

Rebalancing the International Economic Order

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Escaping the “prisoner’s dilemma”

- Urgent need to rotate global demand
- Deleveraging required in advanced economies and greater reliance on external demand
- Less reliance on export-led growth required in emerging market economies and increased reliance on domestic demand
- Fundamental asymmetries in the existing system and the need for co-operative strategies (the G-20 Framework)

Estimating the benefits of co-operation and the costs of failure

Three illustrative scenarios drawn from model-based simulations:

1. The good solution
2. The bad solution
3. The ugly solution

Key elements of the good solution

The good solution involves four key elements:

1. Fiscal consolidation in most AEs
2. Household and bank deleveraging in many AEs
3. Structural reforms to promote growth in some AEs
4. Structural reforms and exchange rate adjustment in many EMEs (**Charts 1, 2**)

Heavy costs of delaying needed adjustment

The bad solution occurs when essential policies are delayed:
(Chart 3)

1. Loss of US \$6 trillion by 2015, equivalent to 8 per cent of global GDP **(Chart 4)**
2. Cumulative loss in global output of US \$16 trillion in net present value (NPV) over the 2012-16 period

Doing half the job could be even worse

The ugly solution occurs if adjustment is asymmetric:

1. Much larger losses over the near term if AEs front-load fiscal consolidation without demand rotation (**Chart 5**)
2. NPV cumulative losses over the next five years equivalent to \$17.6 trillion, 10 per cent higher than the “bad” solution

Exchange rate adjustment is an important part of the solution

Smaller, open economies caught in the middle

- Canada is a small open economy that plays by the rules (**Chart 6**)
- Pressures from those who break the rules are displaced onto more flexible currencies
- Effects of persistent large-scale intervention and capital controls differ substantively from those of quantitative easing
- They target exchange rates directly and lead to zero-sum outcomes

