



## HIGHLIGHTS

- The G20 leaders will meet tomorrow and Friday in Seoul, South Korea, to address some of the most pressing international issues
- Significant, and positive, announcements should come in terms of financial regulatory reforms and IMF governance
- However, progress on dealing with structural global issues has become more elusive. Cooperation and consensus building has become more difficult as the recovery has evolved at a varying pace across countries
- Even if the G20 leaders make the correct diagnosis on structural global imbalances, correcting them will be a slow, multi-year (or even multi-decade) process. This risks continued currency frictions and the possibility of periodic political tensions

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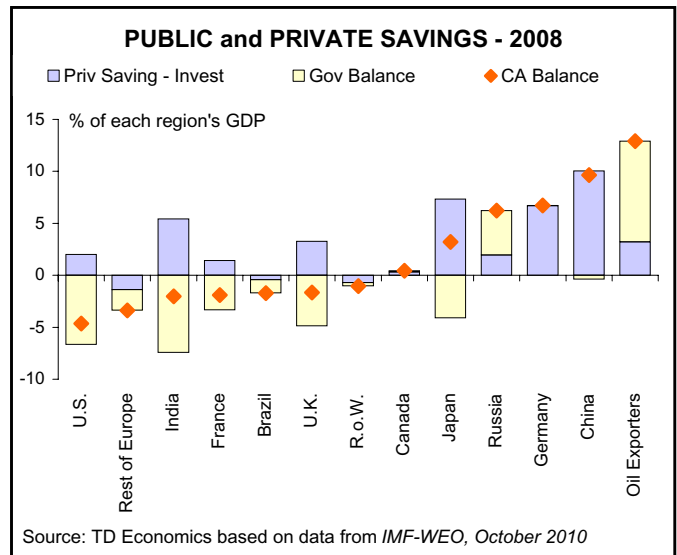
## TACKLING GLOBAL IMBALANCES IS A TALL ORDER FOR G20

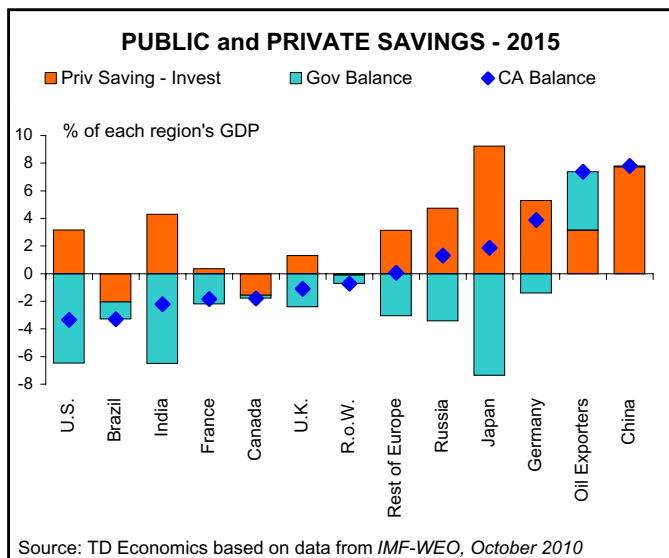
The G20 leaders will meet tomorrow in Seoul, Korea, to address some of the most pressing issues in the global agenda. This will be the fifth summit since the fall of Lehman Brothers in September 2008 sent financial markets into a tail spin. The evolution of the global economy from financial crisis to recession and finally to recovery has resulted in a change in attitude of participating countries with respect to the forum. Immediately after the financial crisis hit, there was a profound sense of urgency to deal with the universal problems that left all countries worse off. General agreement on policy action was relatively easy to attain, which facilitated coordinated, swift policy actions at a global scale. At that time, financial regulation reform was an undisputed element of the agenda. As the financial crisis and deep recession morphed into a sustained recovery, elevated fiscal deficits raised questions about fiscal sustainability in the advanced economies. Opinion among G20 members started to diverge in regards to magnitude and timing of fiscal austerity measures, but ultimately a form of consensus was found with agreement to reduce deficits over time. As the global recovery extends further and high performers begin to noticeably stand out from low performers, consensus on dealing with structural global issues has become more elusive. At the Seoul

