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A Prelude to a Prologue

THE U.S. AND THE G20 SUMMIT

The G20 summit on November 11-12 in Seoul, South Korea, will be another attempt by political leaders, finance ministers, central bank governors and a number of international bodies such as the International Monetary Fund and the World Bank, to halt the current economic crisis, to secure a durable recovery, and subsequently to deliver strong, sustainable and balanced growth. But rising currency tensions in the recent months could overshadow every other topic on the agenda. There is a plausible fear that if these currency tensions worsen, global recovery will be undermined due to protectionism and trade wars. Additionally, there is the risk that when global imbalances stop shrinking, deflation and weak growth will follow. The G20 unity that won praise for coordination of stimulus packages during the 2008 global financial crisis is now being tested by low growth in industrialized countries and various attempts by emerging market economies to preserve their export competitiveness by holding down their exchange rates. Against this backdrop, the overarching policy challenge for the U.S will be how to sustain the recovery while restoring confidence.

While the U.S. economy is no longer shrinking, it is becoming apparent that a real global economic recovery will take more time. With uncomfortably low inflation and a risk that unemployment could increase in the U.S., the Federal Reserve is expected to begin quantitative easing in November in an effort to boost U.S. exports while countering China's slow currency appreciation.

The pressure began early in the year, when President Obama spoke harshly in February about China's economic policies, stopping short of calling China a currency manipulator, and the World Bank issued a report calling the yuan overvalued. For their part, Chinese officials regularly lecture their American counterparts on the need to maintain the value of the American dollar. China has more than $2.6 trillion in foreign reserves, and is the largest holder of U.S. debt.

As China's currency reserves are growing and in an attempt to spread risks while the dollar declines, it is purchasing other currencies, such as the Japanese yen and the South Korean won. With countries starting to intervene in an attempt to stem the rise in their currencies, talk about a currency war is being heavily circulated among government officials in the lead up to the G20 summit.

The basic free market premise at stake is that if countries with large current account deficits should have to accept weaker currency, than countries with large currency surpluses should have to accept stronger currency. But compared with exchange rates before the financial crisis, in 2007, few countries have allowed their currency to appreciate against the dollar. China has amassed $2.6 trillion in official currency reserves and has prompted the U.S.

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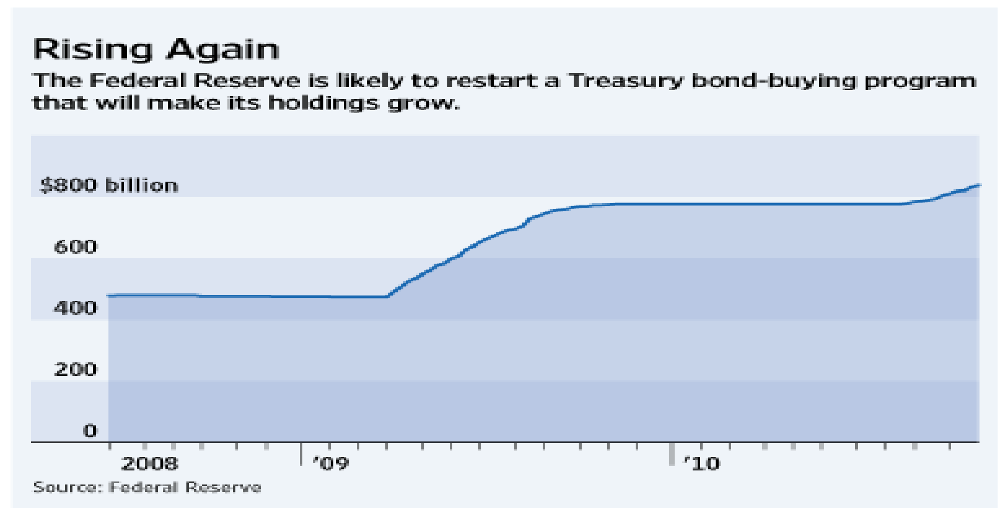
House of Representatives to pass a bill threatening retaliation unless China allows its currency to appreciate and reduce the huge trade surplus with the U.S. [1]

Quantitative Easing

While some economists speculate that the U.S. economy needs more stimulus intervention, lowering interest rates any further or passing more fiscal stimulus is being viewed as politically impossible, given that political partisanship is growing higher as the midterm elections draw nearer. With Congress and the president seeming to be inactive, quantitative easing remains the only viable option, according to Federal Reserve Chairman Ben Bernanke.