Charts



Chart 1: The “good” solution: adjustment in exchange rates

Real effective exchange rates in China and the United States

Index: 2011Q3 = 1

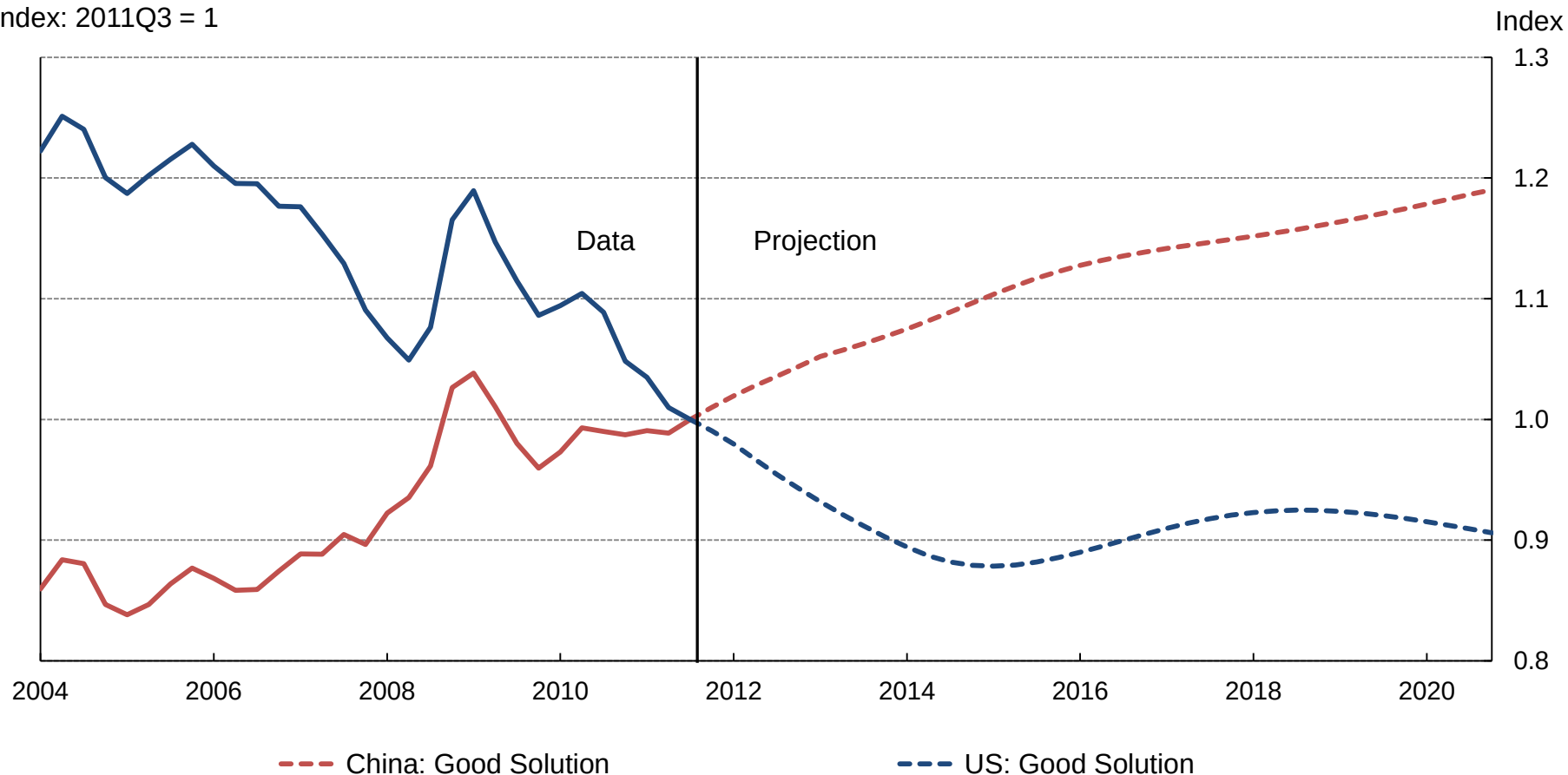


Chart 2 - The “good” solution: global imbalances resolved

