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“Capital Flow Volatility and the Future of International Policy Coordination”

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Section 1: Introduction

Large domestic financial imbalances (in private savings versus investment and/or government revenues versus expenditure) are often associated with large cross-border capital flows and current account imbalances. Such imbalances in several large economies were sustained over a number of years in the period up to 2008 and have been viewed as one of the main factors contributing to the 2008-9 global financial crisis (GFC) and the subsequent eurozone crisis of 2012.[1]

This experience complemented long-standing concerns about the implications of sustained current account imbalances for financial and economic stability as, was seen, for example, in the recycling of oil exporter surpluses in the 1970s which contributed to the developing country sovereign debt crisis of the 1980s.

The trigger for the GFC and earlier crises was a sharp rise in US dollar interest rates - sometimes accompanied by a sharp rise in the dollar exchange rate - which exposed the financial vulnerabilities underpinned by large financial imbalances.

Efforts to prevent a recurrence of such crises through international economic policy coordination have therefore included stepped up efforts to monitor and control global current account imbalances.

The onset of the pandemic in 2020 and the commodity price surge triggered by Russia's invasion of Ukraine in 2022 led to a large spike in the global current account balance[2] which reached 4.1% of global GDP in 2022. This was followed by a very rapid surge in US and other advanced country interest rates as central banks responded to the 2022-23 inflation shock. These developments were accompanied by renewed concern about financial fragility in a number of countries and the possibility that the spike in interest rates could trigger a financial crisis.

But despite the parallels with previous periods of high global imbalances, and evidence of some financial stress in both advanced and developing economies[3], we have not yet seen anything comparable to the global financial crisis or previous crises linked to global imbalances.

Meanwhile 2023 saw a sharp fall in the global current account balance and it is projected by the IMF to reach 2.9% of global GDP in 2024.

In this paper we address, three main questions.

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[1] The other key factor is lax financial regulation. This applies both in the countries receiving net financial flows and where the final investments are made; and in those countries exporting capital and where intermediating financial institutions may be based.

[2] The sum of the absolute values of current account deficits and surpluses.

[3] i.e., the SVB crisis, Credit Suisse collapse, China real estate insolvencies, and the "common framework" cases of sovereign debt distress.

Why hasn't the spike in global current account imbalances from 2020-22 combined with the sharp rise in dollar interest rates from 2022 onwards caused more serious issues for global financial and economic stability up to this point?

What legacy has the period 2022-23 left and what are the future risks posed by excessive global current account imbalances given the rapidly involving international environment?

What role can international economic policy coordination realistically play in mitigating these risks going forwards?

The paper is organised as follows

Sections 2-4 look in more detail at the reason excessive current account imbalances matter, the experience of the most recent spike in the global current account balance, and the prospects and risks looking forward.

Sections 5-7 discuss the historical experience with international economic policy coordination focused on global imbalances, how the current environment differs from previous times and what might be a realistic approach going forward.

Section 8 concludes.

Section 2: Why do global current account imbalances matter?

Current account surpluses and deficits are an essential counterpart to free movement of capital which in turn is critical to delivering a high level of sustainable long-term growth in the global economy. However, excessive current account imbalances sustained over time can have major economic costs and adverse political economy consequences, at both the global and individual country level.

International economic cooperation has often been looked to as a way both to prevent the occurrence of sustained imbalances as well as a means of managing the consequences when they do occur. A key reason for this is that in the absence of international cooperation, the burden of preventing and adjusting to unsustainable imbalances will fall very largely, if not entirely, on deficit economies, producing a sub-optimal outcome at both the national and international level. The exception to this is the United States, which is able to run sustained current account deficits funded by foreigners' willingness to hold dollar assets as an international store of value.

Capital mobility has benefits over both the short term and long term. Short-term private cross-border capital inflows can help countries affected by economic shocks by giving them the time to make necessary policy adjustments and by financing a quicker recovery by businesses and consumers than would be possible if reliance had to be placed on domestic savings alone. This role could become increasingly important as the word faces a greater incidence of shocks.

Long-term capital inflows, both FDI and portfolio, can help ensure that high return projects (judged on a risk adjusted basis) are financed regardless of whether there is a sufficient level of savings available in the local economy. This raises the natural rate of growth for individual economies and increases the extent to which the available supply of international capital is deployed in the highest return projects, judged across all countries, thereby maximising global growth.

Capital mobility also enables the providers of capital to achieve a high return on their savings, even if there are few high return projects available in their local economy. This will be particularly important in aging societies given the need to ensure pension investments are deployed to achieve maximum returns with acceptable risk and given the possibility that an older work force combined with a policy of restricted migration will limit the availability of high return projects domestically.

Of course, *full* capital mobility rarely, if ever, exists in the real world. There are frequently practical constraints on the extent to which available capital is able to flow to the highest (risk adjusted) return projects.

Some of these constraints arise from inappropriate regulation or protectionism. But others reflect a genuine need to mitigate the potential financial stability downsides from capital mobility.

In particular, an extensive literature has developed linking private cross-border capital mobility and the driver of domestic savings-investment imbalances with serious bouts of financial instability.

For example, a number of researchers have argued that a key factor leading to the global financial crisis (GFC) of 2008-9 was the appearance of very large structural net savings surpluses in a number of emerging economies and the related flow of these savings to dollar-denominated assets in the US and hard currency assets in some other advanced economies.

These flows, it is argued, depressed global interest rates and contributed, along with lax regulation, to excessively risky lending in the recipient economies, notably sub-prime loans in the US housing market. A period of Federal Reserve tightening from 2004-2006 reversed the accommodative financial conditions, revealed the poor quality of investments that had been made, and contributed to the start of the GFC.

At the individual economy level, sustained current account deficits may also help create the conditions for "sudden stops" whereby the private sector suddenly decides it is no longer willing to fund an individual country's current account deficit, possibly as the result of a loss of confidence in national policy makers and/or a sharp hike in global interest rates.[4]

Country level savings-investment imbalances also attracted considerable attention during the eurozone crisis from 2010 onwards. Many of the countries at the epicentre of the crisis had previously run current account deficits and had relied on large capital inflows from other

[4] CAPITAL FLOWS AND CAPITAL-MARKET CRISES: The Simple Economics of Sudden Stops (tandfonline.com)

eurozone members made easier by the fact that the flows were denominated in euros, the home currency of both the lender and recipient.[5]

Some researchers have argued[6] that focusing on current account imbalances as a major precursor for financial crises puts too much emphasis on the role of *real economy* factors driving surpluses or deficits in trade in goods and services. They argue instead that *gross* financial flows, and the factors that drive these, play a more important role in determining market interest rates and as a cause of excessively risky investment behaviour in some countries.

This links to a broader debate about whether the current account still matters in a world of highly mobile international capital where current account imbalances and the net financial flows linked to these may be dwarfed by two-way gross capital flows. The latter may give rise to highly dangerous currency and interest rate mismatches or credit exposures in financial institutions, corporates or individual asset holders and debtors, even when there are no excessive current account imbalances.

In reviewing this debate Maurice Obstfeld has argued[7] that the current account balance remains a policy relevant variable on both financial and macroeconomic grounds, but focusing on current accounts is far from sufficient in ensuring global financial stability and "the risks from large gross financial flows may only be distantly related, if at all, to the global configuration of savings-investment discrepancies".

He calls for a better understanding of how gross flows fit together with economic developments, including current account balances. In justifying a continued focus on current account imbalances, he notes that large current account imbalances (either surpluses or deficits) can be *symptomatic* of much deeper structural problems in the way an economy is operating. Imperfect financial markets also limit the extent to which financial flows can fully offset and drive adjustment to real economic shocks. Large current account imbalances may therefore not be self-correcting, requiring policy interventions.

