# The Mismanagement of Global Imbalances: Why Did Multilateralism Fail?

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There is a growing consensus in expert economic policy circles that the emergence of persistent large imbalances in international trade and finance was an important factor in the unsustainable boom that preceded the global financial crisis of 2008-9 (Brender and Pisani 2009; Dunaway 2009; FSA 2009: 32; IMF 2009).[1] This consensus has already had important consequences, notably an official acceptance of the need to address these "global imbalances" more effectively at the multilateral level in the future. At the Pittsburgh summit in September 2009, G20 leaders agreed that they had a collective "responsibility to ensure sound macroeconomic policies that serve long-term economic objectives and help avoid unsustainable global imbalances".[2] This agreement reflected a recognition by most leading policymakers that previous multilateral efforts to deal with global imbalances, including a novel IMF-sponsored multilateral surveillance discussion over 2006-7, had failed. Just before the global financial crisis intervened in late 2008, the IMF was projecting that global economic imbalances would worsen rather than diminish over time (figure 1).

[1] For a dissenting argument, see Dooley and Garber (2009).
[2] "Leaders' Statement: The Pittsburgh Summit", September 24 – 25, 2009, http://www.pittsburghsummit.gov/mediacenter/129639.htm, accessed October 9, 2009.

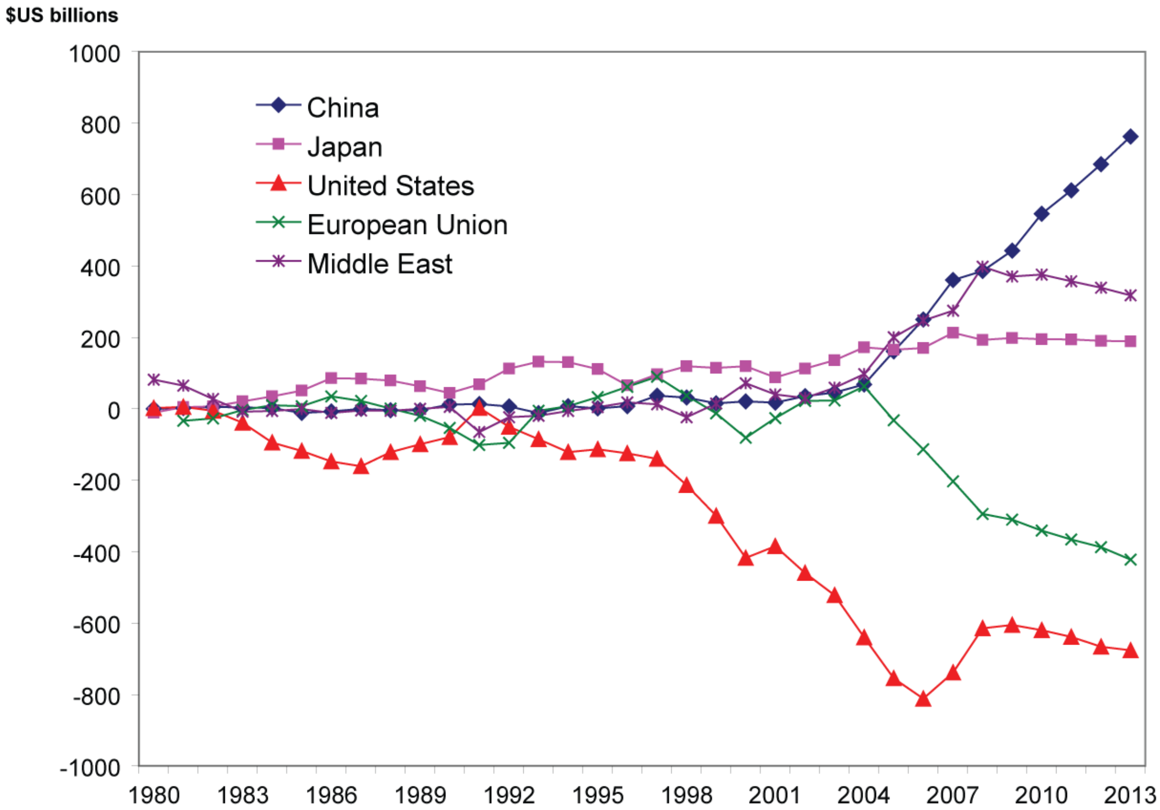


Figure 1. Pre-crisis past and future estimated current account balances, major countries/regions, 1980-2013, US$ billions.
Source: IMF, *World Economic Outlook* database. Estimates for 2007 and after as of April 2008.

