Capital Flow Volatility and the Future of International Policy Coordination

Creon Butler

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Overview

Three questions:

Why hasn’t the spike in global current account imbalances from 2020-22 caused more serious issues for global financial and economic stability?

What legacy has been left and what are the future risks posed by excessive global current account imbalances?

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

Why do current account imbalances matter?

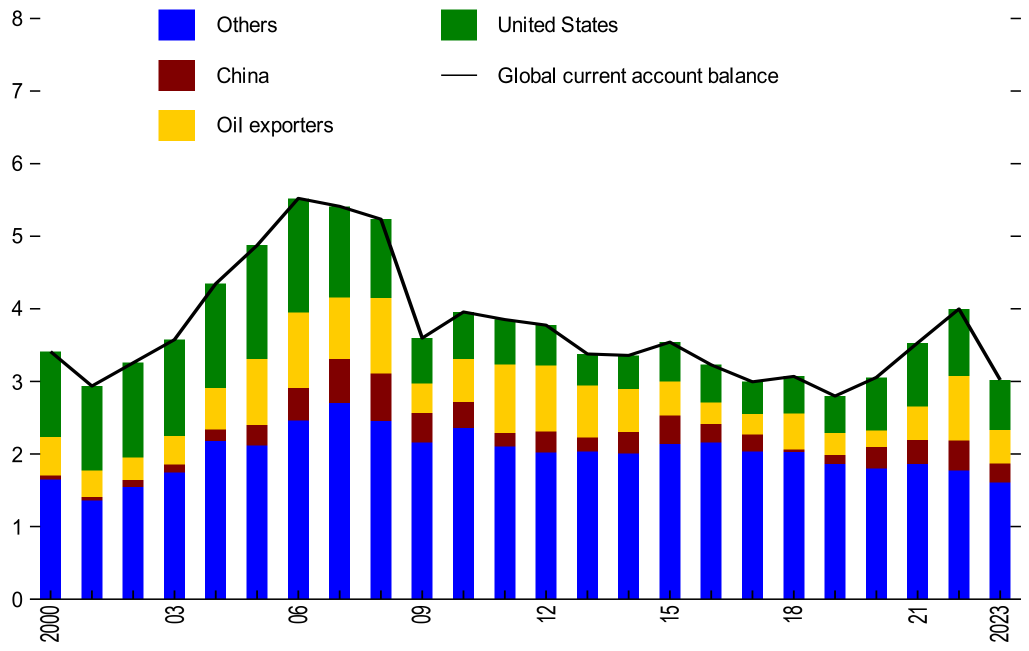
- Short- and long-term benefits of capital mobility linked to current account flexibility
- Historic focus on link between sustained current account imbalances and periods of economic and financial instability
- Importance of gross vs net financial flows in financial stability risk
- A focus on current account imbalances is necessary, but not sufficient
- Current account imbalances were a key focus of the post-GFC international economic policy coordination push
- Political economy consequences are as important as financial and economic stability

Evolution of the Global Current Account Balance

Chart 1

Figure 1.2. Contributions to the Global Current Account Balance, 2000–23

(Percent of world GDP)

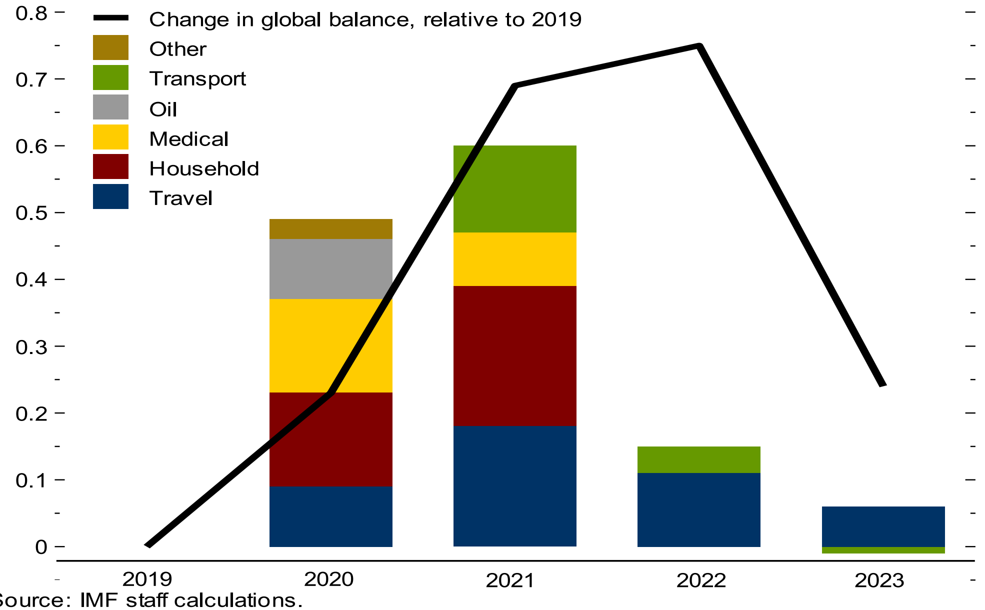


Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: The absolute value of current accounts is shown, in percent of world GDP. The global current account balance is calculated as the sum of absolute values of current accounts across countries. The categories "oil exporters" and "others" are also the sum of absolute values of the current accounts of countries in those categories.