In the event, preventing the buildup of excessive current account imbalances and related net financial imbalances has been a central objective of post-GFC policymaking in many countries and of efforts at international policy coordination, notably the G20 Framework for Strong Sustainable and Balanced Growth, launched at the Pittsburgh Summit in 2009. This has also been reflected in an increased emphasis on monitoring external imbalances, as seen in the IMF External Sector Reports published from 2014 onwards.

The political economy consequences of global imbalances follow from the link that is often made between goods trade deficits, factory closures in the deficit country and the loss of politically sensitive manufacturing jobs. Even where a country has offsetting employment gains in more diffuse services sectors, or where there are flows from foreign investments that keep the current account in balance, the loss of traditional manufacturing jobs can

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[5] The Eurozone crisis: A consensus view of the causes and a few possible solutions | CEPR
[6] https://www.bis.org/publ/work346.pdf

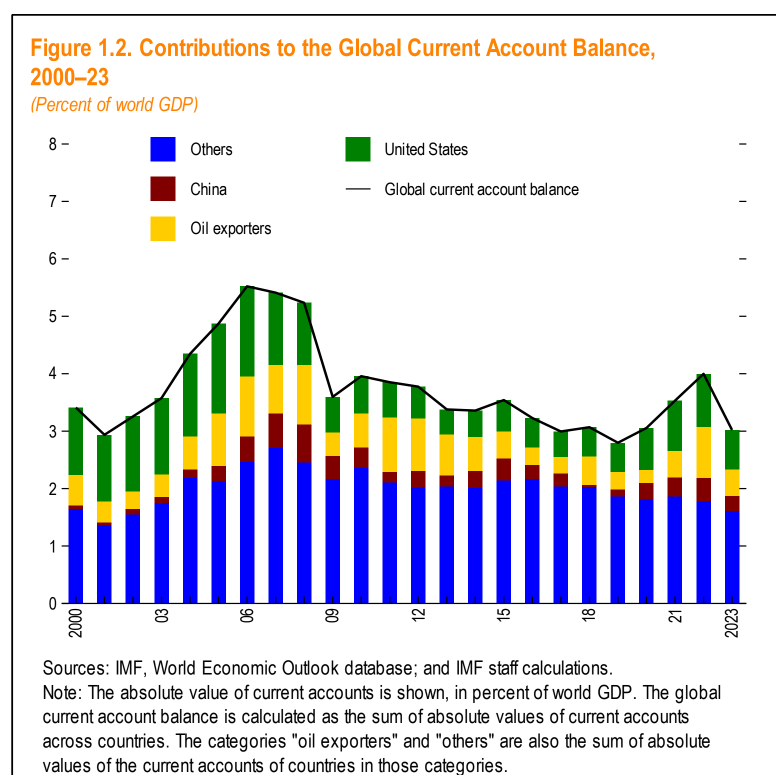
[7] Does the Current Account Still Matter? - American Economic Association

create powerful forces undermining support for free trade and a rules-based international trading system. Safeguarding the rules-based trading system has therefore historically been a key motivation for initiatives on international economic policy coordination.

Section 3: Recent Developments in Global Imbalances

Chart 1 from the IMF's latest External Sector Report[8] shows contributions to the "global current account balance" (the sum of the absolute values of current account deficits and surpluses over the period from 2000 to 2023). After peaking at 5.5% of GDP in 2006, the global current balance declined by 2.8 percentage points by 2019. This comprised a very sharp initial decline during the global financial crisis (GFC), followed by a more gradual trend decline between 2010 and 2019, reflecting shrinking contributions from the US, China and oil exporters. A key factor contributing to this downward trend was the transformation in US energy trade, from a peak deficit of 3.4% of US GDP in July 2008 to balanced trade in January 2024.

Chart 1:



The declining trend in the global current account balance then sharply reversed, rising by 1.2 percentage points of GDP between 2019 and 2022, before falling again by nearly 1 percentage point of GDP between 2022 and 2023.

This spike in global imbalances reflected the temporary contribution from the pandemic and the energy crisis triggered by Russia's invasion of Ukraine in February 2022. The change in

[8] 2024 External Sector Report: Imbalances Receding

the global current account balance over the period can be fully accounted for by the impact of these events on just three countries/country groups: the US, China and the group of oil exporters.

Chart 2 shows the total contribution of the main **pandemic-related factors** to global imbalances estimated for 30 of the world's largest economies which are the focus of the IMF's External Sector Report.

Chart 2:

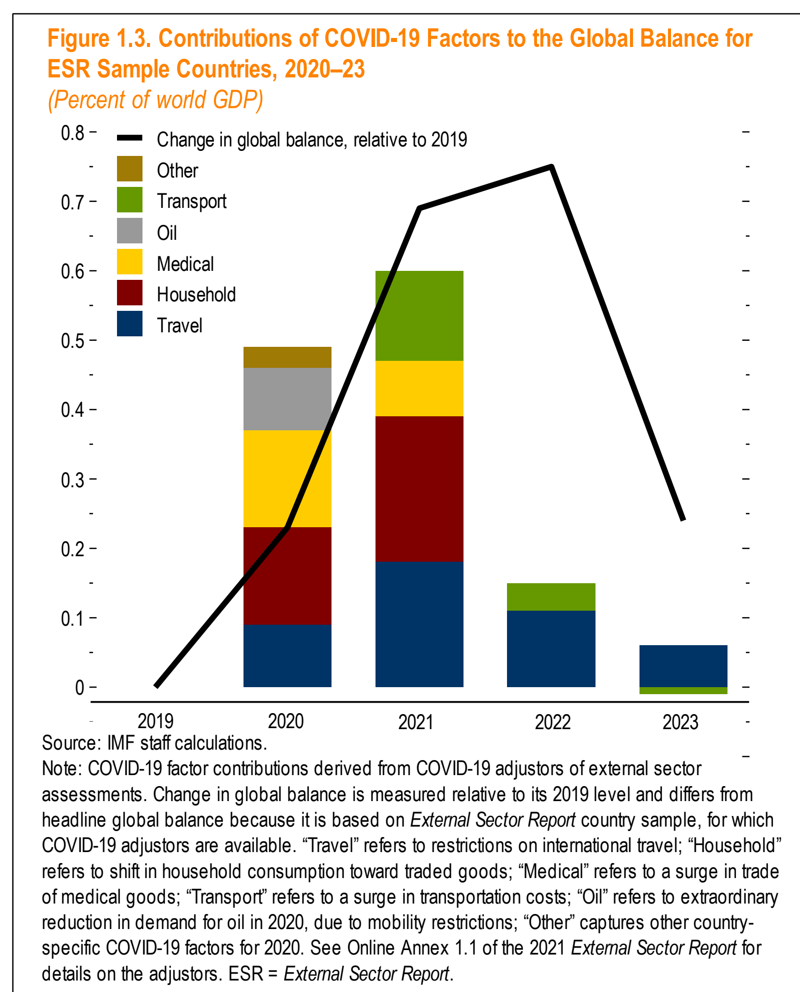


Figure 1.3. Contributions of COVID-19 Factors to the Global Balance for ESR Sample Countries, 2020–23
(Percent of world GDP)

Source: IMF staff calculations.
Note: COVID-19 factor contributions derived from COVID-19 adjustors of external sector assessments. Change in global balance is measured relative to its 2019 level and differs from headline global balance because it is based on *External Sector Report* country sample, for which COVID-19 adjustors are available. "Travel" refers to restrictions on international travel; "Household" refers to shift in household consumption toward traded goods; "Medical" refers to a surge in trade of medical goods; "Transport" refers to a surge in transportation costs; "Oil" refers to extraordinary reduction in demand for oil in 2020, due to mobility restrictions; "Other" captures other country-specific COVID-19 factors for 2020. See Online Annex 1.1 of the 2021 *External Sector Report* for details on the adjustors. ESR = *External Sector Report*.

