006 Article IV consultation with China, IMF staff "urged the [Chinese] authorities to increase exchange rate flexibility," meaning more rapid RMB revaluation than the modest appreciation the authorities had permitted. The robust dialogue between IMF staff and the Chinese authorities was published (with the agreement of the government) and indicates considerable disagreement with the Fund's arguments.[22] Relations became even more strained in the negotiations leading up to the IMF's 2007 Decision on Bilateral Surveillance, which as already mentioned China saw as motivated primarily by G7 interests and as reflecting unequal power in the international system.

As in the Japan-bashing era of the 1980s, some members of Congress took a lead in blaming the growth of global imbalances and the US trade deficit in particular on China. Some prominent Washington-based economists were also much blunter than IMF or US Treasury staff in their criticism of Chinese policy. Morris Goldstein, echoing Fred Bergsten's comments cited above, argued that:

> China has been engaging in large-scale, one-way, sterilized intervention in exchange markets for the better part of four years. The Chinese authorities continue to assert that they do not accept the concept of currency manipulation, and they have accused the IMF of "meddling" in China's exchange rate policies…[This] raises doubts about China's intention to become a responsible stakeholder in the international monetary and trading system (Goldstein 2007: 2-3).

There is some support for these criticisms. In a speech to the US Chamber of Commerce in Beijing in May 2005, Premier Wen Jiabao, generally viewed as a technocrat more open to currency reform, did appear to argue that China's exchange rate system and the appropriate level of the exchange rate were matters of national sovereignty.[23] The Chinese Foreign Ministry responded in early 2007 to mounting pressure from the US Congress for currency revaluation that "On the question of the renminbi exchange rate, we have consistently adopted the principle of responsibility and independence."[24] In April 2007, the deputy governor of China's central bank argued that the IMF "should respect its member countries' core interests and actual economic fundamentals," arguing that its advice ignored the need to maintain domestic economic stability in China.[25] From time to time the senior leadership has also argued that external pressure risked precipitating unmanageable political instability.

Even so, it is not obvious that Beijing rejects the right of the IMF to exercise surveillance over member states' policies.[26] The main point of resistance has been more one of timing. There was no rejection of the principle of IMF surveillance or even of the rule on currency manipulation in the public documents released in the IMF's bilateral surveillance consultations with Beijing,[27] and in negotiations with both the IMF and US, Chinese technocrats have accepted that currency reform is necessary but argued for a cautious, gradual approach.[28] China's stance was similar in the IMF-sponsored multilateral negotiations on global imbalances that were conducted between the major countries over 2006-7. Rather than rejecting the multilateral regime altogether, then, Beijing has insisted on its right to maintain sovereignty over the pace at which China implements such policy advice – another point, it should be noted, on which the multilateral regime is ambiguous.

The other key plank in China's position is that the multilateral regime and associated western pressure have focused excessively on exchange rate policy. Chinese officials have quite justifiably argued that global imbalances, and China's trade surplus more specifically, have “structural” causes that go well beyond exchange rate issues. These other factors include the marked differences in savings rates between countries like China and the US; the relocation of manufacturing production by multinational companies away from other East Asian and many high income countries towards China; and the role of the US dollar as the world’s reserve currency.[29] Less mentioned by officials are a variety of Chinese policies that contribute to an excessive reliance on exports, including underpriced energy, land and other production inputs.

Why has China been so insistent on its right to manage the pace of RMB appreciation? Certainly, the promotion of exports has been an important policy priority for China in recent decades, signified by its joining the WTO and by various tax and regulatory incentives for export-oriented investment. This policy has been extraordinarily successful. China’s current account surplus reached over 10% of national GDP by 2007, far outstripping that of Japan and Germany by this measure (figure 3).