What explains this failure of multilateralism in a crucial area of global economic governance? One candidate is the broad failure within economics and the economic policy community to understand, or even to explore in much depth, the linkages between macroeconomic and financial sector imbalances (Buiter 2009; Rajan 2005b). With the benefit of hindsight, this weakness played an important part in the misdiagnosis of the global imbalances problem and its associated focus on the sustainability of net lending by surplus countries to the US. Had economists better understood the potential for global imbalances to increase financial instability in advanced countries, it is possible that policymakers might have taken more serious steps to reduce them. But this seems unlikely, given that the "hard landing" scenario in the conventional analysis was already fairly frightening: a collapse of the dollar, rising US interest rates, rising protectionism, and a deep global recession (Obstfeld and Rogoff 2004; Rajan 2005a). This possibility was sufficiently plausible to policymakers that the major countries conducted a series of bilateral and multilateral policy negotiations to reduce global imbalances after 2004.

A second possible explanation for the failure of these initiatives to bear fruit is that the sources of global imbalances increasingly lay in policy choices made outside of the G-7 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 G-7) and because it links macroeconomic imbalances to financial instability. It is 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 interest rates excessively low (Bernanke 2005).[3] 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."[4] Before the recent crisis began,

[3] 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; Reinhart and Rogoff (2008a: 11).

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

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 (Bergsten 2008, my emphasis).

In short, Bergsten suggested, Chinese mercantilism has undermined a working multilateral system based upon a previously dominant G-7 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 functioning effectively.

Multilateralism failed to manage global imbalances, I suggest, for two different and deeply political reasons. First, the failure reflected a persistent unwillingness among all major countries, not just China, to accept the 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 resist external policy constraint, but in this regard it is little different to other major countries. Second, the failure reflected the complete inadequacy of the existing multilateral policy surveillance framework inherited from the era of G-7 dominance to facilitate the negotiation of the necessary domestic and international political bargains. In order for multilateralism to become more effective in the future, these flaws would need to be resolved, but it is difficult to see how major governments will accept the constraints on domestic policy choices that this would entail.

The rest of this paper proceeds as follows. The first section considers the existing global rules on macroeconomic policy coordination and exchange rate policy and the framework for implementing them. The second section addresses the question of whether China refused to play by these rules and if so, why. The third section briefly considers the state of the multilateral regime on macroeconomic policy coordination on the eve of the current global crisis and shows that China was far from unusual in resisting multilateral constraint on domestic policy choices. The conclusion considers the potential for recent changes in the shape of global economic governance to make multilateralism more effective in this area in the future.

## 1 <u>What are the global rules on macroeconomic policy coordination?</u>

Under the Bretton Woods rules, the main focus of multilateral policy constraint was firmly on member countries' exchange rate policies, not fiscal and monetary policies. 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. The Second Amendment of the 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."[5] However, this clause was rather general and implied the need to demonstrate an intention on the part of the country to gain an unfair advantage.

Pauly (1997: 109-110) argues that these revisions reflected a persistent underlying norm that countries were mutually responsible for the external effects of their macroeconomic policy choices. But the regime was much narrower than this implies, since the formal rules continued to focus almost entirely on the exchange rate consequences of macroeconomic policy choices. 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 policy choices. The advent of floating exchange rates in the 1970s was a product of demands for greater national monetary policy autonomy on the part of other major countries.

[5] IMF, "Surveillance Over Exchange Rate Policies," Decision No. 5392-(77/63), April 29, 1977: http://www.imf.org/external/pubs/ft/sd/index.asp?decision=5392-(77/63).