There were five main factors. First, the dramatic fall in demand for oil when lockdown measures first hit. Second, the rise in cross-border trade in medical goods, as countries sought supplies of Personal Protective Equipment (PPE) and other goods to deal with the pandemic. Third, the shift in consumption in the US and other advanced economies to tradeable goods (a substantial share of which are imported[9]) as lock down measures restricted consumption of services while fiscal measures helped maintain income levels. Fourth, the impact of supply chain disruptions arising from the direct effects of the pandemic as well as the surge in goods trade. This led to a doubling in global supply chain pressure[10] between January 2020 and January 2022 and a sharp hike in transport costs.

[9] 19% of goods consumption in the US was imported in 2019.
[10] Judged by a global supply chain pressure index.

Fifth, the impact of pandemic restrictions on consumer and business spending on international travel.

The impact of pandemic-related factors on global imbalances was supplemented in 2022-2023 by the contribution of the sharp rise in commodity prices (metals, food, oil and gas) linked to the invasion of Ukraine. In particular, LNG prices increased by more than ten times between January 2020 and August 2022 as Russia cut supplies to European consumers by 80%. At the peak, in 2022, the contribution of oil exporters (which includes many gas exporters) to global imbalances amounted to 0.5% of global GDP. This was fully reversed in 2023.

The preceding description shows that the **impact of the two shocks on the global current account imbalance has been temporary**. Moreover, the IMF's central forecast is that the global current account balance will return in 2024 and the years beyond to its previous trend of a gradual decline, albeit subject to substantial risks.

Linked to the very large swings in current account balances, there were necessarily large offsetting swings in domestic fiscal deficits, investment, and implied savings, particularly in China and US. However, on this occasion, it seems safe to assume that the causality ran from the real effects caused by the pandemic and lock down policy decisions to financial flows.

There were also important **monetary and exchange rate impacts**, linked primarily to the global inflation shock that took advanced country median inflation from less than 1% on Q1 in 2022 to 9% in 2022 Q3. The (nominal) average monthly fed funds rate stood at 5.1% in September 2024, up from 0.1% in January 2020, while the broad trade-weighted index for the US Dollar rose nearly 6% over the same period. In contrast to the impacts on global imbalances, these impacts have *not* yet unwound. Interest rates are expected to fall in the advanced economies in the coming year. But it is unclear where the new equilibrium rate will be.

Nonetheless, despite serious concerns expressed at the time,[11] the hike in global interest rates has not (at least so far) triggered serious and sustained financial stability consequences in either advanced, emerging or low-income countries.

The SVB crisis and collapse of Credit Suisse in March 2023 were serious, but turned out to be limited incidences of financial instability in advanced economies linked to specific failures in financial regulation (in the SVB case) and poor management (Credit Suisse).

According to the World Bank's International Debt Report,[12] Some 60% of (IDA-eligible) low-income countries are currently judged to be in debt distress or at severe risk of debt distress, while one in four developing countries is priced out of international capital markets. There have also been 18 sovereign debt defaults among developing countries in the three years to 2023, more than in the previous twenty years.

[11] Debt dilemma: how to avoid a crisis in emerging nations
[12] International Debt Report 2023

But despite this evident high level of debt distress among developing countries, the risks have for the most part not yet crystallised, and there is an increasing view among some IFI policy makers that the debt challenge facing low-income countries is one of liquidity rather than solvency. Total net debt flows (loan disbursements minus principal repayments) to low- and middle income countries (LMICs) turned negative in 2022 for the first time since 2015 with outflows of US$185 billion, a stark contrast to inflows of US$556 billion recorded in 2021.

The reasons for the better-than-expected financial stability performance are complex. But three factors stand out:

First, the **reforms to financial regulation** put in place around the world following the GFC appear for the most part to have done the job of limiting financial risk in the regulated financial system, despite the pressures created by a sustained period of ultra lose monetary policy. At the same time the declining trend in global imbalances up to 2019 may have helped ensure that liquidity could be managed in line with local requirements and excessive risk taking by local financial institutions avoided. The temporary hike in imbalances from 2020-22 did not last long enough to change this outcome.

Second, low income and emerging economies as a whole have benefited from the **stronger economic governance frameworks** put in place after the global financial crisis, including independent central banks, inflation targeting regimes, and fiscal rules. This contributed to a number of emerging economies moving earlier than advanced economies in responding to the inflation threat.[13]

A third factor is the actions a number of LMICs took in the aftermath of the GFC to **strengthen their financial safety nets** through the build-up of foreign exchange reserves, complimented by the arrangement of bilateral swap lines, development of regional financial arrangements, and the increase in IMF financial resources.

Legacies of the 2020-22 spike in current account imbalances

However, although the 2020-22 spike in the global current account balance has already largely unwound and global imbalances generally do not appear to have contributed to financial instability over the course of the twin crises, there are three important **legacy effects** from the twin crises which are likely to influence global imbalances over the long-term.

First is the contribution to the level and servicing cost of **public debt. T**he IMF's October Fiscal Monitor[14] shows that, despite the temporary improvement in debt ratios resulting from the 2022-23 inflation shock, the US gross debt ratio will rise by 13 percentage points of GDP between 2019 and 2024 and is expected to rise by a further 10.7 percentage points of GDP by 2029. Over the same period US debt service costs will rise from 2.3 percentage points of GDP to 3.9 percentage points of GDP and are then expected to stay broadly stable. China shows a similar dramatic rise in debt/GDP ratio, although it starts from a lower point.

[13] Financial Times
[14] Fiscal Monitor October 2024: Putting a Lid on Public Debt

The picture for other advanced and emerging economies is less serious. However, a key legacy from the pandemic will be the way it makes it harder for the US and other deficit economies to maintain the downward trend in their contribution to global imbalances.

Second, is the impact on **supply chain management.** Surveys suggest that in the aftermath of the pandemic private enterprises planned "to shake up their supply chain strategies to become more resilient, sustainable, and collaborative with customers, suppliers, and other stakeholders." [15] This involved increasing investment in supply chain technologies like AI and analytics and may also result in re-location of some production facilities. Meanwhile governments are researching supply chain risks and looking for ways to mitigate them, either through national actions or in collaboration.[16] This work is also being influenced by heightened national security concerns, which sometimes point to the same mitigating actions as when dealing with natural phenomena, but sometimes don't. The combined impact of these steps on individual country current account balances and the global current balance could be significant, but its direction for any one country and the global current account balance overall is hard to predict.

Third, is the impact of the energy price shock in **accelerating the adoption of renewable energy,** particularly in the EU and other Western economies affected by the Russian gas embargo. Renewable energy and nuclear power accounted for 67% of EU electricity production in 2023, compared to 60% in 2019. As this trend continues, one would expect a gradual reduction in EU energy imports and an improvement in the current account balance for the union as a whole.

In the next section, we look at how these factors are likely to be complemented by others, creating an uncertain outlook for global imbalances.