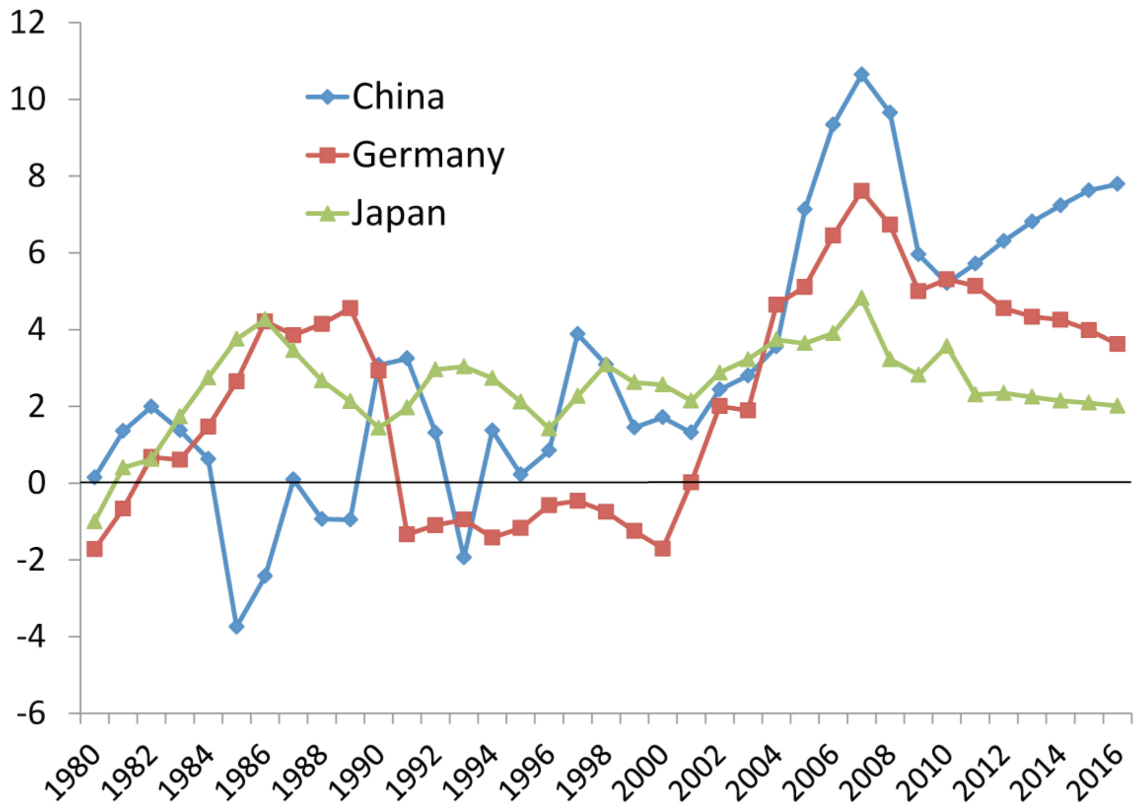

Figure 2. Current accounts of major surplus countries, percentage of national GDP, 1980-2016.

Source: IMF, *World Economic Outlook* database. Estimates from 2010.

Despite this success, the leadership has increasingly recognized the downside of its currency policy. Wen Jiabao said after the National People's Congress of March 2007 that "China's economic growth is unsteady, unbalanced, uncoordinated, and unsustainable."[30] In recognition of these drawbacks, the Chinese leadership stated in its 11th five year plan its objective of "rebalancing" the economy towards domestic growth, higher consumption, and a balanced current account. Before the recent crisis, the share of consumption in total GDP fell to very low levels (about 35%); investment and output were increasingly dependent upon the willingness of foreigners to permit high import growth; the managed exchange rate made it more difficult for the central bank to manage inflation; excessive reserve accumulation increased China's dependence on US policy choices;[31] lending trillions of dollars to the United States was increasingly unpopular at home; and the economy was increasingly dependent upon commodity imports from distant and sometimes politically unstable countries. In March 2008, Wen asked officials to pay attention to global imbalances, foreign protectionism, and the effects of global financial turmoil, and said that the policy priority should be to reduce consumer price inflation.[32] The implication was that the export drive and an associated undervalued RMB was part of the problem.

But it has also been clear for some time that the Chinese government has been deeply split over exchange rate policy and that the gradualist path chosen after mid-2005 was a political compromise. Despite the government's calls for rebalancing and its evident concerns about rising inflation over 2006-8, in early 2008 it remained committed to the target of creating ten million new jobs annually in early 2008.[33] Faster RMB appreciation would assist the fight against inflation and help with the economic rebalancing called for by the leadership, but it would also hurt the export and import-competing sectors, which have become a powerful political lobby and have promoted the idea that continued investment in traded industries is crucial to the maintenance of employment and the prevention of social unrest. The Ministry of Commerce and the National Development and Reform Commission (NDRC) are widely seen as having promoting the view in the State Council that job creation was essential for social stability.[34] Interestingly, however, despite a booming economy, employment growth fell to just over 1% per year over 1993-2004, suggesting that growing import substitution due to RMB undervaluation reduced the labour-intensity of growth.[35]

