28 Managing global imbalances: Is it time to consider some form of sanctions?

Heribert Dieter and Richard Higgott

SWP, Berlin; University of Warwick

This chapter argues that financial reform will be an incremental and multi-dimensional process. Focusing on one element of this process – the need to address global imbalances – it suggests that while global imbalances should be addressed by both sides, surpluses should be the priority with either higher taxes on cross-border capital flows or a new international regime to encourage surplus reduction.

Why do we have to discuss imbalances?

Policymakers have been discussing global imbalances at various summits, in particular at G8 and, more recently, G20 meetings, for decades. They have done so without result. Global imbalances have risen sharply since the end of the 20th century. World current account imbalances (the half-sum of all deficits and surpluses of the 181 countries in the database of the IMF) had been relatively stable between the early 1970s and 1997 – in that period, they oscillated around 1.2% of global GDP. Between 1997 and 2007, they grew to about 3% of global GDP (Brender/Pisani 2010: 24). The current account deficits of capital importing countries (notably the USA) and the surpluses of capital exporting countries (notably, but not only, China, Japan, Germany) rose dramatically.

While capital flows have not been the root cause of the recent financial crises, they contributed significantly to the real estate price increases that spread the crisis globally. Continued global macroeconomic imbalances and inadequate financial regulation are not discrete phenomena. Creating a new and appropriate architecture of regulation will not happen with a "big bang". As Helleiner (2010) points out, the global financial crisis has not led to a second Bretton Woods moment. There is no grand proposal for a completely new financial architecture. Instead, financial reform will be an incremental and multi-dimensional process. In this short chapter we look at but one element of this process – the need to address the issue of imbalances and mitigate the effects of dramatic and speculative capital flows. By any analysis, global finance in its previous form was too risky. A repetition of the bailout measures of 2008/9 is not on the cards.

Capital flows, imbalances and previous and current crises

All too often the import of capital has permitted deficit countries to implement non-sustainable economic policies over extended periods of time. Of course, borrowing abroad to finance investment is a legitimate policy tool. But in recent years, this usage has been the exception rather than the norm. Countries as diverse as the USA, Iceland, Spain, Hungary, the UK, and Greece have engaged in a non-sustainable borrowing binge. A thought experiment illustrates the point. Consider the effects on American real estate had it been financed from domestic savings rather than foreign capital. Since US domestic savings have long been low, a bubble would have been unlikely; at the very worst, it would have been much smaller and the effects of it bursting would have been limited to the USA.

But finance is globalised. The dramatic regulation of capital markets has resulted in serious side-effects that are not welfare enhancing in many circumstances. Instead it creates an unwanted and dangerous interconnectedness of national financial sectors and, in contrast to international trade, the welfare effects of international finance are limited to a minority of participants in financial markets.[1] More specifically, in contrast to long-term credit flows and foreign direct investment, short-term capital flows are hazardous and do not help the world's poor. In this context, we use this chapter to consider the justification and appropriateness of a reduction of capital flows, in particular of short-term speculative money. In so doing, we are not insensitive to the contentious political implications of such proposals and the difficulties of securing a political consensus around such proposals. But perhaps it is time to discuss unconventional ideas. As Martin Wolf has suggested, in times of crisis, "radicalism is the safer option" (Wolf 2010).

Restricting capital flows conventionally

Even if a consensus were to emerge on the lack of utility of some kinds of cross-border capital flows, constraining or reducing them will always be problematic; not only for political reasons but also as a matter of practice too. In particular, applying conventional restrictions on capital flows – reducing them with administrative measures – is technically difficult. Historical experience shows that it is easier to restrict capital inflows than outflows. Once capital has left an economy, authorities have no means of control over it.