Section 4: Longer term factors influencing global imbalances

According to the national accounts, current account balances reflect the following equivalence

Figure 1:

$$(X-M) = (T-G) + (S-I)$$ [17]

[15] How COVID-19 impacted supply chains and what comes next | EY Canada

[16] Global Economic Resilience: Building Forward Better - Roosevelt Institute

[17] Where X is exports, M is imports, T is tax revenue, G is government expenditure, S is private saving, I is private investment.

i.e., the current account surplus is equal to the fiscal surplus (difference between government revenues and expenditure) and the difference between private savings and investment.

This of course says nothing about the direction of causality at any point in time; all the components are endogenously determined, with the exchange rate – and sometimes foreign exchange reserves – playing a central role in facilitating adjustment to shocks.

To understand better whether an individual country's current account position, or the global position comprised of all country's current account positions, indicates underlying concerns, the IMF carries out an annual exercise to estimate **medium term current account balance norms** for thirty of the world's largest economies accounting for some 85% of global GDP.

Under the IMF's methodology[18] advanced economies with higher incomes, older populations, and lower growth prospects tend to have "positive" norms (i.e., current account surpluses), while most emerging market and developing economies (EMDEs), which tend to be younger and are expected to import capital to invest and exploit their higher growth potential, have "negative" norms.

The IMF first uses its External Balance Assessment (EBA) econometric model to produce an estimate of individual country current account norms taking account of the medium-term factors described above. These are then adjusted to reflect the impact of each country adopting what the IMF believes is its desirable medium-term macroeconomic policy.[19] The adjusted norms are then compared with actual current accounts to calculate an "excess" current account balance (surplus or deficit) for each country.

Most of the excess current account balances identified in 2023 related to advanced economies. The largest cases of lower-than-warranted current account balances (when measured as a share of External Sector Report GDP[20]) were, in descending order, the United Kingdom, Italy, and Canada. The cases of larger-than-warranted current account balances (measured as a share of ESR economy GDP) were (in descending order) Germany, India, and the Netherlands.

It is, however, notable that for both the US and China, today's current account positions are broadly in line with the IMF's norms. In addition, when looking at the aggregate level, the sum of the absolute values of IMF staff–assessed current account excess balances remained broadly unchanged relative to 2022, i.e., close to 1 percent of ESR economy GDP. A decrease in the excess balances for the largest economies (China and the United States) was offset by an increase in the excess balances for some of the smaller economies.

This paints a relatively reassuring picture that, despite the turbulence of the period 2020-2022, *today's* current account balances for major countries do *not* indicate major strains.

[18] The IMF's methodology is described in Assessing Global Imbalances: The Nuts and Bolts
[19] Thus, if the IMF believes a given country *should* be running a relatively loose fiscal policy, then, other things being equal, the norm for the current account surplus will be low.
[20] The total GDP of the 30 large economies covered by the IMF's external sector report together account for approx. 85% of world GDP.

However, the uncertainties over the future path of global imbalances are considerable. Four merit particular attention:

- The risk that countries which need to undertake **fiscal consolidation** (notably the US) will not actually do so, leading to much higher current account deficits

- The risk of a further spike in **commodity prices** linked to geopolitical risks or other factors such as rapid technology shifts in the global economy

- The risk of continuing, or even accelerating, **fragmentation in global markets for goods, services and capital** particularly if former President Trump is elected on November 5th and implements 10-20% across the board tariff increases.

- The risk that future policy errors in **China's domestic economic management** will spill over into the wider world economy via their impact on global imbalances.

In the next two sections we consider, first, the historical experience of international economic policy cooperation focused on global imbalances in the run up to and in the aftermath of the global financial crisis.

And second, we ask what is the scope to address global imbalance risks going forward given the general deterioration in the environment for economic policy cooperation.

Section 5: Historical Experience with Policy Coordination on Global Imbalances

Types of international economic policy coordination

There are essentially three types of international economic policy co-ordination at the global level:

First, is the **coordination of national policy measures**, where each country retains full responsibility for its own actions, but agrees to common objectives at the global level, a common framework for setting policies and sometimes a process for accountability and evaluation. This approach is typically the one deployed by "G groups", such as the G7 and G20. The policy areas covered may require a whole-of-government approach, such as fiscal policy or structural reform. But sometimes they may be within the remit of independent or partially independent institutions, notably monetary policy, foreign exchange intervention, financial regulation. There is no international treaty basis which requires country governments to take the actions they commit to; rather, delivery depends on peer pressure and external pressures from media, policy commentators, legislators.[21]

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[21] The EU's fiscal pact is therefore very different. While it is designed to achieve a common goal in the fiscal policy area, it is legally binding and monitored and enforced by a supra national body, the European Commission.

Second, is the development of a system of **bilateral agreements between countries**, to govern, e.g., trade or investment flows (free trade agreements, bilateral investment treaties), or the provision of liquidity in an emergency (bilateral central bank swap lines). The agreements will typically share standard features and may be influenced by advice from international institutions. While the individual agreements are between pairs of countries, the combination of multiple agreements adds up to a coordination system.

Thirdly, coordination may be achieved through **internationally binding rules, underpinned by treaties, and supervised by multilateral institutions**, such as the IMF, WTO or specialised agencies of the UN (such as the UNFCCC on climate change, UNODC on anti-corruption or WHO on health). The Bretton Woods Institutions, established after World War 2 and now 80 years old, are still the most important for global economic management, but have been supplemented by a large number of other universal or near universal economic institutions, ranging from the Financial Action Task Force to the OECD's Global Tax Forum and the Financial Stability Board (FSB).

A high point in the latter type of coordination was reached in 1995 with the foundation of the World Trade Organisation. However, following China's accession to the WTO in 2001, it was increasingly argued by the US and other G7 countries that China was not following the spirit of the institution's rules in such areas as industrial subsidies. And since the election of President Trump in 2016, there has been an increasing tendency by the US also to ignore the spirit of certain key treaty provisions. The biggest impact so far has been through the effective suspension of the WTO's dispute settlement system, and through the use of the national security exemption in the original GATT Treaty to justify a wide range of tariff measures.[22] The weakening of the WTO makes it less clear how cases of excessive global imbalances will be managed in future, since trade restrictions may no longer be seen as a last resort by some countries.

On the other hand, it remains the case that large parts of the rules-based multilateral economic system still function reasonably effectively. This is true of the IMF's role at the core of the global financial safety net. It also holds for the rapidly expanding system of international development finance, notwithstanding the challenges posed by the shortfall in funding for climate action and the SDGs. New institutions are being founded (the AIIB and New Development Bank[23]) while the capital of existing institutions is being increased. Meanwhile new UN conventions with substantial economic policy consequences continue to be developed and signed.[24]

[22] This states that WTO agreements should not prevent any member "from taking actions which it considers necessary for the protection of its essential security interests." However, national security is not strictly defined.