On the other side, the central bank, the People's Bank of China, has favoured greater exchange rate flexibility but its subordinate position in the policymaking hierarchy ensures that this position only gains political traction during periods of rising inflation.[36] Capital controls have provided some degree of autonomy for Chinese monetary policymakers, but they are very imperfect and monetary conditions were much looser than technocrats preferred over 2007-8. The monetary authorities have partly compensated for this through financial repression, including via administrative controls and higher reserve requirements for banks.[37] But this strategy conflicts with another key leadership objective, promoting the gradual marketization and competitiveness of the financial sector.

In the depths of the global crisis, when Beijing's main concern was to prevent a sharp collapse of growth and the concern with inflation evaporated, the authorities reverted to a policy of maintaining a fixed exchange rate against the dollar (figure 3). Once growth seemed assured, the authorities returned to the policy of controlled, gradual appreciation against the US dollar.

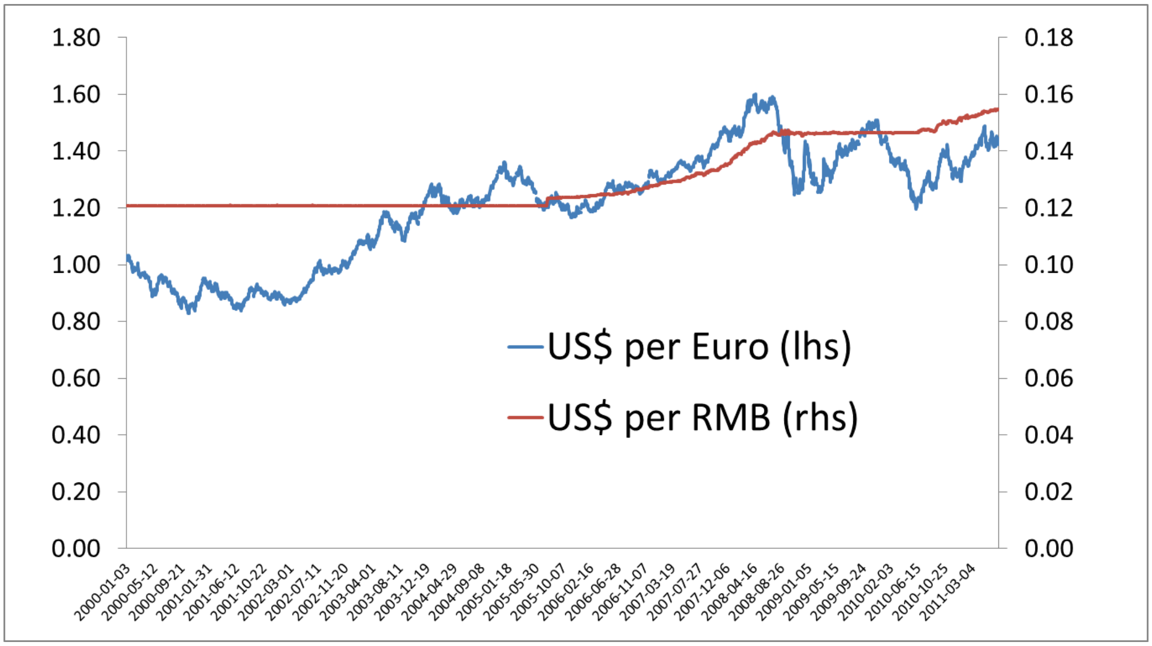

Figure 3. Daily US dollar exchange rates with the Euro and RMB, 3 January 2000 through 7 July 2011.

Source: US Federal Reserve Board exchange rate database.

In short, Beijing's macroeconomic policy choices stem from a complex mixture of short and longer term domestic economic and political goals, including the desire to ensure a stable global environment for Chinese development. The tensions between these objectives have grown over time, just as the possibility of China keeping a low international profile on this and many other policy issues has disappeared. RMB undervaluation has increasingly jeopardized China's strategy of deep integration into the global trading system and its desire to be seen as a cooperative player generally. In particular, it has jeopardized its ability to maintain reasonably cooperative relations with the most important country, the United States.