Contributions of Pandemic Factors to the Global Current Account Balance

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*.

Reasons why economic and financial stability consequences were limited

- Reforms to financial regulation post-GFC
- Stronger economic governance frameworks
- Stronger financial safety nets

Legacies from 2020-23 shock which will influence global imbalances in future

- Higher public debt and debt service obligations

- Changes to global supply chains

- More rapid adoption of renewable energy and phase out of hydrocarbon-intensive investment

Future risks involving global current imbalances

- Reassuring picture from the IMF’s latest external balance assessment of 30 leading economies (including for the US and China)

But <u>four</u> major uncertainties:

- will fiscal consolidation be delivered (particularly in US)?
- prospects for future spike in commodity prices
- risk of accelerated fragmentation in global markets for goods, services and capital (e.g. if former President Trump wins)
- risks linked to economic policy choices by the Chinese authorities

Three types of international economic policy coordination

- Coordination of national policy measures and enforcement through peer pressure etc

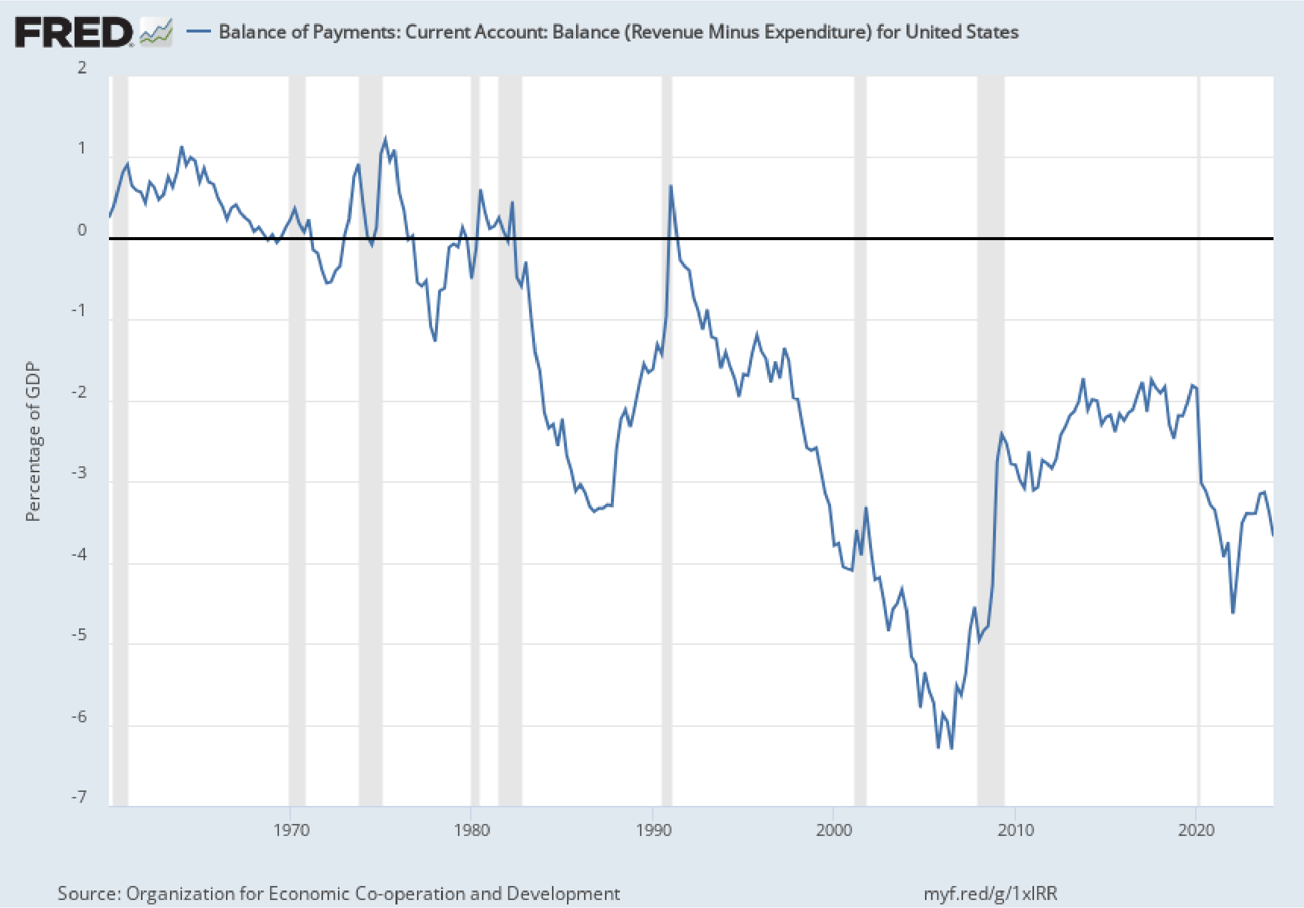
- Networks of bilateral agreements between countries