meeting this week, the risk of a currency war has been thrust into the debate as countries deal with differing structural issues within their nations. Discussions regarding currency valuations are likely to overshadow some positive developments such as progress on financial regulation reform, as well as on the governance of the IMF. And, although reaching consensus on financial regulation was no small feat, the task of tackling global savings imbalances and currency misalignments is even more daunting. There will be no consensus on fully resolving this matter at the G20 meeting. Altering the dynamics behind the global savings imbalances will be a slow multi-year or possibly even multi-decade process. This means that we can expect continued currency friction and political tensions to persist for some time yet.

### Consensus is easy when everybody is sinking

The G20 has become a key forum for addressing the world's economic and financial challenges. It was founded in 1999 after the Asian financial crisis dem-





global growth.” Included in that message was the “need to shift from public to private sources of demand, establish a pattern of growth across countries that is more sustainable and balanced, and reduce development imbalances.” The need to embark in meaningful global financial regulatory reform ultimately acted as a cohesive backdrop to attaining these goals.

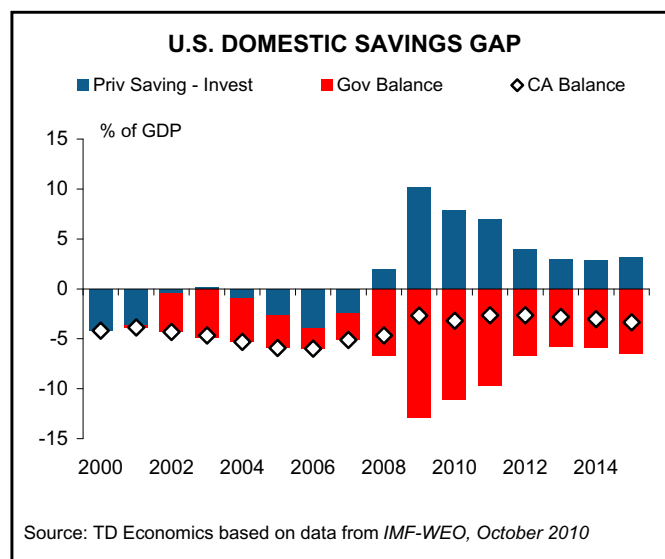
This framework took greater shape at the Toronto G20 summit nine months later. However, in the weeks leading up to the summit, financial market jitters flared over escalating European sovereign debt. While all G20 participants recognized the pressing need to address ‘exit’ strategies for rising government debt levels, it became clear at the Toronto summit, that opinions were diverging. This was in large part due to differing individual cyclical and structural circumstances, evident in the uneven growth profile that started to shape the global recovery as emerging economies sprinted ahead, while advanced economies limped forward. For instance, U.S. President Barack Obama showed less resolve in immediately addressing fiscal imbalances. Instead, his rally cry was for greater exchange rate flexibility at a global scale – implicitly targeting China for its control over the renminbi – and for countries to be mindful of the fragility of the global recovery when implementing fiscal and monetary stimulus exit strategies. In the end, the agreement from G20 participants was that fiscal rebalancing should not jeopardize the economic recovery, but at the same time advanced economies would at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016. In a nod to President Obama’s agenda, there was also acknowledgement that current account and trade imbalances were a major challenge for the world economy that ran the