Debates surrounding the utility and disadvantages of restricting capital flows are vast and sophisticated. They cannot be rehearsed here and we discuss neither the theoretical nor empirical arguments for restrictions. Suffice it instead to consider the changing intellectual climate evinced by the changing position of the IMF over time – for decades it criticised restrictions on both outflows and

1 Empirical evidence demonstrates that hundreds of millions of poor people escaped their precarious existence because of international trade. For a discussion of the utility of international trade see the report of the Warwick Commission on the future of international trade (see Warwick Commission 2007: 13ff).

inflows. Yet February 2010, in a remarkable u-turn, saw the IMF for the first time develop an argument in favour of restrictions on capital flows under certain conditions (for a discussion see Ostry et al. 2010).

But traditional capital controls, opponents would argue, are, and will always be, both administratively cumbersome and burdensome. Some transactions would require monitoring and approval, while others would continue to be unrestricted. The post-war Bretton Woods regime may have depended on capitals controls and of course, that era was a period of very high growth in the global economy, but this argument is not relevant in the age of globalised finance. Coincidence does not prove causality.

Taxing capital flows

Given the difficulties that result from the imposition of administrative restrictions on capital flows, other rationales and practices need to be found for the contemporary era. Thinking what for many in the global financial policy community (both public and private) would be the unthinkable, a different use could be found for James Tobin's erstwhile proposal for a tax on capital flows. Where Tobin's primary, though not exclusive, concern was to stabilise exchange rates, a 21st century equivalent of the Tobin tax could be used as a market-compatible instrument to create both an incentive for surplus countries to reduce the export of capital and to make importing speculative capital less attractive. A 1% tax on cross-border capital flows – the tax rate initially envisaged by James Tobin – could be expected to sharply reduce cross-border capital flows. The crucial political issue is whether this would be a good thing? The question for the political theorist here is what "good" means. It does not mean politically acceptable, since it would certainly be resisted in a range of influential quarters. Moreover, implementation would require a political will that is unlikely to be present amongst many ruling elites of the OECD world. Therefore, the test of "good" would be the impact of a Tobin tax on public policy and specifically its ability to enhance stability and the public good.

Of course, a 1% tax on cross-border capital flows would make borrowing abroad more expensive compared to borrowing domestically. This would have an intended effect: historically, three quarters of all financial crises have been preceded by high rapid capital inflows and the growth of high current account deficits. All recent cases – Iceland, Hungary, the Baltic States, the US, Spain, the United Kingdom, Portugal, and of course Greece – have been characterised by large to very large current account deficits in the years before the crisis. A significant tax on inflows would provide an incentive for capital importing countries to raise their domestic level of saving and reduce the appeal of borrowing abroad.

Yet critics who might not object on principle are likely to object at the number. Even a 1% tax on capital flows would be assumed to have devastating effects on capital mobility. But it need not be seen as, or used as, simply a blunt instrument. Nuance is possible. Brazil, it should be noted, has been applying a tax on capital inflows of 2% since 20 October 2009. The measure, contained in Brazilian

Government Decree 6,983, addresses only portfolio investment, excludes foreign direct investment and is not levied on capital outflows, which are more difficult to monitor. Previously, Chile successfully applied an unremunerated reserve requirement – in effect a tax on capital inflows – in the 1990s. The Brazilian case demonstrates that a relatively robust, but targeted, tax aimed at capital inflows can be applied in practice, not just in theory.

Brazil's experience is new and rare, if not unique. But it is only one element of a public policy aimed at controlling capital flows. The experience of China, the most successful economy of the last three decades, suggests quite strongly that comprehensive capital controls can contribute to the greater welfare of an economy. Let us not forget the historical record either. Those governments vigorously opposing restrictions on capital flows today, especially the USA and the UK, implemented restrictions on capital for two decades in the 1950s and 1960s, and these were phases with above average economic growth.