In June 2007, the IMF's Executive Board approved a clarification and strengthening of the currency manipulation clause in its Decision on Bilateral Surveillance:

> The 2007 Decision provides 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."[6]

This revision appeared tailor-made for declaring China to be in breach of multilateral obligations and there is little doubt that this was motivated by the perception in developed countries that the existing rules were too weak to do so (Mussa 2007: 2, 40). Although the decision apparently did not discriminate between member countries with floating and pegged exchange rates, it is not easy to see how the rule could be applied to countries that do not appear to have explicit or implicit exchange rate targets (sustained intervention in foreign exchange markets could indicate the latter). Furthermore, the 2007 Decision does not specify how the difficult problem of measuring equilibrium exchange rates is to be resolved. It raises the risk that any country with an exchange rate target and consistently positive net exports could be judged in breach of multilateral rules. Unsurprisingly, China, along with some other emerging market countries, voted against the decision.[7]

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[6] "IMF Surveillance — The 2007 Decision on Bilateral Surveillance," http://www.imf.org/external/np/exr/facts/surv07.htm, accessed March 5, 2008.

[7] Interviews, Chinese officials, Beijing, September 2008.

In short, multilateral rules on macroeconomic policy focus mainly on currency policy and are strongest in their prohibition of 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 general rise in capital mobility since the 1970s, the regime therefore 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 (Reinhart and Rogoff 2002; Reinhart and Reinhart 2008). There are various reasons given for this, notably the view that pegged and undervalued exchange rates promote economic development and can substitute for a range of institutional weaknesses common to developing countries (Broz 2002; Rodrik 2008). Whatever the source of this preference, however, it this puts them at much greater risk of falling foul of existing global rules and norms. This is especially true for China given its unusual size and importance in the global political economy; most other developing countries, lucky for them, are just smaller.

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

Having briefly sketched the multilateral rules on macroeconomic policy, to what extent does China accept them? According to IMF staff, since the time that China joined the IMF in April 1980 it accepted its position as a rule-taker on monetary and financial issues.[8] 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 as a key player in the western-dominated global system and in the major multilateral institutions. 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 any suggestions that it does not accept and play by multilateral rules. Second, the Chinese government's willingness to accept multilateral rules, standards and norms has also been driven by the desire to provide clear and challenging reform and competitiveness benchmarks for domestic financial and non-financial firms.

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 probably increased since the 2008-9 financial crisis, as reflected in China's growing willingness to demand openly an increased weight and voice in the IMF and World Bank.[9] 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 is 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.

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[8] The following paragraphs are based on interviews with IMF officials, Chinese officials, and independent analysts, September 2008 to April 2009.

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

Relations with the Fund became more strained in the middle of this decade, with the growing focus on global imbalances and the role played by China's exchange rate policies. By 2005, pressure on China to revalue the RMB from the US, the G-7 and the IMF reached a crescendo. After permitting the RMB to appreciated modestly from July 2005, Beijing became increasingly annoyed that this 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 and gradual appreciation the authorities had permitted since July 2005. 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 (IMF 2006b: 18-20). Relations became even more strained in the negotiations leading up to the IMF's 2007 Decision on Bilateral Surveillance, which China saw as motivated primarily by G-7 interests and as reflecting unequal power in the international system.

Some prominent western critics of China's exchange rate policy argue that this tension is an inevitable consequence of China's mercantilist growth strategy and that the IMF, the US government, and the developed countries in general have been far too soft on China. Morris Goldstein, echoing Fred Bergsten's comments cited above, argues 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 this view. 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.[10] And 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."[11] 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.[12] Chinese officials have also argued that global imbalances, and China's trade surplus more specifically, have "structural" causes that go well beyond exchange rate issues. These 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 (Wu 2008).

There is, however, no definitive evidence that Beijing rejects the right of the IMF to exercise surveillance over member states' policies, as Goldstein claims.[13] The main

[10] "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.

