Eurozone pointers to a new global monetary system

The lessons of the global financial economic crisis in general, and the eurozone's difficulties in particular, are becoming clearer, writes Heiner Flassbeck. He outlines key elements for a new international system for financial and monetary co-operation

The financial crisis of 2008 and its global ramifications propelled the G20 centre-stage to lead a co-ordinated international response. The G20 finance ministers highlighted the need to measure and tackle global imbalances, and now their concern is increasingly to address internal structural balances, fiscal policy and currency alignments, and to come-up with a common policy package that can weather whatever the next stage of the crisis turns out to be. The G20 ministers' welcome dose of inclusive multi-lateralism and their new thinking on interdependence have come at the right time, because exchange rate management is coming to the fore in the global policy debate.

It's a debate that is opening some new paths towards improving global economic governance. It acknowledges that the mantra of "leaving currencies to the market" has lost its persuasive power. The contradiction between expecting market forces to do their job, and hoping for a realignment of currencies according to the fundamentals that determine competitiveness, has become glaringly obvious, as was once again revealed when Brazil recently found itself faced with having to fend-off huge capital inflows that risked causing an unsustainable appreciation of its currency, the Real.

To monitor global trade imbalances and make progress towards greater sustainability, the G20 is to consider technical guidelines showing when imbalances start moving away from being sustainable. One suggestion has been to focus on the size of a country's current account deficit or surplus, as a percentage of GDP. Others favour a range of indicators that contribute to imbalances and to inconsistent fiscal, monetary and exchange rate policies.

Timely as these efforts are, it would be a mistake to use the current account as the key indicator for measuring the sustainability of large imbalances. That would be to focus on a symptom rather than the cause of global imbalances.

To focus on current account imbalances alone is also flawed because of the difficulty of quantifying the bands beyond which imbalances become truly unsustainable. There are also many good reasons why a current account may be in deficit or surplus at any given point in time; one being that a county's domestic economy may be growing faster than those of its trade partners, causing imports to rise more than exports, as is the case with the United States. Another is that a country may be a major importer of a commodity whose price tends to keep on rising and so increasing its import bill without there being any compensation through higher exports – the low-income, food deficit countries being a good example of this. Yet another reason is that a country may serve as a hub for foreign corporations to produce manufactured goods there on a large scale, but may not have enough wealthy consumers in its population to ensure that its own imports are roughly in balance with its exports, China being the pre-eminent example.

The right approach to the twin problems of global trade imbalances and destabilising short-term capital flows is straightforward, and involves adjusting the nominal exchange rate in line with the constant real exchange rate rule

In all of these cases, a short-term buffer of either net capital inflows or outflows is needed if the international trading system is to function smoothly. In other words, current account imbalances are not in themselves a sign of a systemic problem that needs co-ordinated intervention. It is not so much the current account position of any one country that's important – a commodity exporter like Saudi Arabia, for instance, can rely on maintaining its surpluses indefinitely. What really matters is any overall loss of competitiveness that may be at the origin of a current account deficit.

The only current account imbalances that are clearly unsustainable are those that stem from a loss of economic competitiveness as a whole. A general over-valuation of a country's currency means that its nominal exchange rate has appreciated against others more than differences between its domestic price levels and those of other countries would warrant.

Exchange rate management has to be at the centre of any package of measures designed to avoid unsustainable imbalances. The right approach to the twin problems of global trade imbalances and destabilising short-term capital flows is straightforward, and involves adjusting the nominal exchange rate in line with the constant real exchange rate rule. This rule would in the first place be enforceable by a multi-lateral agreement on the pattern of optimal or reasonable exchange rates, and secondly, concerted central bank action would maintain this pattern and would also help to remove the incentive for short-term currency speculation that has been aggravating global imbalances so much.

Just as important as the trade distortion effect of real exchange rate changes is the way that a large deviation of nominal exchange rates from the inflation difference can make capital flows so much more volatile, and so reduce countries' ability to pursue growth oriented counter-cyclical monetary policies. Large short-term interest rate differences between countries attract speculative capital flows (currency carry trade) that are normally associated with inflation differentials of a similar size because central banks decide their short-term interest rates in line with their inflation

EUROPE'S WORLD BACKGROUND BRIEFING

It's not only the eurozone's credit 'addicts' who are to blame, but also the credit 'pushers' in the German banks

It is widely accepted that external imbalances were at the origin of what has become the worst economic and financial crisis in almost 80 years.

In the mid-2000s, China and Germany became the world's export champions, accumulating huge trade surpluses and currency reserves that financed a spending spree by the United States government and the American people.

When the U.S. binge collapsed with the sub-prime mortgages crisis, Europeans haughtily insisted this was an American problem for which the world would have to pay. After almost a decade of monetary union, imbalances were not seen as a problem for the EU.

Germany may have enjoyed a current account surplus of 7.5% of GDP, while Spain had a 10% deficit, but within the eurozone, these were judged as being as insignificant as differences between the likes of California, Ohio or Mississippi.

Some countries were simply in a natural process of catching up, it was explained, and transfers of funds from the EU's central budget would help the process along.

But the sudden eruption of the eurozone sovereign debt crisis in 2010, which has forced Greece, Ireland and lately Portugal to seek external assistance to keep their finances afloat, gave the lie to that complacency and shows the limits of monetary union in keeping the whole euro edifice together without a deeper economic union.

Those internal imbalances are a measure of the competitiveness lost by Portugal and the others during the first 10 years of the euro, as inflation and wages were allowed to grow well above the eurozone average. In 2007, Greece saw wage increases of 6.2%, Spain 4.8%, Ireland 5.4% and Portugal 3.6%, compared to a eurozone average of 2.6% and a rise of only 0.9% in Germany.