If we can get beyond the knee jerk ideological aversion to the idea of something that approximates a "Tobin Tax" (maybe the nomenclature should be banned) then applying a tax on cross-border flows would probably be an easier technical exercise in public policy than more conventional restrictions on capital flows. The taxation of capital flows would serve two purposes. First, it would provide an incentive for surplus economies (China, Germany, Japan, Saudi-Arabia, Russia) to reduce their surpluses, which have played a role in the current crisis. Second, they would force deficit economies to evaluate more closely whether importing large quantities of capital is a sustainable policy. A robust tax would force borrowing economies to pay a higher interest rate, which would remind them of the risks of that path early on, not only when liquidity dries up.

Of course, the recent discussion in Europe on specific taxes for the financial sector has been opening the debate on these instruments. But neither a bank levy nor a very low tax on all transactions will have any effect on cross-border capital flows. The currently discussed financial transaction tax, levied with a rate of 0.01%, will not provide a sufficiently large incentive. But the export and the import of capital won't be affected. The instruments applied will have to be more robust.

Good behaviour incentives for surplus economies

Traditional theoretical discussions of capital flows have focussed on their implications for capital importers. Imbalances were thought to be more their problem than that of the creditor nations. Of late, and especially since the housing boom created the global financial crisis, increasing attention has fallen on capital exporters. Yet the principle that both surplus and deficit countries should be sanctioned was at the core of John Maynard Keynes' plan for the Post World War II financial order. Keynes thought surplus countries needed to adjust and suggested the creation of an international clearing union. While today's international transactions are far too complex to make the introduction of an international clearing union a realistic proposal, the principle that underwrote

Keynes proposal is still plausible. Surplus countries should contribute to the resolution of a problem to which they have contributed. Since voluntary corrections of the current account surpluses are not happening, the question arises whether there could be other options.

At the risk of being cliché, the current crisis has been a wake-up call for the surplus economies. Germany, for example, with pleasure verging on hubris at being thought of as the global export champion, paid little or no attention to the issue of capital outflows. As a result, it exported Porsches and got Lehman derivatives in return. German savers, traditionally so risk-averse, deposited their savings with thrifts and other seemingly risk-free institutions while their bankers exported capital and bought American securities, the risk of which they seemingly understood little.

While it would therefore be in the self-interest of surplus economies to export less capital or to invest it more wisely they show little sign of doing it voluntarily. Maybe it is time therefore, in Martin Wolf's words, to think radical thoughts and consider the introduction of measures that sanction surplus countries. For example, in addition to some taxation of capital flows, countries that produce large current account surplus over longer periods might be asked to pay a percentage of these surpluses to a global authority. Defining "large" surpluses and "longer" periods is of course a problem – maybe for openers in any negotiations they could be defined as larger than 4% of an economy's GDP, and longer than three years. A penalty of 10% of the surplus in the fourth year could be paid by the surplus country in SDRs to the International Monetary Fund.[2]

Of course, such a proposal raises a range of critical issues for resolution. First and as noted, the definitions used are arbitrary. Neither a ceiling of 4% of GDP nor a three year time frame can be supported by hard economic rules; they would have to be negotiated and this is a political process. Second, that the export of capital is largely a private not a government controlled activity. While this is true in a narrow technical sense, governments do have obligations to monitor and regulate the effects of the activities of its country's citizens for other countries. Just as governments take responsibility, in theory at least, for the proper behaviour of its corporate citizens abroad, government could accept responsibility for the negative effects arising from the production of large capital exports.

Third, critics might also suggest that transferring taxpayers' money to an international organisation is neither politically acceptable nor feasible. But even the suggestion of such a process might enhance better domestic policy that mitigates the need to transfer such funds. Policymakers have a range of options at their disposal to discourage the export of capital; they can, for example make domestic investment more attractive or encourage domestic consumption. There is no doubt that some of today's capital exporters have failed to address major problems in their own economies and a penalty on the creation of surpluses could provide an incentive for correcting these issues. Japan, notably, failed to clean up the fallout from its own financial crisis. Resorting to a zero interest rate policy has been a major source of instability since the mid-1990s. China, another major capital exporter, has forced its citizens into high savings because the country

2 For a similar discussion along these lines see Eichengreen 2009.

lacks an adequate system for both the financing of education and for retirement. Germany has stimulated export growth, paying no attention to the consequences of that strategy for both its European partners and economies elsewhere. In all such cases, a penalty on sustained surpluses might focus policymakers' minds on more sustainable and less aggressive economic models.