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

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

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

point of resistance is more one of timing. Notably, there is 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 (e.g. IMF 2006b: 18-20). In private negotiations with the US, Chinese technocrats have accepted that currency reform is necessary but prefer a cautious, gradual approach (Taylor 2007: 299-300). In IMF consultations, the Chinese government also "agreed that greater flexibility was needed over the medium term, but stressed that exchange rate reform would proceed in a gradual and controlled manner" (IMF 2006b: 3). China's stance was similar in the IMF's multilateral surveillance initiative that ran over 2006-7. Rather than rejecting the multilateral regime altogether, then, it seems that Beijing only insists on its right to maintain sovereignty over the pace at which China implements such policy advice. This points to another weakness in the surveillance regime itself, which says little about the timing of policy implementation.

What does this interpretation imply about the underlying determinants of China's exchange rate policy? 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 nearly 12% of GDP by 2007, far outstripping that of Japan and Germany by this measure [figure 2]. In addition, China has consistently run a large surplus on capital account. With the above-mentioned official intervention in foreign exchange markets, reserves increased at an average monthly rate of about $50 billion from 2007 and exceeded $2 trillion by early 2009.

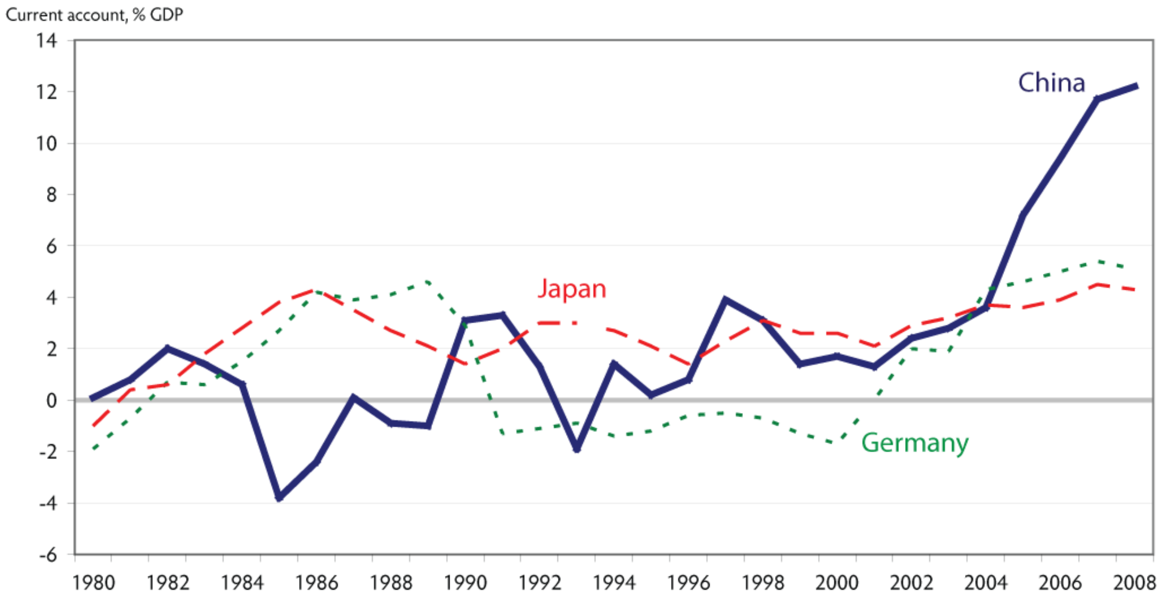


Figure 2. Current accounts of major surplus countries, % of national GDP, 1980-2008. Source: IMF, *World Economic Outlook* database. 2007 and 2008 figures are estimates as of October 2007.

The growing downside to this export growth success has been increasingly recognized by the Chinese leadership, though it has been unwilling to date to risk a rapid adjustment that would move the economy towards a different growth model. 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; and the economy was increasingly dependent upon commodity imports from distant and sometimes politically unstable countries. 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. Wen Jiabao said after the National People's Congress of March 2007 that "China's economic growth is unsteady, unbalanced, uncoordinated, and unsustainable."[14] 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.[15] The implication is clear that the export drive and an associated undervalued RMB has been part of the problem. But is this call for rebalancing the economy more than rhetoric?