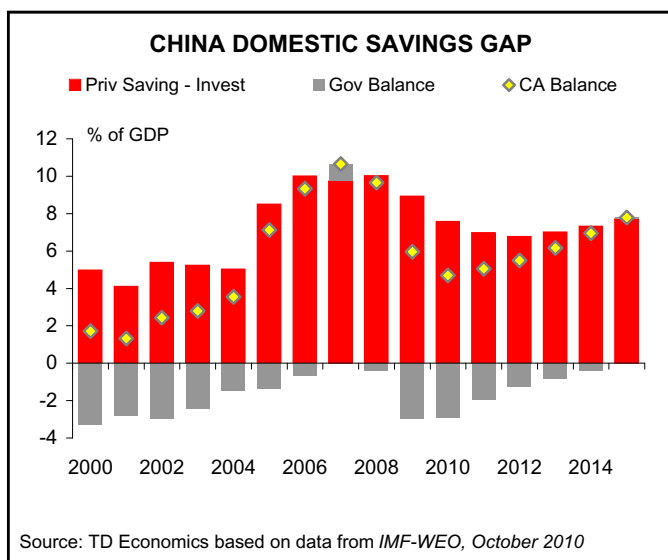
onstrated a need for leaders in both developed and emerging market economies to engage on key economic, financial, social and political issues. However, the importance of the G20 really took off in the wake of the global financial crisis in late 2008. World leaders came together in Washington in 2008, London and Pittsburgh in 2009, and Toronto in 2010. The focus of these meetings has been on how to manage and coordinate monetary and fiscal policy through a financial crisis, a recession, and a recovery. This coming weekend, G20 leaders will meet in Seoul, South Korea to once again tackle key issues in this arena.

In the initial stages of the financial crisis in 2008, there was strong consensus for coordination of policy. Agreement was relatively easy because the synchronicity and severity of the financial crisis left no country unscathed from its consequences. Moreover, the reckless behavior of too many globally relevant financial institutions transformed “big finance” into a uniform problem, reinforcing the sense of unity among G20 participants. Accordingly, participants agreed to inject coordinated and substantial monetary and fiscal stimulus to limit the economic contraction and help foster a recovery. As well, all were in agreement that there was an urgent need for financial regulatory reform. There is little doubt that the subsequent stimulus injected into the global economy did help shift the economic tide by mid-2009, supporting the global recovery we have today.

**Division in opinions is widening**

A pivotal moment for the G20 forum occurred in Pittsburgh (September 2009) when leaders agreed to launch “a framework that lays out the policies and the way we act together to generate strong, sustainable and balanced





risk of creating foreign exchange and political tensions. The wording in the G20 statement called for, “strengthening social safety nets, enhancing corporate governance reform, financial market development, infrastructure spending, and greater exchange rate flexibility in some emerging markets”.

**Wedge in opinion has grown**

As we head into the Seoul meeting, the division of opinion among members appears to have deepened. At the very least, it is clear that the path to resolve ongoing global structural imbalances is becoming more of a political minefield. That’s because it was far easier in 2008 and early 2009 to build public and political consensus that financial institutions were the ‘bad guys’ and countries needed to put policies in place to stoke economic growth. Who would argue with the latter amidst deteriorating global economic activity? However, it is clear now that the structural problems in the global economy extend far beyond the financial system, and the ‘winners’ and ‘losers’ from policy prescriptions differs among G20 participants.

Since Toronto’s June summit, a series of economic developments have rippled through financial markets, pushing the focus towards current account imbalances and currency trends. First, China has only modestly delivered with regards to its announcement ahead of Toronto’s summit to allow for more flexibility in the renminbi. Second, the U.S. economic recovery lost significant momentum in the second quarter. High unemployment combined with low and decelerating inflation prompted the Federal Reserve to announce a second round of quantitative easing (QE) on November 3rd. This decision has drawn open criticism from Germany, China, Brazil, and Russia. Third, anticipating the

Fed’s move, Japan put in place some quantitative easing of its own and intervened in the foreign exchange market to alleviate appreciating pressures on the yen. And lastly, all of these actions triggered counter-responses in some emerging markets, who are worried of the potentially damaging effects of a sharp increase in capital inflows. For instance, Brazil has increased the tax rate on capital inflows to deter short-term investments, while South Korea has also stepped up investment controls and intervention in foreign exchange markets to stem the increase in the won.