- Internationally binding rules, underpinned by treaties, and supervised by multilateral institutions

Long history of efforts at international economic policy coordination focussing on global imbalances

- Bonn G7 Summit, 1978
- Plaza accord, 1985
- IMF multilateral consultation process, 2006
- G20 Framework for Strong Sustainable and Balanced Growth, 2009-10, ongoing

Chart 3: US Current Account Balance (shows efforts at international cooperation often linked to new troughs in the US deficit)



Key components of the G20 "Framework"

G20 members would:

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

- 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;

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

- r**eport 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.

Successes and failures of the G20 Framework

- Significantly increased transparency about planned policies, the associated risks, and their likely medium-term consequences;

- Initially maintained high level focus on potential benefits from cooperation;

- Provides a mechanism that can be geared up quickly in the event of an emergency;

But:

- it has *not* achieved its primary aim of persuading leading economies to factor in the external effects of their domestically driven economic policies on other countries, or the global economy as a whole;

Today's challenge in international economic policy coordination

- Threats/opportunities even bigger (with AI and Climate Change);

- Level of trust among key players is lower, and may deteriorate further if Donald Trump is elected;

- The *objective has changed*, from a *sole* focus on capturing benefits from coordinated policies, to, in addition, limiting negative effects of national-security related actions;

- Connection to addressing global imbalances less clear cut and urgent;

A way forward…

- Agree on change of mind set, “new paradigm” in international economic policy cooperation;
- Don’t specifically target action on global imbalances; choose more focussed and urgent policy issues that still provide medium term support;
- Be ready to adopt “tiered institutional arrangements” and potentially give “stronger role to autonomous bodies” following example of central banks;

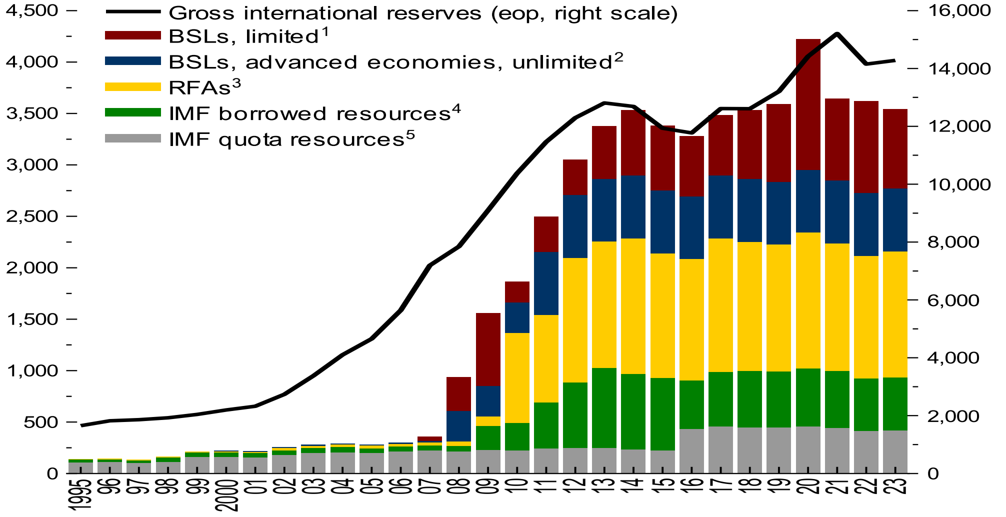
Possible new focus areas for economic policy cooperation

- Addressing collectively the causes of the rapid build-up in public debt;
- Reform of the WTO to deal with new economic realities;
- Consequences for financial imbalances of the net zero transition;
- Sustaining the global financial safety net in the aftermath of the G7 decision to freeze Russian state assets;

Strengthening the Global Financial Safety Net

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.