It seems likely that the government is deeply split over exchange rate policy. In combination with growing foreign pressure for RMB revaluation, this produced a compromise policy of very cautious, gradual nominal appreciation against the dollar after July 2005. This continued until mid-2008, when the authorities returned to a policy of maintaining a stable exchange rate against the dollar during a period of substantial volatility in the major developed world exchange rates [figure 3].

[14] Quoted in Lardy (2008: 5).

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

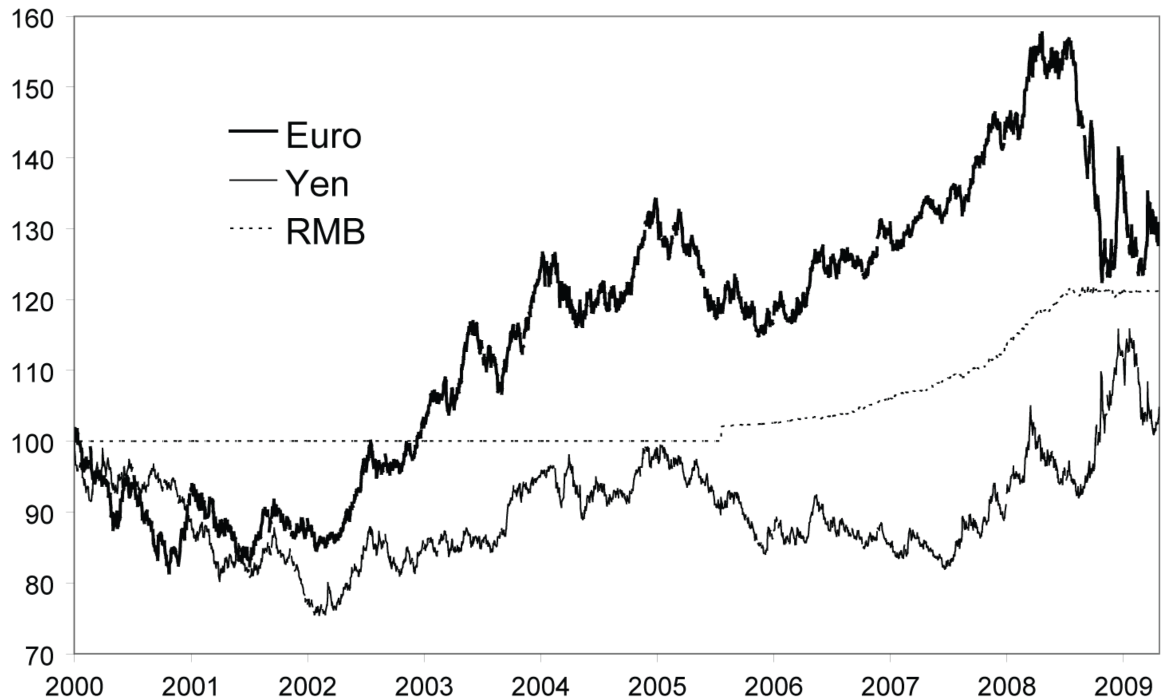


Figure 3. Major exchange rate movements against the US dollar, 3 January 2000 through 24 April 2009 (rebased: 3 January 2000=100, nominal daily rates).
Source: US Federal Reserve Board exchange rate database.

The leadership has tried to resolve these internal splits by the usual policy of choosing a middle, gradualist path. 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.[16] Faster RMB appreciation would assist the fight against inflation, but it would also hurt the export and import-competing sectors, which have become a powerful political lobby and have

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

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 that job creation was essential for social stability in the State Council.[17] Interestingly, however, despite the booming economy, employment growth fell to just over 1% per year over 1993-2004, suggesting that growing import substitution has reduced the labour intensity of growth (Bergsten et al. 2008: 110).

Since the crisis, the concern about inflation has given way to deflation, and this seems to have convinced the leadership to stop the gradual appreciation strategy. This, as well as the heavy emphasis on infrastructure spending in the government’s stimulus package of spending measures adopted in 2008, suggests that the government still sees investment rather than consumption as the primary engine of growth. The other major loser from the pegged exchange rate policy is the central bank, the People’s Bank of China. Capital controls have provided some 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 partly compensated for this through financial repression, including via administrative controls and higher reserve requirements for banks (Lardy 2008). But this conflicts with another key leadership objective, promoting the marketization and competitiveness of the financial sector.