Current account balances

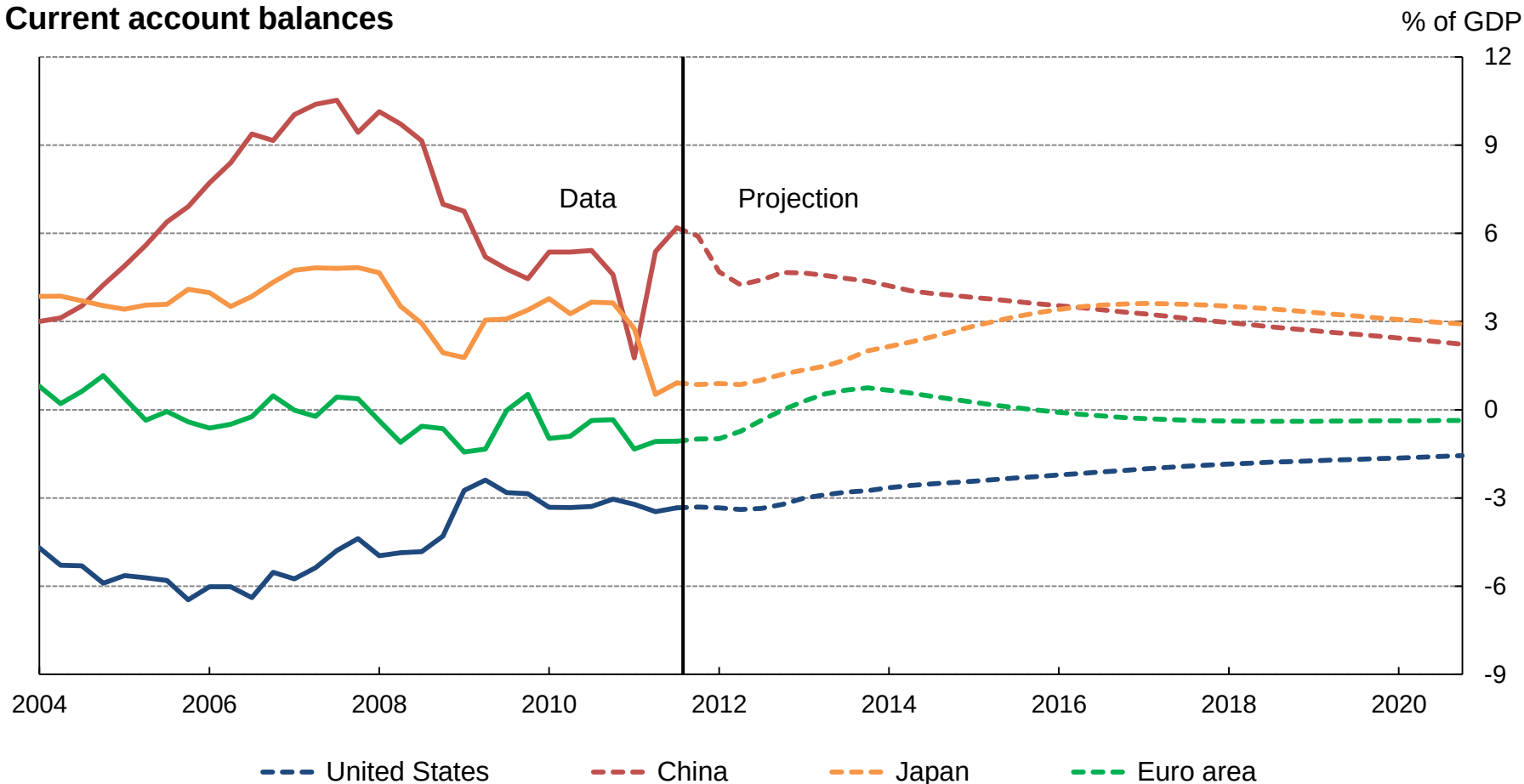


Chart 3 - The “bad” solution: adjustments are delayed

The “bad” solution – Chinese real effective exchange rate

Index: 2011Q3 = 1

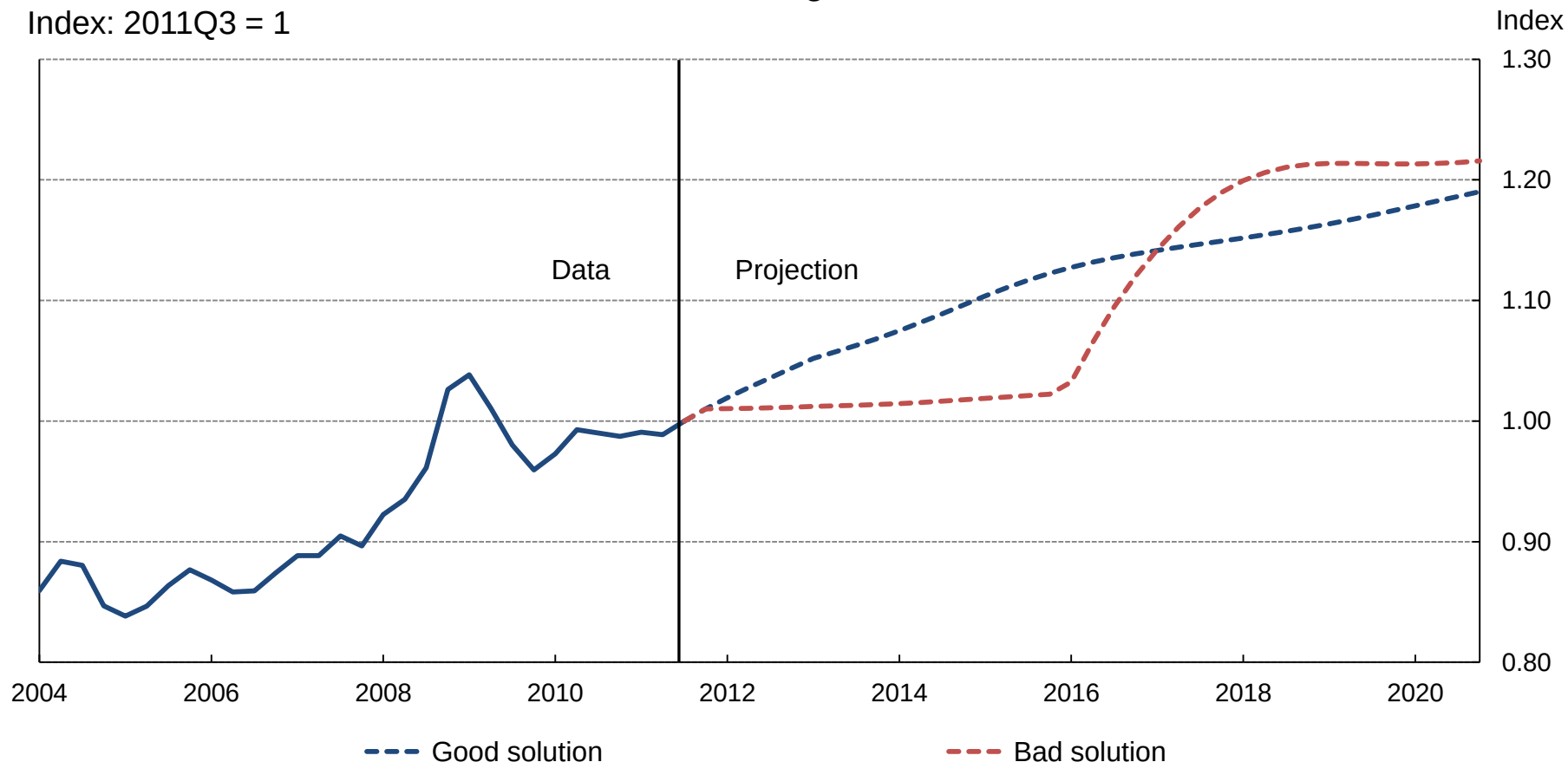