The Federal Reserve is likely to unveil a program of U.S. Treasury bond purchases worth a few hundred billion dollars over several months, a measured approach in contrast to purchases of nearly $2 trillion it unveiled during the financial crisis. The Fed's aim is to drive up the prices of long-term bonds, which in turn would push down long-term interest rates. It hopes that would spur more investment and spending and liven up the recovery. But officials want to avoid the "shock and awe" style used during the crisis in favor of an approach that allows them to adjust their policy, and possibly add to their purchases, over time as the recovery unfolds.

The purchases will be limited to only federally insured paper, which includes Treasuries and mortgage-backed securities insured by Fannie Mae and Freddie Mac. But they are also allowed to buy short-term municipal bonds, and given the difficulties faced by state and local governments this may well be the route they choose, at least for some of the quantitative easing. Even if the Fed wanted to, it couldn't buy other securities, such as corporate bonds, as it would require Congress's approval.[2] Chairman Ben Bernanke's push to restart the bond-buying program has been greeted with deep scepticism among some of his colleagues and will be a source of contention at the upcoming G20 summit.



Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, said that more expansive monetary policy was a "bargain with the devil."[3] In normal economic equations,

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[1] Daniel Flyn and Louise Egan, "US Plans For Trade Targets Runs Into G20 Headwinds." Montreal Gazette, October 22, 2010

[2] David Blanchflower, "Quantitative Easing is Only Show in Town," Bloomberg, October 18, 2010

[3] Jon Hilsenrath and Jonathan Cheng, "Fed Gears up for Stimulus," Wall Street Journal, October 26, 2010

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the Fed reduces short-term interest rates when it wants to spur growth. But the central bank already cut short-term rates to near zero in 2008, so it is turning to an unconventional measure. Some Fed officials argue the economy is going through long-term changes that the central bank can't rush, and worry a large bond-buying program might only stoke future inflation or a new asset bubble.

In another rebuke of the Fed's quantitative easing policy, German Economic Finance Minister Rainer Bruederle said that, "It's the wrong way to try to prevent or solve problems by adding more liquidity. Excessive, permanent money creation in my opinion is an indirect manipulation of an exchange rate."[4]

The U.S. has to carefully consider how much quantitative easing will actually stimulate the economy, provided the costs exceed the benefits nationally and globally. The risk that economists see with raising inflation expectations is that it can be hard to adjust them downward and that the U.S. could instead face problems of higher interest rates, a weak economy and high inflation. Much has been said in the media concerning quantitative easing as regards its affect on the domestic economy. While a majority of economists agree that it does very little in the short term, in the global economy it weakens the US dollar [5], thus making U.S. exports more competitive; and as a byproduct it lessens the US dollar's attractiveness to global foreign exchange reserves managers. China has already noted that it is prudent not to hold all its reserves in one currency as that currency could devalue, thus altering significantly its reserves portfolio. There is also the risk of negative effects that excessive capital inflows could cause in emerging countries.[6]

"Seoul presents what should be a golden opportunity for the G19 to press China – which hates to be isolated in international fora in a visible way – very hard on this [currency] issue," says Stewart Patrick of the Washington-based Council on Foreign Relations think-tank. "But, to date, the G20 has shown very little solidarity. If the G20 cannot rise to the occasion in the run-up to Seoul and get tangible progress from China on the currency front, it will show itself to be a toothless talk shop."[7]

Some worry that quantitative easing may complicate global recovery, since its driving capital to countries offering higher returns, i.e., emerging economies. There is fear that the capital inflows now affecting these countries could lead to new bubbles, overheating and instability. With every country trying to export its way out of the crisis for lack of better economic tools, the G20 summit in Seoul will focus on the need for different economic recovery plans to be implemented in a way that are not detrimental to the economic recovery efforts of other countries.

Apart from quantitative easing, another challenge for economic cooperation comes from emerging market powers, particularly in Asia. The danger is that there is significant sentiment in those countries that the crisis was a "North Atlantic" one that requires action by the U.S. and Europe, but not by emerging markets. Taken too far, this could lead to "regulatory arbitrage" in which much of the financial activity that is globally mobile could move to

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[4] Simon Kennedy and Eunkyung Seo, "G20 Pledges to Avoid Devaluations in Push to Defuse Global Trade Tensions," Bloomberg, October 23, 2010

[5] Douglas Borthwick, "Speak Softly and Carry a Big Stick-G20 and China," Seeking Alpha, October 21, 2010

[6] Cecilia Hermansson, "Currency Tensions put Global recovery at Risk," Economic Research Department, Swedbank, October 19, 2010

[7] http://blogs.ft.com/techblog/

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lightly regulated jurisdictions that did not make changes corresponding to the current international finance regulatory framework.