RMB undervaluation also increasingly jeopardized China’s strategy of deep integration into the global trading system and its desire to be seen as a cooperative player

[17] Interviews, Beijing, September 2008.

generally. The rising export surplus produced growing concern in China's major trading partners and growing foreign pressure for more rapid RMB appreciation, especially from within the US Congress. Unions and non-multinationalized US firms in import-competing sectors increasingly demanded more aggressive measures. By 2005, there was growing pressure on the US Treasury, which preferred more quiet diplomacy, to cite China as a currency manipulator under the terms of the 1988 Omnibus Trade and Competitiveness Act.[18] 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 (Henning 2007: 789). This was a policy priority for the Treasury from this time (Taylor 2007: 291, 294). The IMF staff report on China of June 2005 also recommended a RMB revaluation and both China and the US knew that the IMF's Executive Board would discuss this report in August (Sanford 2006: 11-12).

Caught between these conflicting problems and demands, the Chinese leadership chose to avoid being judged officially in breach of its multilateral obligations by opting for a very gradual RMB appreciation in mid-2005. Maintaining a pegged exchange rate with the dollar had become politically untenable by mid-2005 as the Bush administration struggled to control demands for retaliation. But the Chinese leadership refused the

[18] 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 Frankel and Wei (2007).

option of a large one-off revaluation of the RMB, suggesting that arguments that more rapid appreciation risked disruption to growth, employment and social stability won the day.[19] The Chinese leadership also probably viewed foreign demands for rapid RMB appreciation as self-interested and aiming to induce China to bear an excessive proportion of the total costs of unwinding global imbalances (see IMF 2006b: 20; Yu 2007: 11). It was helpful in this regard that some key external interlocutors such as the US Treasury and the EU Commission appeared to share the leadership's concerns in stressing their common interest in Chinese growth and political stability (European Commission 2007b; Paulson 2008).

To summarise, China's leadership has tried to balance a range of competing and increasingly contradictory domestic and international pressures in its exchange rate policy choices. Until mid-2008, rising concerns about inflation and the possibility of foreign protectionism seems to have convinced Beijing to allow the RMB to appreciate modestly against the US dollar and on a trade-weighted basis. After the outbreak of the global crisis in 2008, however, renewed concerns about deflation and the rising level of bankruptcy in the export sector led the leadership to return to the previous policy of a dollar peg. Once again, this policy attempted to balance competing pressures, notably those from the traded goods sector demanding currency depreciation and other groups, not least the US Congress, for whom depreciation would have been unacceptable. China's exchange rate policy over the past decade has been sufficiently within the political boundaries of multilateral rules and norms to avoid a rupture in its relations with

[19] A range of other arguments against rapid appreciation were given, but these were often less convincing or even contradictory. See IMF (2006b); Prasad (2007); Yu (2007).

the IMF and major trading partners like the US, though this policy has revealed growing contradictions over time.

## 3 The state of the multilateral regime before the current global financial crisis

The Chinese government's solution to the policy dilemma of the mid-2000s succeeded in avoiding the immediate threat of being classified as a currency manipulator by the IMF and US Treasury, but over 2006-7 the threat re-emerged in response to steadily rising Chinese current account surpluses and foreign reserves. This threat increased when the major developed countries pushed for a revision of IMF rules on currency manipulation, which eventually produced the 2007 Decision on Bilateral Surveillance. The perception that the IMF was being used by the US and other major countries to increase the pressure on China to accelerate RMB appreciation sharpened the growing sense in China that the multilateral regime is itself asymmetric and flawed. Although the 2007 Decision raised the risk that any country adopting a policy of exchange rate targeting could be in breach of multilateral rules, it left other aspects of the multilateral surveillance regime largely unaddressed. This highlighted the contrast between the still weak multilateral rules and norms relating to monetary and fiscal policies and the strengthened rules on exchange rate policy. Those who argue that China is exceptional in its degree of disregard of multilateral rules underestimate this asymmetry.