[23] Home - New Development Bank

[24] Annual Treaty Event Shows Support for Agreements on Ocean Biodiversity, Nuclear Weapon Prohibition | Meetings Coverage and Press Releases

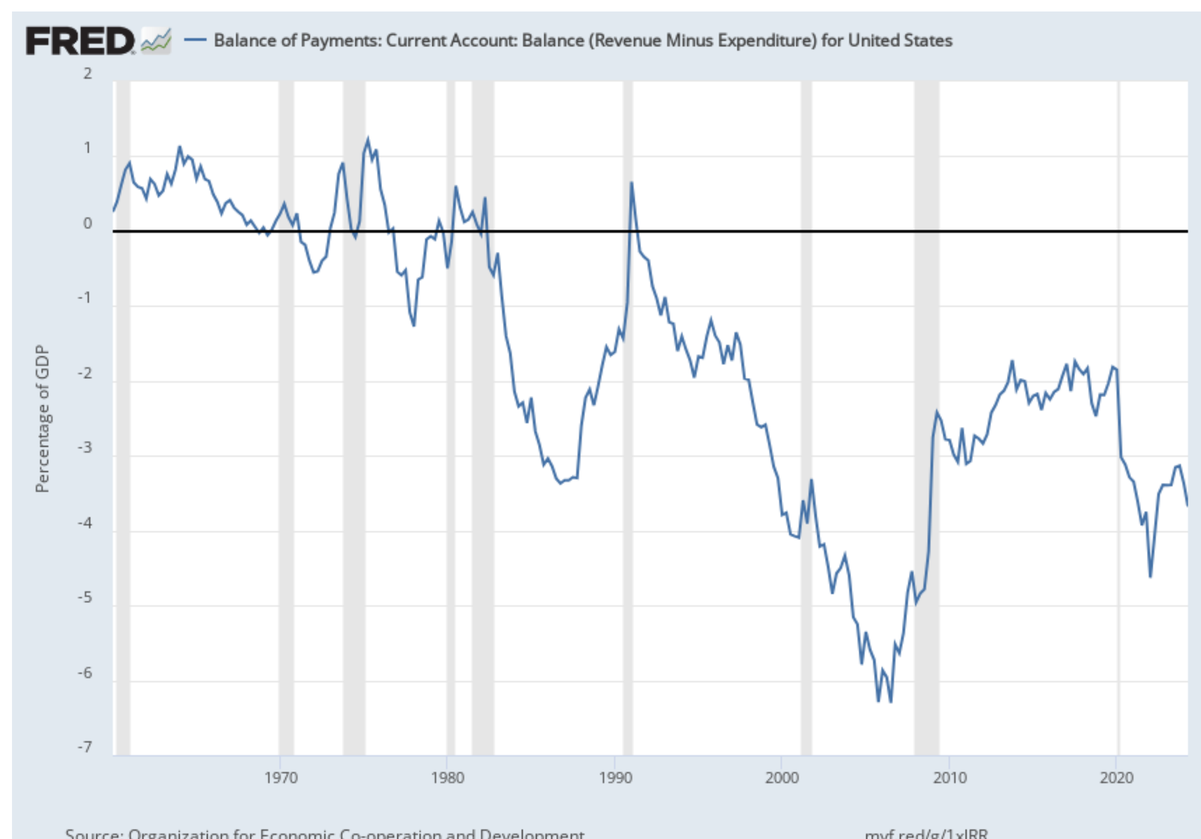
The focus of international economic policy coordination on global imbalances

Avoiding the economic and political costs of excessive global imbalances - including increased pressure to weaken global trade rules - has long been a focus of international economic policy coordination with all three types of coordination being deployed to address it.

A core purpose of the IMF during the fixed exchange rate system that prevailed from 1945-73 was to assist adjustment by countries with excessive deficits through policy advice and financial facilities. This continued, primarily, but not entirely, for low-income and emerging economies in the period of flexible exchange rates. With some important exceptions (linked to the EU's exchange rate mechanism and eurozone) advanced countries were able to rely on flexible exchange rates and private capital flows as they adjusted to external or internal shocks.

On several occasions, efforts have been made to address global imbalance crises through policy coordination. These have typically been associated with a new trough in the US current account deficit. Chart 3 below illustrates this, with new troughs in the US current account deficit as a share of GDP in the late 1970s, mid 1980s and mid 2000s. Unlike other deficit countries, the demand for dollar-denominated investments as reserve assets, means that the US cannot be forced to adjust by market pressures.

Chart 3:



At the **1978 Bonn Summit**[25,26] G7 leaders agreed on a joint statement of commitments to revive global growth under which Germany and Japan would undertake a fiscal stimulus of 1-1.5% of GDP, while the US agreed to curtail its dependence on oil imports. However, this is now widely viewed as a failure, in part because all the countries involved subsequently faced a surge in inflation leading them to focus on national anti-inflation measures centred on monetary policy.

Several further efforts to address global imbalances through policy coordination have been made, including the **1985 Plaza accord** which focussed on addressing exchange rate misalignments through coordinated foreign exchange intervention to depress the value of the dollar. This took a targeted approach rather than seeking to coordinate a comprehensive set of policy adjustments and is now generally viewed as being a success – the dollar's exchange rate fell 40% over the subsequent two years and the US Congress refrained from enacting protectionist measures.

In April 2006, in the context of rapidly growing global current account imbalances, which reached 5.5% of global GDP that year, the IMFC[27] reiterated that action to achieve an orderly medium-term resolution of global imbalances was a shared responsibility with coordinated actions bringing greater benefit to members and the international community than actions taken individually. The IMFC mandated the IMF[28] to "work on modalities, in consultation with country authorities, aimed at encouraging actions needed to reduce the imbalances" and called for a report at its next meeting. The IMFC's statement was linked to, and gave tacit support for, an on-going initiative by the IMF Managing Director, dating from 2004, to use multilateral consultations with leading economies to facilitate a collective response to global imbalances. This focused on a broader range of countries than the G7, including China and Saudi Arabia. A key part of its theory of change was that by sharing information and plans, it would encourage the adoption of more coherent policies among the key decision makers.

Global imbalances stabilised after 2006, albeit at a high level, and the IMF has argued that its multilateral consultation process was a success.[29] However, it is clear from the subsequent onset of the GFC two years later that what was done was not being done fast enough, was insufficiently ambitious, and did not have sufficient political backing. In particular, the IMF process was driven by the IMF bureaucracy, rather than being fully "owned" by the participating countries.

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[25] Text of Declaration at the Bonn Summit - The New York Times

[26] In 1977, the US current account deficit reached a new low of -0.7% of GDP, having only recently been in sustained surplus.

[27] International Monetary and Financial Committee

[28] In the News: 2006 IMFC Communique: IMF Gets Strengthened Role to Address Global Imbalances in: IMF Survey Volume 35 Issue 008 (2006)

[29] Issues Brief - The Multilateral Consultation on Global Imbalances

Framework for strong, sustainable and balanced growth

The global financial crisis of 2008-10 resulted in what was arguably the strongest and most comprehensive coordinated effort to tackle the problem of global imbalances since the foundation of the Bretton Woods institutions in 1944.

The **immediate crisis** was addressed through the G7 Finance Ministers meeting in October 2008[30] and London G20 Summit in April 2009.[31] By expanding to the G20, the latter brought in all the key actors in the global economy, notably China. This built on the pattern established at the G8 Gleneagles Summit in 2005 when five of the largest emerging market economies joined the summit for discussions on the global economy. It was critical both for the substantive contributions they were able to make to policy action, but also through the confidence effects of having all the major economies in the world being seen to be fully engaged.

Later in 2009 attention turned to **how to manage the exit** from the exceptional measures taken in response to the crisis, and also **how to address what were seen as its root causes**, particularly the build-up in very large global imbalances and weaknesses in financial regulation.

The G20 Pittsburgh Leaders' Summit in September 2009[32] confirmed the G20 as "the premier forum for our international economic cooperation" and launched the G20 Framework for Strong, Sustainable and Balanced Growth which was described as "a compact that commits us to work together to assess how our policies fit together, to evaluate whether they are collectively consistent with more sustainable and balanced growth, and to act as necessary to meet our common objectives."