Domestic political pressure on the US government to cite China under American trade legislation as a currency manipulator has been growing since the early 2000s.[38] The Schumer-Graham Senate bill of early 2005 would have authorized a 27.5% tariff on Chinese imports if negotiations with China did not result in the elimination of the assumed equivalent undervaluation of the RMB. A version of this bill obtained a substantial majority in the Senate in March 2005, but a final vote was deferred on the understanding that the Treasury would take action to ensure concrete change in China's currency policy.[39] Thus, the Chinese government also understood that the US administration's decreasing ability to manage the domestic politics of RMB undervaluation has necessitated a more flexible currency policy on Beijing's part.

In many ways, the multilateral surveillance regime became as much a hindrance as a help in facilitating China's path towards limited currency flexibility. The Chinese leadership saw the focus of IMF surveillance on exchange rate policy, sharpened by the 2007 Decision, as both unfair and nonsensical, and as reflecting continued western political dominance and bias.[40] The IMF was increasingly seen as lacking objectivity and as aiming to induce China to bear an excessive proportion of the total costs of unwinding global imbalances. The multilateral regime also did little to address directly or effectively other causes of the Chinese external surplus and America's large deficit, such as taxation and spending policies, financial and wage repression in China, and financial deregulation in the United States.

3 Is China an outlier?

There is little doubt, then, that China's emergence as a major exporter with an undervalued currency and extraordinary reserve accumulation has considerably increased the strain on the multilateral regime of macroeconomic surveillance. Does this mean that China is an outlier in the global political economy and that it poses a unique threat to this aspect of multilateralism? I argue in this section that China is unique in some respects but not in others. By contrast with Germany and Japan, China is even larger but still poor, highly dependent on foreign investment and technology, and not a strategic ally of the United States. On the other hand, China's insistence on considerable national policy autonomy in areas of perceived vital importance and domestic political sensitivity is broadly shared by all other major countries, including notably the United States. Furthermore, the multilateral regime itself has been systematically weakened and biased in its focus by years of western dominance, leaving it ill-equipped to deal not just with China's rise but that of emerging economies generally.

As noted already, many US critics saw the 2007 Decision on Bilateral Surveillance as a necessary (if still inadequate) attempt to strengthen the IMF's hand in dealing with the problem of emerging market currency undervaluation, above all by China. From China's perspective, however, in spite of the Decision's emphasis on 'external stability' and its neutral phrasing, it reinforced the continuing regime bias towards external constraint on exchange rate policy and the lack of credible constraint on fiscal and monetary policies in the major advanced countries.

The roots of this bias go back to the origins of the Bretton Woods system, when US and British negotiators agreed that the IMF should have little effective influence over national fiscal and monetary policy choices in non-borrowing countries. The Fund's annual Article IV consultations with major developed countries provided no serious constraint on macroeconomic policy choices for the latter, except in the unusual cases in which they were subject to loan conditionality (as with Britain and Italy in the late 1970s). The United States was especially unwilling to accept new external constraints upon its macroeconomic policy choices after the end of gold convertibility in the early 1970s, having viewed the end of the Bretton Woods exchange rate system as a kind of liberation.[41] Indeed, Washington had always viewed the multilateral regime as a means of constraining less well managed and less democratically legitimate countries; the Bretton Woods institutions were never seen as a legitimate source of external constraint over US policies.[42] Furthermore, in response to the inflationary episodes of the 1970s and 1980s, G7 countries and advanced countries generally focused on building *domestic* mechanisms of monetary policy constraint such as more independent central banks and inflation targeting strategies.[43] Fiscal policy meanwhile was driven largely by the shifting winds of domestic politics, the domestic business cycle, and (especially in the US case) by perceived strategic imperatives.

Such factors proved far more important in shaping macroeconomic policies in the advanced countries than the very episodic attempts at international policy coordination. Since the mid-1970s, the G7 countries consistently chose to conduct macroeconomic policy discussions outside of the IMF framework in a more narrow, flexible and non-rules based 'minilateral' grouping. But even the G7 process was ineffective in coordinating macroeconomic policy given the growing power (and domestic orientation) of central banks and the dominance of domestic politics in fiscal policymaking. Unsurprisingly, the G7 proved unable to prevent the emergence of persistent, large payments imbalances between its members.[44] Even the much-heralded Plaza and Louvre accords in the mid-1980s were primarily agreements on exchange rate intervention and affected fiscal and monetary policy marginally. In general, the G7 process underlined the unwillingness of the major countries to contemplate serious and binding macroeconomic policy coordination, and contributed to the continuing atrophy of the multilateral surveillance regime based on the IMF. This contrasted with the evident desire of G7 governments to enhance the stringency of IMF and World Bank conditionality for developing country borrowers.