Michel Barnier, European Commissioner for Internal Markets and Services, speaking in Washington recently said that the 3 major achievements made by Europe and the U.S. regarding the financial system have been significant and should not be overlooked by their Asian counterparts.

"First, we have strengthened financial supervision in Europe. The creation of the three new authorities, for banks, for insurances and for the securities markets, is a decisive step towards a safer and more integrated European financial market. Second, our American friends have made a significant step with the adoption of the Dodd-Frank Act. I know that many details require time, but I want to salute the determination of the U.S. Administration and of Congress to reform the financial system. Undoing the reforms would give a very bad signal for financial stability throughout the world. The U.S. and the E.U. must show leadership and finish the job of repairing the financial system," said Commissioner Barnier.

Commissioner Barnier went on to say that the third achievement was the effective and fruitful E.U.-U.S. cooperation. "Europe and the U.S. must work together reforming the financial system. The agreement on capital requirements reached in the Basel Committee is essential. We will propose next year the necessary legislative proposals to translate the agreement into European law. And I trust that our U.S. colleagues will do the same on this side of the Atlantic."

A Tepid Agreement

During the G20 Finance Ministers and Central Bank Governors meeting in Gyeongju, South Korea in late October, G20 finance ministers worked on the upcoming agenda and priorities for the leaders' summit in November. The resulting communiqué from the G20 ministers had several recommendations, the first being a global move toward rebalancing misaligned exchange rates. The second recommendation was to reform the International Monetary Fund's voting and governance structure to appropriately represent emerging and developing countries. The final recommendation was the need for supporting the healthy operation of the international monetary and financial systems to foster, above all, job creation.

During the meeting, U.S. Treasury Secretary Timothy Geithner sent letters to G20 nations running large trade surpluses asking them to limit the size of their trade surplus or deficit to 4 percent of their gross domestic product. Additionally, after meeting with Deputy Prime Minister Wang Qishand, Secretary Geithner said that he was optimistic that China will "continue to move" on the yuan. This is, in effect, at the very heart of the discussions. At the upcoming summit in Seoul, President Obama will have the opportunity to forge a multilateral response to China's exchange rate misalignment since Asian and European countries have been feeling the negative economic effects of China's exchange rate policy. Additionally, developing countries are being priced out of export markets or pressured into undertaking competitive currency devaluations of their own.

Equally important to exchange rates, the G20 discussions in Seoul will have to focus on the commitment to reform the International Monetary Fund so that emerging countries like China, India and Brazil, have a greater role corresponding with their growing share of the responsibility for the health of the global economy. There is the hope that once the G20 leaders meet in November, they will be able to agree on the formula for these reforms, which will make the International Monetary Fund the main arbitrator to address re-balancing the global economy, including through market-determined exchange rates to prevent competitive devaluations.

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Additionally, the G20 finance ministers and central bank governors, by acknowledging the need for job creation in the communiqué, have left the door open for the leaders to take on a much more active role in discussing tangible strategies to create jobs for the millions of people who were negatively affected by the recent global financial crisis.

A Real Test

The US has not persuaded the rest of the G20, many of whom are probably intimidated by China's diplomatic and military clout, to gang up on Beijing. Washington's latest plan, to set targets for current account surpluses and deficits, has received a mixed reception. Meanwhile America faces its own criticism. Emerging markets complain about volatile inflows of capital thanks to the prospect of the Federal Reserve resorting to quantitative easing, pushing yet more money into markets to stimulate growth.

The recent G20 ministers meeting laid out an ambitious agenda that G20 leaders will have to address in Seoul. While the meetings and discussions will be filled with high emotions and messy confrontations between the U.S. and China, many think that this is for the better, because not addressing these issues would call into question the very purpose and function of the G20. In the past, G20 summits have suffered from the same problem since the inaugural gathering. While governments are happy to make a show of unity at times of crisis, the grouping has no means of enforcing promises. In the end, the G20 summit, at best, will move incrementally. The U.S. and its counterparts will look for discrete, if unspectacular, projects that need political momentum rather than aiming at a fundamental reinvention of global economic governance. A small step is better than no step.