Under the new Framework, G20 members with sustained, significant external deficits pledged "to undertake policies to support private savings and undertake fiscal consolidation while maintaining open markets and strengthening export sectors." At the same time those with significant external surpluses pledged "to strengthen domestic sources of growth. According to national circumstances this could include increasing investment, reducing financial market distortions, boosting productivity in service sectors, improving social safety nets, and lifting constraints on demand growth."

The leaders then called on their Finance Ministers to establish a process of "mutual assessment" under which G20 members would:

- agree shared policy objectives and set out their medium-term policy frameworks;

- with the support of the IMF and other international economic organisations, assess the forward-looking implications of the combination of these policy frameworks for the level and pattern of global growth, as well as risks to financial stability;

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[30] G7 Finance Ministers Meeting October 2008
[31] G20 Communique: London Summit – Leaders' Statement; 2 April 2009
[32] G20 Leaders Statement - The Pittsburgh Summit_25092009.pdf

- based on the results of the mutual assessment, agree collective actions to meet the common objectives;

- report regularly to both the G20 and the IMFC on key risks with respect to patterns of growth and proposed G20 policy adjustments, individually and collectively.

They further stated that the forward-looking assessment should, among other things, focus on the implications and consistency of fiscal and monetary policies, credit growth and asset markets, foreign exchange developments, commodity and energy prices, and current account imbalances.

Finance Ministers delivered on these instructions at their St Andrews Meeting in November 2010, and the Framework was then put into operation the following year.

A key feature of the G20 Framework was that it was a “country-led” process. The IMF, World Bank, OECD and WTO played a critical role in providing analysis, forecasts and policy recommendations and invested considerable resources to deliver this. But G20 members took the lead, ultimately deciding on the process that should be followed and how the outputs should be used.

The Framework made considerable progress in increasing transparency around the national economic policies of the leading economies and their consequences. It also helped to maintain the focus of policy makers on the potential benefits of policy coordination and forced countries to justify changes in policy or a failure to meet targets (e.g., vis-à-vis fiscal consolidation).

But it did *not* achieve its primary aim of persuading leading economies to factor in the external effects of their domestically driven economic policies on the other countries, or the global economy as a whole.[33] This was partly because of the series of economic shocks that buffeted the world economy after the new mechanism was established, notably the eurozone crisis. While keeping political leaders focused on macroeconomic risks, these crises also made it harder to maintain the **medium-term focus** that was meant to be a hallmark of the Framework. But, more importantly, however strong the arguments made through the Framework’s analysis for modifications in policy to achieve gains from cooperation, this did not stand up against domestic political priorities.

The Framework has continued to be a feature of the G20 process over the fifteen years since the Pittsburgh Summit. The mechanism itself has been renamed “The Framework for Strong Sustainable *and Inclusive* Growth”. While understandable, particularly in the context of the Covid-19 Pandemic, this has further complicated the analysis and arguably muddied the focus, reducing the emphasis on policies that are most relevant to prevent the build-up of unsustainable imbalances. The Framework Working Group continues to meet under the G20

[33] Creon Butler, 2013. "The G-20 framework for strong, sustainable, and balanced growth: glass half empty or half full?," Oxford Review of Economic Policy, Oxford University Press and Oxford Review of Economic Policy Limited, vol. 28(3), pages 469-492, AUTUMN.

Finance Track, feeding into meetings of the G20 Finance Deputies and Finance Ministers. And the IMF prepares a regular report analysing the medium-term consequences of existing polices and making detailed country by country recommendations on monetary stance, fiscal policy and structural reform.[34] However, the Framework's outputs, as reflected in the first few pages of the latest leaders' declaration from the New Delhi G20 Summit[35] are very high level and aspirational. And to the extent there are concrete recommendations, these mainly reflect the specific priorities of the Presidency (e.g., in the case of the New Delhi Summit, on improving skills and financial inclusion and tackling corruption) rather than the specific needs of macroeconomic policy coordination at the time.

In the light of the above, the key question for international policy coordination on global imbalances going forward is **whether there is a way to revive the original focus of the Framework and the political commitment behind it.** This would need to take on board the substantial *erosion in trust* among G20 members since the Framework was first established in the aftermath of the GFC. It would also need to reflect a situation in which the *immediate* prospects for global imbalances are not overly concerning as reflected in the IMF's latest External Balance Assessment (although the medium-term risks are considerable). Answering this question is the focus of the next section.

Section 6: The Potential Role of International Policy Coordination in Addressing the Risks arising from Global Imbalances

The challenges facing the global economy today are arguably even greater than during the global financial crisis of 2008-9. Climate change poses an existential threat which requires a complete transformation of the world economy in a very short space of time and unprecedented financial flows, given the **climate financing gap** faced by low-income and emerging economies (excluding China) is currently expected to reach $2.4tn pa by the end of the decade. At the same time, we are just beginning to see the disruptive effects of a parallel technological transformation driven by AI. The IMF has estimated that 60% of jobs in advanced countries are likely to be affected, of which half will may be affected negatively.[36] In both cases, it is clear that much better outcomes can be achieved with international cooperation – both addressing threats and capturing potential gains.

But the environment for cooperation is considerably worse than in 2010, and indeed probably at its lowest point since the end of the Cold War.

The reasons for this are well understood. They include: the G7's disillusionment with China's role in the WTO following the latter's accession; former President Trump's actions to undermine the rules-based international trading system, particularly the WTO, by paralysing the latter's dispute settlement system and using the national security exemption to deploy

[34] https://www.imf.org/external/np/g20/pdf/2023/110723.pdf
[35] Pages 3-6 in https://www.mea.gov.in/Images/CPV/G20-New-Delhi-Leaders-Declaration.pdf
[36] Cazzaniga and others. 2024. "Gen-AI: Artificial Intelligence and the Future of Work." IMF Staff Discussion Note SDN2024/001, International Monetary Fund, Washington, DC. AI_SDN_published (002).pdf

wide ranging tariffs; the growing strategic competition between China and the West resulting in restrictions on trade and capital flows; Russia's attack on Ukraine and the fundamental principles of the UN Charter which led the G7 to adopt unprecedented financial and economic sanctions against Russia, including freezing Russian state assets and confiscating the income derived from them; and the growing tensions between the West and low-income/emerging economies over the diversion of Western aid to support Ukraine and the extent to which Russia should be excluded from the international economic system and international forums (including the G20) as a result of its actions in Ukraine.

If Donald Trump is elected President for a second time in just a few days, the situation is likely to deteriorate further, not least because of his proposal to impose 10-20% tariffs on all US trade, including that with the US's close allies, and 60% on trade with China. This is likely to trigger retaliation from the US's main trading partners, including its close allies in Europe and Japan. One authoritative estimate of just the 10% across-the-board tariff increase,[37] puts the cost in term of lost US output (alone) at 0.36% of GDP (assuming no retaliation), and 0.9% with retaliation.

The other planks of Trump's economic policy platform, including deporting up to 8mn undocumented workers, withdrawal from the Paris Agreement, and a possible weakening in the Federal Reserve's independence would further undermine trust with both the US's close allies and the emerging economies in the G20. The impact of a Trump win is likely be particularly pronounced in the G7. This is currently seen by its members as one of the most effective forums for international policy cooperation and a key vehicle through which to coordinate inputs to the G20 on how to address global challenges. But it could quickly face paralysis if Trump wins, leaving non-US members with a difficult question to answer of how to coordinate their activities in areas where the US does not wish to engage or is actively hostile to multilateral cooperation.[38]

The effect of a Trump victory on the scope for international policy cooperation could be further amplified if far right parties in Europe continue to gain electoral support and influence in government policies.