Even the G7 accepted that this contrast created a legitimacy problem. In February 2007, G7 finance ministers agreed that: "To be more effective [IMF] surveillance must be applied equally and even-handedly, focused on external stability, and subject to a clear accountability framework, without creating new obligations."[45] But these sentiments were not matched by action. For example, in G7 meetings from 2005 and in the IMF-sponsored multilateral consultations of 2006-7, Washington did agree language calling for US fiscal consolidation as part of a multilateral effort to reduce global payments imbalances, but it ensured that the emphasis was firmly on spending reductions. Tax increases, crucial then (as now) to any credible deficit reduction plan, were not mentioned. Although the Bush administration did succeed in marginally reducing the fiscal deficit over 2004-7, references to multilateral obligations in domestic fiscal policy debates are very difficult to find. This was clearly a case in which the IMF found it difficult to ‘speak truth to power.’ Even regarding a less-powerful Britain, IMF surveillance was ineffective in part because the British government vigorously and successfully resisted IMF criticism.[46] Nor was the European Union sympathetic to any substantive IMF involvement internal EU macroeconomic policy discussions.[47]

In the face of perceived G7 hypocrisy, the emerging market response was inevitably one of self-help. The Asian crisis of the late 1990s was pivotal in this respect for China and a number of its regional neighbours, many of whom built exceptionally large foreign exchange reserves in the years that followed so as to avoid any future need to borrow from the Fund. The irony is that by pursuing greater autonomy from the Fund by running large current account surpluses, these countries came under growing pressure to contribute to the reduction of global imbalances. From the emerging country perspective, this was highly unwelcome because they had no voice in the G7/8 process and were substantially underrepresented in a western-dominated IMF. In addition, as noted above, the IMF surveillance regime was focused on exchange rate policy, an aspect that constrained the policy choice of emerging countries without touching those of the major advanced countries. Unsurprisingly, many emerging countries, including China, became increasingly open in demanding that the IMF surveillance regime be rebalanced during the 2008-9 crisis. The Chinese central bank’s Deputy Governor stated in March 2009 that “we feel that the IMF particularly needs to strengthen its surveillance of the economic and financial policies of the major reserve-currency-issuing nations”.[48] In the midst of the worst global economic crisis since the Great Depression, it was clear that the multilateral regime on macroeconomic surveillance was not up to the task – but it had never really been so.

4 Conclusion – towards a more effective multilateral regime?

In many ways much has changed since the global crisis began. The G7 has been replaced as the informal steering committee of the global economy by the G20; the voice and influence of emerging countries in the IMF has been increased, with more to come; the IMF has been given the task of elaborating the policy changes required to achieve a large and sustained reduction in global imbalances and of assessing country compliance with them; and the Fund has been much more vigorous in its criticism of major countries' policies, most notably those of the United States. Does all this amount to a substantial enhancement of the multilateral surveillance regime?

At the Pittsburgh Summit in September 2009, G20 leaders committed themselves to a "cooperative process of mutual assessment of our policy frameworks and the implications of those frameworks for the pattern and sustainability of global growth." They also made a commitment to a strengthened process of multilateral review and consultation:

> We ask the IMF to assist our Finance Ministers and Central Bank Governors in this process of mutual assessment by developing a forward-looking analysis of whether policies pursued by individual G-20 countries are collectively consistent with more sustainable and balanced trajectories for the global economy, and to report regularly to both the G-20 and the International Monetary and Financial Committee (IMFC), building on the IMF's existing bilateral and multilateral surveillance analysis, on global economic developments, patterns of growth and suggested policy adjustments.[49]

The IMF executive board also agreed in October 2008 on a statement of surveillance priorities to guide surveillance through 2011, among which was a commitment to promote an "orderly reduction of global imbalances."[50] For its own part, the IMF acknowledged the past failures of surveillance and re-committed itself to be a "ruthless truth-teller" in the wake of the crisis. The IMF has produced a series of reports outlining in a concrete and balanced fashion what is required to achieve the G20's stated objective of a sustained reduction in global imbalances.[51] In its bilateral surveillance, the Fund has also been markedly more robust in its criticism of policies in major advanced countries, notably of the United States.[52]