Both the debate on instruments that would reduce the appeal of cross-border capital flows and the creation of a scheme that sanctions large, persistent current account surpluses are issues for the G20. While the group has identified imbalances as an important topic that requires policy change, the G20 has not yet suggested any instruments that would help to achieve the goal of shrinking imbalances. Without a change in incentive structures, imbalances will not go away, and the G20 will have to realise that mere pleas will not be sufficient.

Conclusion

In the political debates over imbalances a critical questions is invariably 'who adjusts?' Capital exporters tend to assume that it is up to the deficit countries to put their house in order. Influential debtor nations, most notably the USA, argue that the surplus exporters should adjust; either by exchange rate adjustment or the dramatic stimulation of domestic demand. In this short chapter we have suggested that large imbalances cause severe difficulties and that while they should be addressed by both surplus and deficit countries we have focussed on the kinds of policies that might be considered to address the issue of surpluses – one of the major weaknesses of today's international financial order. We suggest either the introduction of a relatively high tax on cross-border capital flows or the creation of a regime that would provide an incentive for capital exporters to reduce them. This is the kind of "out of the box" thinking that the current global climate requires. In so doing, we are not suggesting that this in any way alleviates the need to address the questions posed for the stability of the global economy by the world's major creditor nations.

While, in theory, the production of surpluses should be self-correcting through currency re-alignments, in practice this has not worked. It does not work because while we might have a global economy, with global financial markets, we do not have a "global polity" capable of developing (global) public policies to address economic adjustment questions in a collective manner. Public policy remains largely national and driven by narrow domestic political concerns. Several examples must suffice. Japan has been manipulating its exchange rates by accumulating large foreign reserves. China uses an exchange rate that is set by the government, not by markets, and can do so because it implements restrictions on capital flows. Germany could produce surpluses without an effect on its exchange rate if it wished.

Of course, an alternative to addressing global imbalances would be to ignore them. Taking this perspective, cross-border capital flows would simply not be an issue for policymakers, neither in the capital exporting nor in the importing economies. This is the line of least resistance and we are mindful of the tendentious political nature of recommending increased regulation. But our suggestions are neither particularly radical nor are they without historical precedent and the risks of a "hands-off" approach are clear. Frustration at the unwillingness of capital exporters to reduce their surpluses can all too easily spill over into the trade domain. Indeed, the linkages between heightened political tensions arising from a failure to reform the financial system and the potential for the rise of economic nationalism and exacerbated protectionism are all too clear (see Baldwin and Evenett 2009).

Are the proposals politically feasible? The rhetoric of collective action problem solving and regulation has clearly strengthened since the global financial crisis and with the increasing activities of the G20. The world's major economic policymakers have stared into the void. But what seemed like a second Bretton Woods moment seems to have passed and there is neither expert consensus nor political determination among the major powers that will secure the necessary collective incentives and/or enforcement of rules. Change, if it is to come, will be incremental and slow. Nothing posed in this chapter is ripe for implementation. But it should be, we argue, ripe for discussion. Such discussion should not prove impossible if governments (still the sovereign agents of policymaking when they put their minds to it) have really escaped, and can remain free from, the regulatory capture by the Anglo-American financial community that led to the global crisis in the first place.

Perhaps the major generic lesson of the global financial crisis is that it is no longer axiomatic that what is good for market actors is in the public interest (see Baker 2010). Financial regulation remains principally nationally derived and the global economic policy community is in deliberative mode. The crucial thing that academics can do is to ensure that no options are left off the table in these deliberations.

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