But whether or not Trump wins, the goals of international cooperation are also very different today compared with fifteen years ago. In 2010 the prime focus of the G20 Framework for Strong Sustainable and Balanced Growth was to address situations where national policies determined entirely in relation to domestic needs and political priorities could result in sub-optimal or even dangerous global economic outcomes. Notwithstanding deep seated disagreements over, e.g., who should bear the burden of adjustment it was nonetheless a common goal and a collaborative effort to achieve it made sense.

This is still partly true today, although the common goal of limiting the threat to financial stability from global imbalances is now arguably much more complex because of the interaction with the macroeconomic effects of climate change/climate action and the tech

[37] Working Paper 24-20: The International Economic Implications of a Second Trump Presidency
[38] The US election could create the need for a G7 alternative – without American representation | Chatham House – International Affairs Think Tank

revolution. But, more importantly, this common goal now coexists with the urgent need to moderate or offset the broader economic impacts of certain national economic policies driven by national security considerations, and which may be specifically focused on defending against fellow members of the G20. This is much more akin to multilateral efforts at nuclear arms control.

In these circumstances, it is perhaps not unreasonable to ask whether substantive policy coordination to address the future threat from global imbalances is even possible, because the minimum required level of trust simply does not exist.

This paper argues that the effort is worth it. But it requires a **fundamental change of mind set**, or even a "new paradigm" for international economic cooperation, compared with that which prevailed in 2009-10 or earlier.

The new approach should have three pillars. First, capturing the gains from policy coordination (as before, but including in new areas like building resilience to physical shocks). Second, managing and constraining defensive measures so that they are as far as possible restricted to addressing genuine national security concerns, evidence based, and proportionate. And third, designing a collaborative process that puts much more emphasis than was necessary previously on building or re-building trust through incremental steps.[39]

Three further considerations will be important

Choosing an initiative focus which will get traction

It doesn't make sense to launch a further comprehensive initiative specifically focussed on global imbalances now, even though the threat of *future* destabilising imbalances is large. The lack of an immediate threat, as revealed by the IMF's External Sector Report, would make it hard to get political traction. Moreover, the fact that both the early warning mechanism and machinery for responding are already in place through the G20 Framework, and can be geared up quickly, will also reduce enthusiasm for a new "global imbalances" initiative. There are also better uses of the very limited political capital available for international cooperation at present.

A more effective approach is to identify one or more topics which are *narrower in scope* than the overall question of excessive global imbalances, but where there is a stronger and more immediate collective interest in progress, and where improvements in policy coordination will have a direct effect in reducing the threat such imbalances pose. The **next section** will look in detail at some possible candidates for this approach and how they might be defined in a way that can get political traction.

[39] A number of recent academic papers have proposed detailed architectures for addressing the challenges inherent in this new paradigm for international economic policy cooperation. See for example Dani Rodrik, Stephen Walt, *Oxford Review of Economic Policy*, Volume 40, Issue 2, Summer 2024, Pages 256–268, https://doi.org/10.1093/oxrep/grae011 who propose a "meta-regime" in which states agree to classify policies under four categories: prohibited actions, cooperative negotiations and mutual adjustments, independent autonomous policy responses and multilateral governance.

Use of a "tiered" institutional architecture

A likely feature of the "new paradigm" for international economic cooperation is that it will be more important to use a multi-level (or "tiered") institutional framework which enables each aspect of a given issue to be addressed in the most appropriate forum. This will need to borrow from other international policy areas, such as counterterrorism, where some issues are dealt with at UN level, some through the G20 and some through the G7 or even narrower and more closely aligned groups. For example, responding to supply chain vulnerabilities (which have both a physical, scientific and national security dimension) may require some actions at UN or G20 level, and some at G7 level, or bilaterally.

Linked to this it is also important to choose the best forum, or group, to drive any given aspect of the overall initiative and to be flexible on the extent to which existing institutions or initiatives are repurposed to achieve the updated goal.

Factoring in autonomous domestic actors

Monetary policy has from the outset been a central component in the policy mix to address excess global imbalances. But the wide prevalence of independent central banks with domestically focussed inflation-targeting mandates has meant that their contribution is typically understood as a <u>residual</u> which responds to the fiscal, regulatory or structural reform actions taken by governments, whether or not they are coordinated. In line with this, they are generally described in policy statements, if not in the IMF recommendations, as being committed to following their core mandates of price stability. The main exception is where they are contributing to specific and exceptional emergency measures, as in 2008-9, or in 2020-21 during the covid pandemic, and may take the lead in policy action.

The treatment of central banks in this manner has been a long-standing feature of "G-group" economic policy coordination. However, autonomous actors in other policy areas are likely to become increasingly important in international economic policy cooperation as the issues of competition policy and regulation of the digital space take centre stage.

Deploying autonomous actors in this way may also provide a means to rebuild international trust as their mandates, powers and accountability are typically more clearly defined than for governments as a whole. The key, as with monetary policy, will be for governments to coordinate on objectives and instruments, ideally enshrining their decisions in legislation, and then for independent actors to have full authority in implementation.

Section 7: Possible Focus Areas for Policy Coordination

In the previous section, we argued for a more targeted approach to international economic policy cooperation and the selection of one or more topics which are *narrower in scope* than the overall question of excessive global imbalances, but where there is a stronger and more immediate collective interest in progress, and where improvements in policy coordination will have a direct effect in reducing the threat such imbalances pose.

Below are four possible candidates for this approach:

Addressing the threat from rising public debt

This is very unlikely to work if it took the form of international organisations (such as the IMF) or other members of the G20 trying to put pressure on the US or China to reduce the growth in their public debt in the wider interest. Instead, it would need to be framed as a *common goal* such as understanding much better the size of the escalating collective costs from competing industrial strategies and related subsidies. It could then include consideration of how these costs might be curtailed in the common interest, and possible mechanisms to achieve this. If successful, this would then help curtail the growth in public debt in individual countries. The approach could also take on board new evidence on the multiplier from public to private investment and the opportunities and pitfalls created by the use of fiscal rules in the EU and UK. This might result a possible broadening of the focus of the initiative from *gross* public debt to *net* public debt.

A renewed effort at adapting the WTO to modern realties

U.S. National Security Advisor Jake Sullivan's most recent speech on the US's approach to economic security[40] calls for "revitalizing international institutions to address today's challenges, including genuinely reforming the WTO to deal with the challenges I've outlined."

The speech comes across as more positive about the need for the WTO to play a role in managing future trade and investment relations than some private comments of senior US administration officials over the past year.

Any renewed effort at WTO reform would need to accept that the theoretical model of free and open trade and investment envisaged in the 1990s is now impossible to deliver, even if it were desirable.

And there are plenty of specific proposals, e.g., for a more limited, but functional, dispute settlement system; or defining the national security exemption more clearly and placing some limits on its use; or formalising the approach of Joint Statement Initiatives (JSIs), in which progress can be made in new areas (e.g., e-commerce) without complete consensus or participation by all WTO members; or setting down acceptable approaches for those countries which wish to limit carbon leakage through trade and investment measures.

The question is whether it would be possible to reach agreement on such a package of highly sensitive but essential policy areas without in the process undermining so much of the core system of principles and methodologies underpinning the WTO that it is not worth the effort. And even if there is a plausible argument that this can be done, it will be an enormous challenge to persuade many emerging and low-income countries that this is the case.