Uncertainty remains, however, as to how much effect such reports will have on the policy choices made in the most systemically important countries and areas. The commitments of individual G20 countries to global rebalancing have mainly been elaborations of previously announced national policy objectives. Furthermore, particularly in the case of the advanced countries in which growth has been weak since 2009, many of these early official commitments have lacked credibility. Although the Obama administration did eventually commit to serious medium-term deficit reduction in mid-2011, domestic politics in the United States has continued to increase uncertainty about the achievability of fiscal consolidation. In the debt ceiling reduction negotiations in Washington over July-August 2011, it was also once again very evident that previous US commitments in the G20 process played little role in shaping the domestic debate. Continued economic weakness also prompted the Federal Reserve to maintain an extraordinarily loose monetary policy, which was seen in many emerging countries as an attempt to force exchange rate appreciation or inflation on them. Policy choices within the European Union and in Japan also remain almost entirely internally focused.

Meanwhile, in China, export surpluses and reserve accumulation have continued to grow rapidly and it is clear that achieving greater reliance on domestic consumer demand will take much longer. Many emerging countries also concluded that current account surpluses and large foreign exchange holdings provided good insurance in this latest global financial crisis. The IMF's own baseline projections on current account imbalances are for these to increase rapidly in absolute terms over the next five years (figure 1) and to return to historically high levels as a proportion of global GDP – which may indicate how much the Fund sees G20 rebalancing commitments as credible.

In the end, the G20, like the G7 before it, wishes to retain authority over implementation and peer review, which suggests continuing limits to the multilateral surveillance process. The G-20 may now have brought the major players into the multilateral consultation process, but larger numbers also means greater complexity. Greater diversity and less commonality of values and political purpose are also likely to reduce prospects for policy cooperation.[53] Monetary, public spending and taxation issues ultimately remain far too politically sensitive for governments to negotiate in any international forum – the strong desire on the part of creditor countries even within the Eurozone to retain fiscal policy sovereignty have become all the more clear during the recent sovereign debt crisis. This in turn implies that we should expect little real change in the multilateral surveillance regime, which is likely to remain weak compared to the most important advanced and emerging countries. We are likely to be living with large global imbalances for some time to come.

[1] Following convention, when referring to 'global imbalances' I mean (except where noted) persistent large imbalances on current account on the part of major countries. There is no agreed definition of what 'large' means in this context. For arguments that global imbalances were one important cause of the crisis, see Anton Brender and Florence Pisani, *Globalised Finance and its Collapse* (Paris/Brussels: Editions La Découvertes/Dexia, 2009); Steven Dunaway, *Global Imbalances and the Financial Crisis* (New York: Council on Foreign Relations, Center for Geo-economic Studies, Council Special Report No. 44, March 2009); Financial Services Authority [UK], *The Turner Review: A Regulatory Response to the Global Banking Crisis* (London: FSA, 2009), 32; and International Monetary Fund [IMF], *Initial Lessons of the Crisis* (Washington, D.C.: Research, Monetary and Capital Markets, and Strategy, Policy, and Review Departments, IMF, 6 February 2009). For dissenting views, see Michael Dooley and Peter Garber, "Global imbalances and the crisis: A solution in search of a problem," *VoxEU*, 21 March 2009, and Claudio Borio and Piti Disyatat, "Global imbalances and the financial crisis: Link or no link?" *BIS Working Paper*, no.346, May 2011.

[2] For further discussion, see Rosemary Foot and Andrew Walter, *China, the United States and Global Order* (Cambridge: Cambridge University Press, 2011).

[3] "Leaders' Statement: The Pittsburgh Summit," 24 – 25 September, 2009, http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf, accessed 8 August 2011.

[4] Willem Buiter, "The unfortunate uselessness of most 'state of the art' academic monetary economics", *VoxEU*, 6 March 2009; Raghuram G. Rajan, "Has Financial

Development Made the World Riskier?," September 2005, http://www.kc.frb.org/publicat/sympos/2005/pdf/rajan2005.pdf.