Chart 4 - The “bad” solution: 6 trillion USD loss in global GDP by 2015

The “bad” solution—GDP relative to the baseline scenario

Index: 2011Q3 = 1

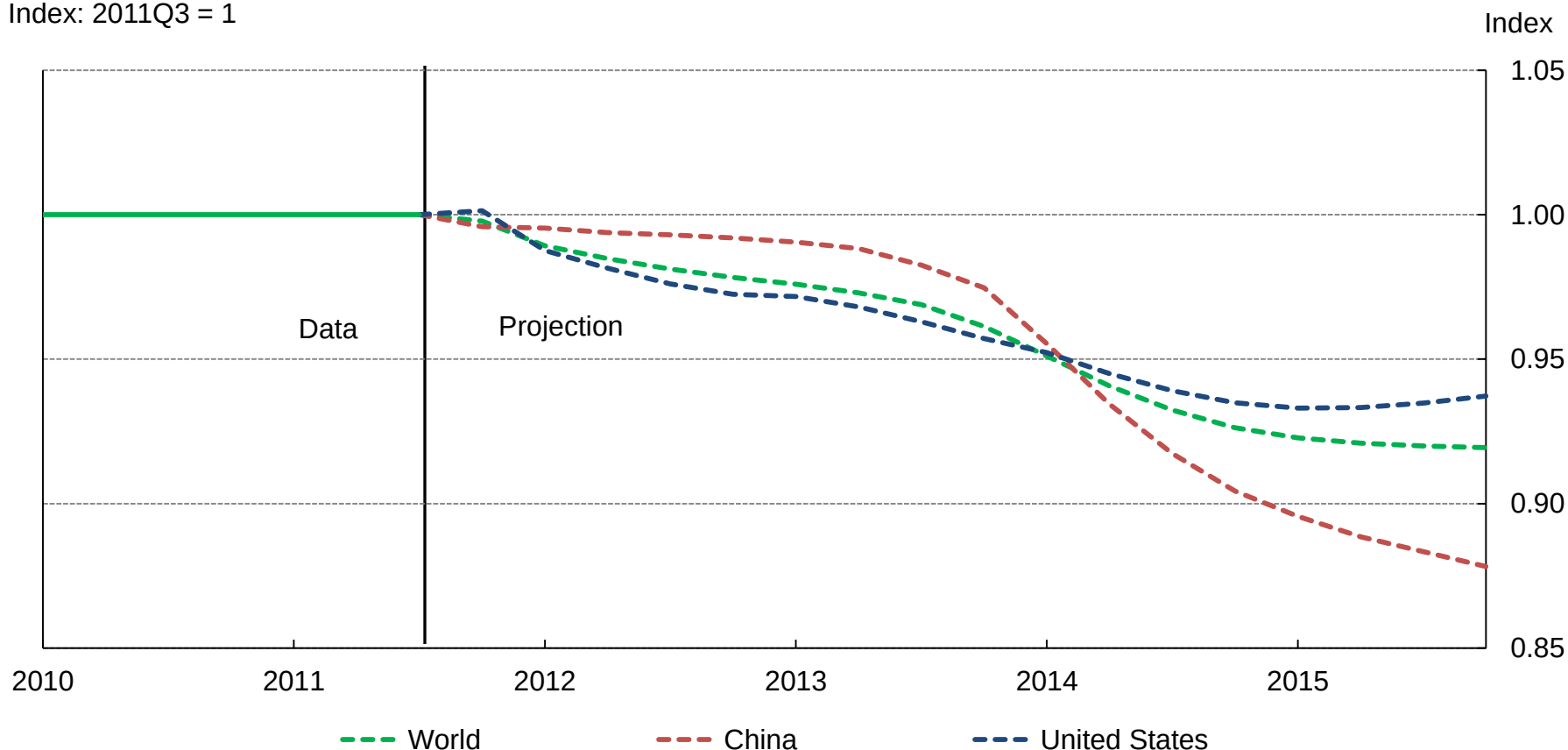


Chart 5 - Doing half the job could be even worse...