German banks were awash with capital inflows, thanks to the country's export boom, but were denied many domestic investment opportunities by a determined savings culture. So they were only too happy to finance the excesses in the southern and western flanks of the eurozone.

German bank exposure to banks in Portugal, Greece, Ireland and Spain was calculated at €392.4bn in February 2010. But since then the peripheral bubbles have burst and German politicians have placed the blame firmly on the "spendthrift southerners" rather than pointing to the responsibility of their own banks in funding the bubble. For many within the EU there has been a dawning realisation that blaming the credit addicts, but not their pushers, will need to change if the eurozone is finally to resolve its debt crisis. □

targets. The nominal short-term interest rate in countries with rather high inflation rates will incorporate this inflation rate, plus a premium set by the central bank, to achieve a positive short-term real interest rate. In this way, the real interest rates in a country with open capital accounts will deviate much less than the nominal interest rate, or could even be equal to it.

As interest rate arbitrage of the carry trade type exploits the differentials of short-term nominal interest rates – the speculator not being at all interested in buying goods in the country he is investing in – a rule to adjust exchange rates along the lines of PPP removes most of the incentive to invest short-term in countries with high inflation and interest rates. As huge amounts of short-term capital following carry trade operations tend to drive the exchange rate in systems of free floating in the wrong direction (i.e. the appreciation of high-inflation countries' currencies) and to add a currency profit to the interest profit, enforcing the PPP rule yields an important second dividend; it is the only way to reduce large-scale speculation short of closing the capital account, and thus of avoiding financial crises triggered by misaligned currencies.

The financial markets would quickly understand that to challenge such a multi-lateral policy framework is impossible because the stabilisation of the system would call for the active participation of not only central banks of countries whose currencies have a tendency to depreciate but also of those whose currencies are under pressure to appreciate. Their reach is always greater than that of the market because they can print all the currency they need.

The idea of a co-operative global financial and monetary system would be to ensure the same rules for all, just as multi-lateral trade rules apply to all trading partners. The main idea behind the International Monetary Fund's creation was precisely to avoid competitive devaluations. In a well-designed global monetary system, the advantages of currency depreciation in one country would have to be balanced against the disadvantages in another. Since exchange rate fluctuations that deviate from purchasing power parity affect international trade in a very similar way to changes in tariffs and export duties, these changes should also be governed by multi-lateral regulations. A multi-lateral regime would require countries to specify the reasons for real devaluations. If applied strictly, real exchange rates would tend to remain more or less constant, since the creation of competitive advantages would generally be unacceptable.

So the question is whether the problems besetting Europe's economic and monetary union (EMU) suggest that in practice such an arrangement would never work? That is clearly not the case. Much of the debate on EMU's crisis misses the most crucial point; the external imbalance inside the monetary union. Greece's budget problems and those of other southern eurozone members are important, but they are closely related to external deficits. The key to the euro's future is to be found in external adjustments in all countries. It is the gaps in competitiveness that will force the dissolution of EMU unless strong corrective action is taken soon. Only external adjustment will provide the basis for a proper judgment of eurozone countries' misdoings, and Germany has to move definitively because it has misunderstood EMU more than any other.

Comparison of Greece and Germany reveals the core of the problem. Greece's current account deficit reached nearly 15% of GDP in 2007, and has recently come down slightly because of falling imports. Germany accumulated a huge current account surplus in the same period, peaking in 2007 at 8% of GDP. Between 2003 and 2007, Germany's net exports exploded but domestic demand stagnated.

Nominal compensation and unit labour costs in Germany rose only marginally in the decade at a 0.4% annual rate. In Greece, real compensation to labour increased at 1.9% annually per employee, a little less than productivity. But nominal compensation grew by 4.9% and the ratio of nominal compensation to productivity (unit labour costs), the most important measure of international competitiveness in a currency union, advanced with a rate of 2.7% per annum and if 2000 is set as 100 reached a level of 130 in 2010.

The gap in unit labour costs means that a comparable basket of goods and services produced in 2000 at the same cost in all the eurozone countries now costs 25% more if it comes from Greece than from Germany, with much the same being true of Spain, Portugal and Italy. But the gap for France is 13% even though France was the only eurozone country where unit labour cost strictly followed the 2% inflation target set by the European Central Bank.

The inflation target is crucial when trying to judge the wrongdoers. EMU was not meant to be a zero inflation union but a 2% one. Measured against this scale the conclusion is obvious: a 2% inflation target is compatible with a 2% unit labour cost increase, but an increase of 2.7% as in Greece has meant living beyond its means, yet has violated the rule to a lesser degree than the Germans living below their means at 0.4%. Germany explicitly agreed to the target of close to 2% because it was its own target prior to EMU. Given this target and the overriding importance of unit labour costs for inflation, Germany headed towards a clear violation of the common target once the federal government started to put enormous pressure on wage negotiations to improve the country's competitiveness, both within the eurozone and outside it.

Globally, the lesson is clear: competition between nations doesn't follow the same rules as competition between companies. Whether with fixed or flexible exchange rates, an indebted country can only service and repay its debt if the surplus country allows the deficit country to sooner or later regain a surplus by means of changes in competitiveness through price adjustment triggered by wages and/or exchange rates. Once a surplus country refuses to become a deficit country, the debtor's default is unavoidable because for a recession that is long and painful to produce a surplus only through falling imports would be political suicide for any government. □

Heiner Flassbeck is a former German deputy finance minister who is Director of UNCTAD's Globalisation and Development Strategies Division.
Heiner.Flassbeck@unctad.org