[5] Maurice Obstfeld and Kenneth Rogoff, "The Unsustainable US Current Account Position Revisited," *NBER Working Paper*, no. 10869, November 2004; Raghuram G. Rajan, "Global Current Account Imbalances: Hard Landing or Soft Landing?," speech to the Crédit Suisse First Boston Conference, Hong Kong, 15 March 2005. These more pessimistic diagnoses were not shared by all (e.g. Michael P. Dooley, David Folkerts-Landau and Peter Garber, "The Revised Bretton Woods System," *International Journal of Finance and Economics*, 2004, 9(4), October, 307-313), but no-one could be sure that they were incorrect.

[6] Ben Bernanke, "The Global Saving Glut and the US Current Account Deficit," Sandridge Lecture, Virginia Association of Economics, Richmond, VA, 10 March 2005.For extensions of the savings glut hypothesis, see Martin Wolf, "Asia's Revenge," *FT.com*, 8 October 2008, and "Global imbalances threaten the survival of liberal trade," *FT.com*, 2 December 2008; Carmen M. Reinhart and Kenneth S. Rogoff, "Is the 2007 U.S. Sub-Prime Financial Crisis so Different? An International Historical Comparison," *NBER Working Paper,* no. 13761, January 2008, 11.

[7] "Paulson says crisis sown by imbalance," *FT.com*, January 1, 2009.

[8] C. Fred Bergsten, "A Partnership of Equals: How Washington Should Respond to China's Economic Challenge," *Foreign Affairs*, 87(4), 2008, 57-69 (my emphasis).

[9] IMF, "Surveillance Over Exchange Rate Policies," Decision No. 5392-(77/63), 29 April 1977.

[10] Louis W. Pauly, *Who Elected the Bankers? Surveillance and Control in the World Economy* (Ithaca: Cornell University Press, 1997), 109-110.

[11] John G. Ruggie, "International Regimes, Transactions and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization*, 36(2), Spring 1982, 379-415.

[12] Michael C. Webb, *The Political Economy of Policy Coordination* (Ithaca: Cornell University Press, 1995).

[13] Bank for International Settlements, *Annual Report 2010/11* (Basel: BIS, 2011), 35.

[14] IMF, "IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies," Public Information Notice, no. 07/69, 21 June 2007, I.A.4.

[15] *Ibid*: I.A.6. Article IV.1 requires members to foster (i) "orderly economic growth with reasonable price stability" and (ii) "orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions."

[16] *Ibid*: Annex I.2.b.

[17] On this controversy, see Maurice Goldstein, "A (Lack of) Progress Report on China's Exchange Rate Policies," *Working Paper Series*, WP 07-5, Peterson Institute for International Economics, Washington D.C. 2007, and Michael Mussa, "IMF Surveillance over China's Exchange Rate Policy," paper presented at the Conference on China's Exchange Rate Policy, Peterson Institute for International Economics, Washington D.C., 19 October 2007.

[18] Carmen M. Reinhart and Kenneth S. Rogoff, "The Modern History of Exchange Rate Arrangements: a Reinterpretation," *NBER Working Paper,* no. 8963, June 2002; Carmen M. Reinhart and Vincent R. Reinhart, "Capital Inflows and Reserve Accumulation: The Recent Evidence*," NBER Working Paper*, no. 13842, March 2008; Dani Rodrik, "The Real Exchange Rate and Economic Growth", *Brookings Paper on Economic Activity*, Conference paper, September 2008.

[19] Harold J. Jacobson and Michael Oksenberg, *China's Participation in the IMF, the World Bank, and GATT: Toward a Global Economic Order* (Ann Arbor: University of Michigan Press, 1990); Anne Kent, *Beyond Compliance: China, International Organizations, and Global Security* (Stanford, CA: Stanford University Press, 2007).

[20] For an elaboration of this argument, see Foot and Walter, *China, the United States and Global Order*.

[21] E.g. "Rising Powers Challenge U.S. on Role in I.M.F.", *New York Times*, 29 March 2009.

[22] IMF, *People's Republic of China: 2006 Article IV Consultation - Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion* (Washington D.C.: IMF, October 2006), 18-20.

[23] "RMB exchange rate a sovereignty issue of China: Premier," May 17, 2005, Embassy of the People's Republic of China in Australia, http://au.china-embassy.org/eng/xw/t195926.htm.

[24] "China urges respect, not threats, from US on Yuan," *Reuters*, March 29, 2007.

[25] "Central bank rejects IMF Yuan advice," *China Daily*, April 16, 2007.