The “bad” and the “ugly” scenarios – GDP relative to the good scenario

Index: 2011Q3 = 1

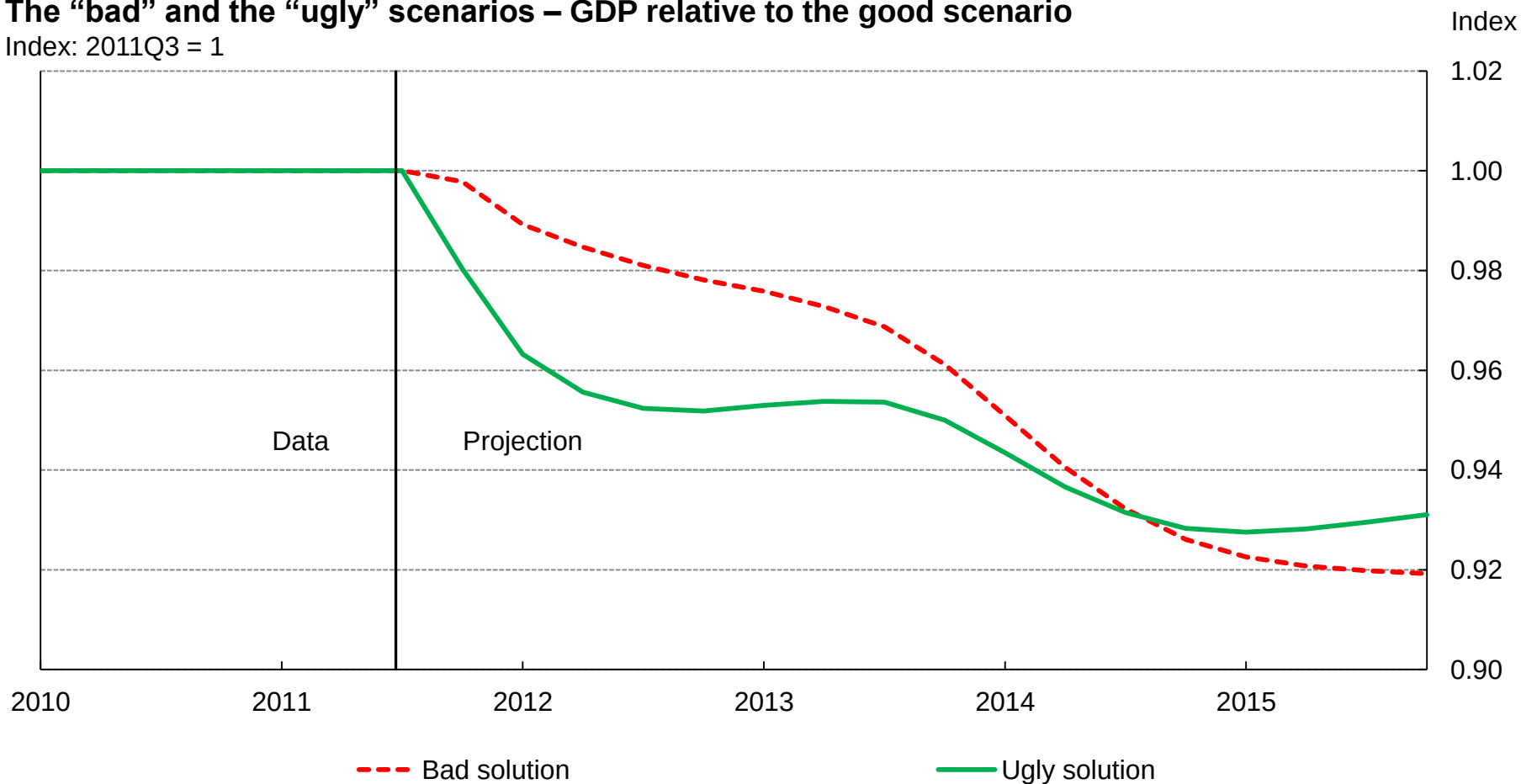
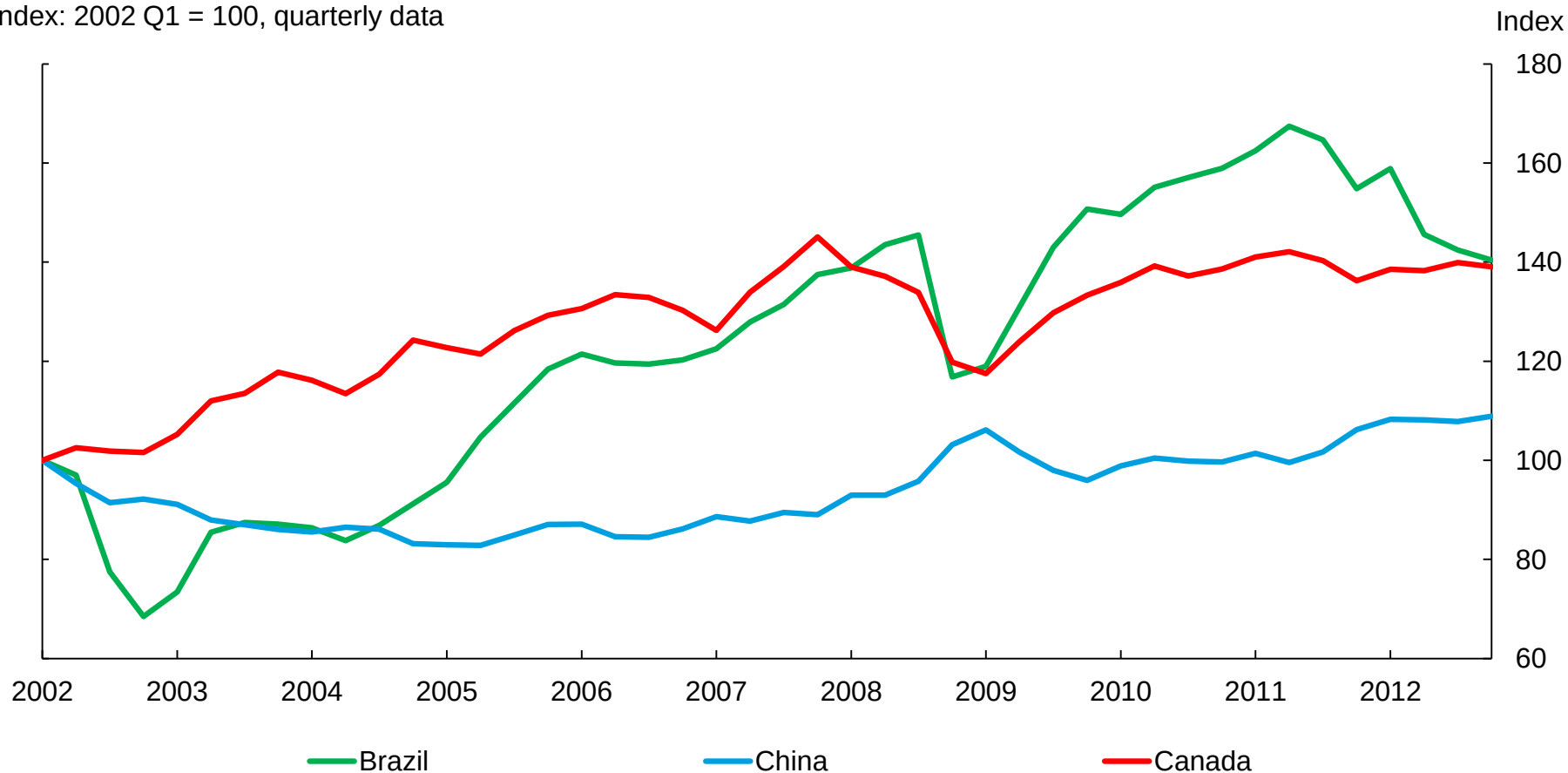


Chart 6 - Adjustment has been displaced

Real effective exchange rates

Index: 2002 Q1 = 100, quarterly data



Quotes



What are the rules of the game?

Article IV, Section I, paragraph iii of the IMF's Articles of Agreement states that members shall:

“avoid manipulating exchange rates or the [international monetary system] in order to prevent effective balance of payments adjustments or to gain unfair competitive advantage over the members.”

What are the rules of the game? (cont'd)

2007 Decision on Bilateral Surveillance over Members' Policies
broadened members' obligations (paragraph 14):

- “C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.
- D. A member should avoid exchange rate policies that result in external instability.”

References



References

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