[40] Remarks by APNSA Jake Sullivan at the Brookings Institution | The White House

Manging the implications of the net zero transition for public and private debt (and global imbalances)

The cross-border investment flows to low-income and emerging economies required to deliver the net zero transition will have considerable implications for private savings and investment imbalances and public saving, even if only partially delivered. Moreover, in the longer term, the transition will have further implications for oil and gas exporters which only seem to be partially recognised and understood at present.[41]

Another possible focus area for international economic cooperation is therefore to look at how these twin processes may be managed from the perspective of maintaining global financial stability. This will link to a parallel discussion on managing sovereign debt distress where the environment for international cooperation recently appears to have improved (as seen at this year's Paris Club Debt Forum which was attended at senior levels by Chinese central bank and finance ministry officials).

Future development of the Global Financial Safety Net (GFSN)

The GFSN is important to the management of global imbalances because it gives individual countries - and the international system as a whole - the time to adjust to real or financial shocks in circumstances where private sector financial flows may not always be relied on and resorting to capital controls is unattractive because of the long-term damage it may do to a country's international capital market access.

Chart 4 below shows how the key elements of the global financial safety net (GFSN) have developed at a very rapid pace since the global financial crisis.

Gross foreign exchange reserves were already increasing rapidly after the Asian Financial Crisis of 1997 as emerging economies sought to protect themselves against future shocks and the loss of policy freedom that resulted from IMF conditionality. However, they increased even faster after the global financial crisis, rising from $7.8tn in 2008 to $14.3tn at the end of 2023. The vast majority of these reserves - some 87% - are held in US dollars and other western convertible currencies.

Total "multilateral" and "bilateral" elements of the GFSN also increased rapidly after 2008, rising from just under $1tn to $3.5tn. However, multilateral and bilateral components together still only account for 24% of *total* resources available under the GFSN. And, of this, IMF "multilateral" resources account for less than 4%. The 50% increase in IMF quotas agreed at the end of 2023 under the 16th General Review of Quotas should boost this component somewhat, but it will still be relatively insignificant.

[41] As seen in the strong disagreements between the International Energy Agency and some major oil producers on when "peak" oil is likely to occur.

Chart 4:

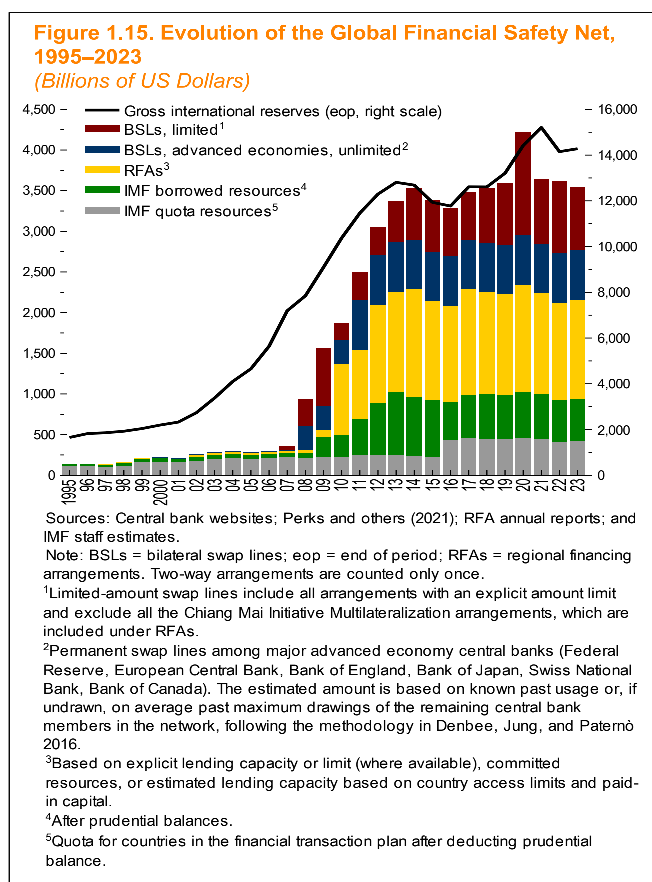

Figure 1.15. Evolution of the Global Financial Safety Net, 1995–2023
(Billions of US Dollars)

Sources: Central bank websites; Perks and others (2021); RFA annual reports; and IMF staff estimates.
Note: BSLs = bilateral swap lines; eop = end of period; RFAs = regional financing arrangements. Two-way arrangements are counted only once.
[1]Limited-amount swap lines include all arrangements with an explicit amount limit and exclude all the Chiang Mai Initiative Multilateralization arrangements, which are included under RFAs.
[2]Permanent swap lines among major advanced economy central banks (Federal Reserve, European Central Bank, Bank of England, Bank of Japan, Swiss National Bank, Bank of Canada). The estimated amount is based on known past usage or, if undrawn, on average past maximum drawings of the remaining central bank members in the network, following the methodology in Denbee, Jung, and Paternò 2016.
[3]Based on explicit lending capacity or limit (where available), committed resources, or estimated lending capacity based on country access limits and paid-in capital.
[4]After prudential balances.
[5]Quota for countries in the financial transaction plan after deducting prudential balance.

Choosing the optimum size and composition of the GFSN is in any case not straightforward. On the one hand, holding large gross foreign exchange reserves is potentially costly compared with reliance on contingent liquidity instruments provided multilaterally or bilaterally.[42] On the other hand, use of foreign exchange reserves avoids the risk of being subject to unwelcome policy conditionality.

The decision by the G7 and some like-minded governments in 2022 to freeze some $300bn in Russian foreign exchange reserves and more recently to confiscate the future income on a large share of these assets so that it can be used to underwrite a $50bn G7 loan to Ukraine must inevitably have led several holders of large foreign exchange reserves to question the latter's utility over the long-term.

Russia's attack on Ukraine crossed a very high and unprecedented threshold as an action which runs against the fundamental principles of the post-WW2 international political and diplomatic system. But other countries may not want to run the risk that the threshold will be lowered in future or that they may nonetheless be perceived as crossing a similar threshold under certain circumstances.

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[42] Safe foreign assets typically have low returns. While a small proportion of foreign exchange reserves may be funded through foreign exchange borrowing, the bulk are typically funded through issuing domestic public debt. Large reserve holdings may therefore pre-empt more productive public investment.

However, the concrete alternatives to Western hard currencies are very limited. A non-convertible currency may be used as a medium of exchange or unit of account, but there is currently no realistic alternative to Western convertible currencies as a “store of value”.

A key question therefore is whether a **multilateral solution to maintaining an effective GFSN** (with an expanded role for the IMF and possible changes in governance/distribution of quotas linked to that) is the only way to prevent very serious collective costs linked to a future shift *away* from holdings of hard currency foreign exchange reserves by some countries.

If no other action is taken, there could be substantial real economic effects. For example, some current major holders of foreign exchange reserves might conclude that their only effective response to the risk that their foreign exchange assets might in certain exceptional circumstances be confiscated is to target current account *balance*. This could enable them to manage future economic shocks with a more limited financial safety net and would avoid the accumulation of further significant hard currency assets. However, the adoption of such a policy by large economies could be highly damaging to the efficient operation of the world economy as a whole.

Section 8: Conclusions

Despite the very large swings in current account balances and financial flows over the period 2020-23, the immediate threat from excessive current account balances as judged by the IMF’s external imbalance analysis is relatively low. However, the future risks remain substantial.

Managing excessive current account imbalances has long been a prime focus of, and justification for, international economic policy coordination. But the topic is unlikely to gain political traction as a basis for a new comprehensive initiative at present, particularly in the current context of reduced trust among key contributors.

This paper therefore proposes that a push is made to rebuild international economic cooperation in one or more targeted and urgent policy areas. If successful, this will also make a contribution to reducing future risks from global imbalances.