[26] Goldstein, "A (Lack of) Progress Report," cites a *China Daily* article from 2007: "IMF Meddling Disturbing," *China Daily*, 17 April 2007, as evidence for the latter claim.

[27] E.g. IMF, *People's Republic of China: 2006 Article IV Consultation*, 18-20.

[28] *Ibid*, 3; John B. Taylor, *Global Financial Warriors: The Untold Story of International Finance in the Post-9/11 World* (New York: W.W. Norton, 2007), 299-300.

[29] Wu Xiaoling, "Keynote Address: China's Exchange Rate Policy and Economic Restructuring," in Morris Goldstein and Nicholas R. Lardy, eds, *Debating China's Exchange Rate Policy* (Washington, D.C.: Peterson Institute for International Economics, 2008), 355-362.

[30] Nicholas R. Lardy, "Financial Repression in China," *Peterson Institute Policy Brief*, no. PB08-8, September 2008, 5.

[31] With extensive official intervention in foreign exchange markets, China's reserves increased at an average monthly rate of about $50 billion from 2007, exceeding $2 trillion by early 2009 and $3 trillion by March 2011.

[32] "China to focus on curbing inflation," *FT.com*, 6 March 2008.

[33] See Michael Pettis, "More, or less, RMB appreciation?," 7 March 2008, http://piaohaoreport.sampasite.com/blog; Victor Shih, "China's credit boom," *Asian Wall Street Journal*, February 21, 2008; and "China lets Yuan appreciate a bit faster," *China Daily*, December 29, 2007.

[34] Interviews, Beijing, September 2008.

[35] C. Fred Bergsten, et al., *China's Rise: Challenges and Opportunities* (Washington D.C.: Peterson Institute for International Economics, Center for Strategic and International Studies, 2008), 110.

[36] Victor C. Shih, *Factions and Finance in China: Elite Conflict and Inflation* (Cambridge: Cambridge University Press, 2008).

[37] Lardy, "Financial Repression in China."

[38] US law in this area is based upon the IMF's 1977 rules on currency manipulation and is intended to strengthen their enforcement. See 22 U.S.C. 5304, section 3004, and Jeffrey A. Frankel and Shang-Jin Wei, "Assessing China's Exchange Rate Regime," *Economic Policy*, 22:51, 2007, 575–627.

[39] C. Randall Henning, "Democratic Accountability and the Exchange-Rate Policy of the Euro Area," *Review of International Political Economy*, 14(5), 2007, 774-799 (at 789).

[40] IMF, *People's Republic of China: 2006 Article IV Consultation*, 20; Yu Yongding, "Global Imbalances: China's Perspective," paper prepared for conference on global imbalances, Washington D.C., February 2007, 11.

[41] Joanne Gowa, *Closing the Gold Window: Domestic Politics and the End of Bretton Woods* (Ithaca: Cornell University Press, 1983).

[42] Foot and Walter, *China, the United States and Global Order*, chapter 3.

[43] European monetary integration is an important exception to this generalization intra-regionally, but the Eurozone as a bloc is consistent with it.

[44] Yoichi Funabashi, *Managing the Dollar: From the Plaza to the Louvre* (Washington D.C.: Institute for International Economics, 1989); Webb, *Political Economy of Policy Coordination.*

[45] G7 Finance Ministers' Meeting, Essen, February 9/10, 2007.

[46] On the pre-crisis failure of IMF surveillance in the US and British cases, see the IMF Independent Evaluation Office, *IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07* (Washington, D.C.: IEO, 2011), especially background papers 4 and 5 on the United States and Britain respectively.

[47] Mussa, "IMF Surveillance over China's Exchange Rate Policy," 2.

[48] "China Seeks More Involvement – and More Clout", *Wall Street Journal,* 31 March, 2009.

[49] "G20 Leaders' Statement", Pittsburgh Summit, 24-25 September 2009.

[50] "IMF Executive Board Adopts Surveillance Priorities for 2008-2011," IMF Press Release no. 08/238, 8 October 2008.

[51] See, for example, IMF, *G-20 Mutual Assessment Process – Alternative Policy Scenarios* (Washington, D.C.: IMF, June 2010).

[52] See, for example, IMF, *The United States: 2011 Article IV Consultation* (Washington, D.C.: IMF, Country Report no.11/201, July 2011).

[53] Ian Bremmer and Nouriel Roubini, "A G-Zero World," *Foreign Affairs*, 90(2), 2011, 2-7.