This perception of asymmetry was reinforced for developing countries by the way in which the process of multilateral surveillance was conducted. After the inflationary episodes of the 1970s and 1980s, G-7 countries focused on building *domestic* mechanisms of monetary policy constraint such as independent central banks and inflation targeting strategies.[20] The US was especially unwilling to accept external constraints upon its macroeconomic policy choices after the end of gold convertibility in the early 1970s (Gowa 1983). To the extent that the major countries were willing to engage in multilateral policy discussions, they preferred to do so on an informal basis within the G-7 club itself, rather than within the IMF. The IMF Managing Director was even effectively excluded from intra-G-7 exchange rate discussions (Mussa 2007: 1-2). Key issues, such as the asymmetries that stem from the role of the dollar as the world's key currency, were also kept off the multilateral agenda. Nor was the G-7 process very effective in coordinating macroeconomic policy: such discussions were infrequent and did little to prevent the emergence of persistent, large payments imbalances (Funabashi 1989; Webb 1995).

To be fair, the G-7 has recognized that this creates a legitimacy problem. In February 2007, the G-7 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." But there is little evidence that this has been matched by real policy action. In G-7 meetings from 2005, Washington did agree language calling for US fiscal consolidation as part of a multilateral effort to reduce global payments imbalances, but the emphasis was firmly on spending reductions. Tax increases, crucial to any credible deficit reduction plan, were not mentioned. Although the Bush administration did succeed in reducing the relative size of the fiscal deficit from 2004-7, references to multilateral obligations in domestic debates about fiscal policy are very difficult to find (though IMF support provided some political cover

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

for deficit increases over 2008-9). Meanwhile, the dominant European view for some time was that global imbalances were simply not Europe's problem (Ahearne and Von Hagen 2006). And although the EU likes to see itself as more naturally multilateral than the US, it has never been willing to allow an IMF role in internal EU macroeconomic policy discussions (Mussa 2007: 2).

The considerable gap between the rhetorical commitment of many governments to the principle of multilateral policy coordination and the reality is inevitable given that political legitimacy lies at the national level in most countries. Fiscal and monetary policy instruments are simply too important for national economic stabilization and redistributive purposes. Europe is exceptional only in respect of monetary policy, though to the outside world the European Central Bank looks as internally focused as the US Federal Reserve.

Even if it is understandable, the conspicuous resistance of the major developed countries to multilateral constraint on their macroeconomic policy choices is still seen as hypocritical because G-7 countries have often seen the IMF as an important source of policy leverage over developing country borrowers. The Asian crisis of the late 1990s was arguably 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 have come under growing pressure to contribute to the reduction of global imbalances. China, along with Saudi Arabia, agreed in mid-2006 to the first IMF-sponsored Multilateral Consultation on Global Imbalances because of their systemic importance. Even at the time, the Executive Board assessment of these consultations suggested that the results of this process were disappointing:

> Directors particularly welcomed the individual statements of policy intentions set out by each participant. While these policies are generally not as ambitious as the Fund has recommended in individual Article IV consultations or the *World Economic Outlook*, they nonetheless constitute significant steps forward.[21]

Since the 2008-9 crisis, many emerging countries, including China, have been increasingly open in stating the criticism that the IMF surveillance regime must be rebalanced. The PBOC 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".[22] In the light of heightened Chinese concerns about the sustainability of US fiscal policy and the prospect of further US pressure on China to accept additional RMB appreciation, it is not surprising that demands for greater symmetry should be focused on the US. It may also reflect a tactical judgement by Beijing that the likelihood of the US accepting greater multilateral constraint over its domestic policy choices is small, thereby reducing pressure on China to adjust. China's Congressional critics have done little to dispel this perception. Past

[21] "IMF Executive Board Discusses Multilateral Consultation on Global Imbalances", IMF Public Information Notice, No. 07/97, August 7, 2007.

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

bills demanding faster RMB appreciation typically did not offer any credible quid pro quo on US fiscal policy.[23]

## 4 Conclusion

Both China and the major developed countries have shown little real willingness to submit macroeconomic policy choices to multilateral surveillance and negotiation. This stems from a natural tendency of most national governments to wish to retain autonomy over key decisions over the often highly politicized policy areas of taxation and spending, monetary policy, and exchange rate policy. At the same time, however, the multilateral regime on macroeconomic policy constrains exchange rate policy choices much more than fiscal and monetary policy choices. This asymmetry is a legacy of the Bretton Woods era with its concerns about beggar-thy-neighbour devaluations, but it has been reinforced since the breakdown of the pegged exchange rate system, notably in the 1977 Amendments and the 2007 Decision on Bilateral Surveillance. Since developing countries such as China have a much stronger revealed preference for exchange rate targeting as a monetary policy anchor compared to advanced countries, there is a strong perception of bias in the regime for many developing countries.

Now that major emerging countries are being brought into the global policy process in a more systematic way, first in the 2006-7 multilateral consultations on global imbalances and more recently via the G20, this perceived asymmetry constitutes a major

[23] Chinese experts also note that Western critics often emphasize the negative effects of China's surplus (such as the effects of surging exports on jobs) but omit the benefits of low-cost imports and cheap finance (Yu 2007: 3).

obstacle to the promotion of a more effective system of multilateral policy consultation and peer review. The asymmetry is related to the reluctance of governments to submit their macroeconomic policy choices to serious multilateral consultation and constraint noted above. As long as the major developed countries, above all the US, resist subjecting fiscal and monetary policy choices to external constraint, there seems to be little prospect for a more balanced multilateral regijme.

Within the G20, only two countries (China and Saudi Arabia) retain clear exchange rate targets, though some other countries continue to intervene in foreign exchange markets to smooth fluctuations. Even so, there has been a general trend towards accepting greater exchange rate flexibility among large emerging countries in recent years, so it may be unlikely that the transition from G-7 to G20 will produce a new consensus that is more permissive of exchange rate targets. The IMF's *Triennial Review of Surveillance* identified various weaknesses in the surveillance process, including the lack of analysis of linkages between macroeconomic and financial sector developments, but it also appeared to reflect a continued resolve to integrate exchange rate analysis into the surveillance process (IMF 2008). Given that other major emerging countries are concerned that RMB undervaluation could hurt their exports or their ability to attract mobile investment projects, the G20 may well on balance retain the existing bias in the regime that discourages such policies. If so, this could open up differences between the new elite club, the G20, and much of the rest of the developing world.

As regards the willingness of G20 countries to submit their monetary and fiscal policy choices to greater multilateral scrutiny and constraint, there have been some recent interesting developments. 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. We believe that regular consultations, strengthened cooperation on macroeconomic policies, the exchange of experiences on structural policies, and ongoing assessment will promote the adoption of sound policies and secure a healthy global economy. Our compact is that G-20 members will agree on shared policy objectives."

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.[24]

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".[25] For its own part, the IMF has re-committed itself to be a "ruthless truth-teller" in the wake of the crisis.

The question remains, however, whether these commitments will be met when the IMF and other G20 members identify conflicts between the preferred policy choices of particular countries and the "global interest". The history of past commitments of this kind should lead us to be somewhat sceptical. The G20, like the G-7 before it, wishes to

[24] "G20 Leaders' Statement", Pittsburgh Summit, September 24-25, 2009.
[25] "IMF Executive Board Adopts Surveillance Priorities for 2008-2011", IMF Press Release No. 08/238, October 8, 2008.

retain authority over implementation and peer review, which suggests limits to the newfound willingness of the major developed and developing countries to submit to multilateral constraint. Is the US Congress, or China's NDRC, very likely to take the IMF's advice if their preferences are inconsistent? The absence of a technical consensus in many key areas of macroeconomics (including the effects of currency realignments and macroeconomic policy changes on global imbalances) also makes it more difficult to achieve political consensus. The G20 may now have brought the major players into the multilateral consultation process, but larger numbers also means greater complexity. As a pre-crisis independent evaluation of IMF exchange rate policy surveillance concluded, "The reduced traction [of IMF surveillance] with advanced economies is in danger of being extended to large emerging market economies, and beyond" (IEO 2007: 35). There seems little reason to believe that things will be very different after the crisis of 2008-9.

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