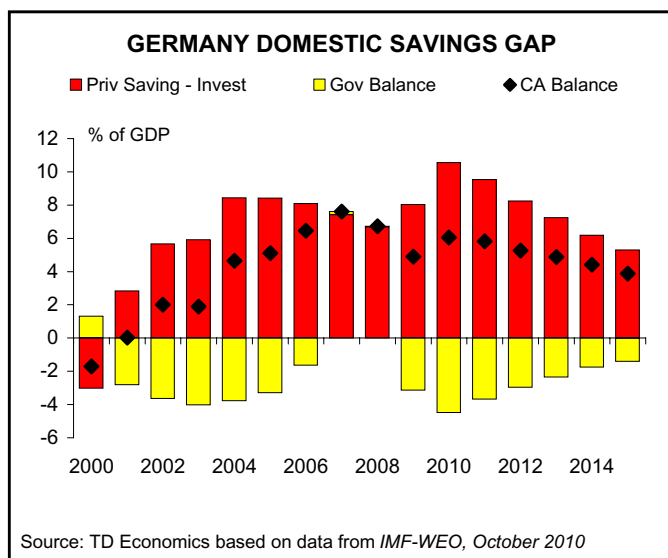
To defuse rhetoric attacks on the U.S. for its QE decision and to move the discussion away from currency valuations, U.S. Treasury Secretary Timothy Geithner has floated the idea of an early warning system by establishing current account targets as a means to reducing global imbalances. Geithner’s suggestion was that the current account-to-GDP ratio could not exceed 4%. Although this might seem like a good idea on the surface, it is unlikely to transform into concrete actions. First, it would be difficult to find an enforcer for the sanctions to be imposed on those countries who repeatedly breach the targets. In other words, punishment for breaches would have little teeth. Second, the size of the imbalances and their structural roots make them a persistent phenomenon that could take many years to correct. In other words, there is no quick fix. Worst still, the establishment of a formal current account limit could be used as a excuse to impose protectionist policies.

**How big are these global imbalances?**

As the accompanying tables highlight, global trade has become heavily skewed, resulting in wide current account

	2009 Share of World GDP	Current Account Balance (% of World GDP)		
		2006	2009	2015 (f)
U.S.	24.4	-1.63	-0.65	-0.73
France	4.6	-0.03	-0.09	-0.07
Canada	2.3	0.04	-0.07	-0.04
India	2.1	-0.02	-0.06	-0.07
Brazil	2.7	0.03	-0.04	-0.11
U.K.	3.8	-0.17	-0.04	-0.04
Russia	2.1	0.19	0.09	0.04
Japan	8.8	0.35	0.25	0.15
Oil Exporters	5.6	0.84	0.26	0.45
Germany	5.8	0.38	0.28	0.18
China	8.6	0.51	0.51	0.95
Rest of Europe	15.1	-0.16	-0.16	0.01
R.o.W.	14.0	0.09	0.10	-0.12
Discrepancy		0.43	0.37	0.60

Source: TD Economics based on IMF’s data and forecast (f)



there is a strong political will, which China currently does not show on this front. Second, any movement away from this export-led model requires relaxing capital controls. However, in order to do so, China would have to change the way the entire banking system operates. (For details see [China: Foreign Exchange Rigidity, Asset Bubbles, And The Role Of Chinese Banks](#))

While we detailed China’s structural constraints, the problem is global in dimension. Unwinding the surplus in nations where the structure of the economy is leveraged to oil production and exports is difficult, especially considering that there is every reason to believe crude oil prices will remain elevated in the coming decade. Also, the ability of the U.S. to reduce its deficit is constrained by the fact that it has a dearth of domestic savings. In addition, its currency represents the world reserve currency, which inherently leads to a capital account surplus and a current account deficit – this latter impact is formally referred to as the Triffin dilemma.

**Global saving imbalances are overlooked**

While current account and international trade imbalances get considerable attention, the underlying details of the saving imbalances tend to be overlooked. To illustrate, the accompanying charts break savings into the various components of private sector, government sector, and the external sector (i.e. current account balance). The stories vary, but outside of oil nations, government deficits are adding to net borrowing or diminishing net saving. In much of the industrialized world, the private sector is now generally a net saver. This is due to deleveraging by households and high cash balances among businesses. In the developing

surpluses and deficits. China, Germany, Japan, and the oil exporting nations are running enormous current account surpluses, while the major developed nations are recording large deficits. The problem breaks down into two separate issues: the size of the imbalances and the structural roots that inhibits improvement.

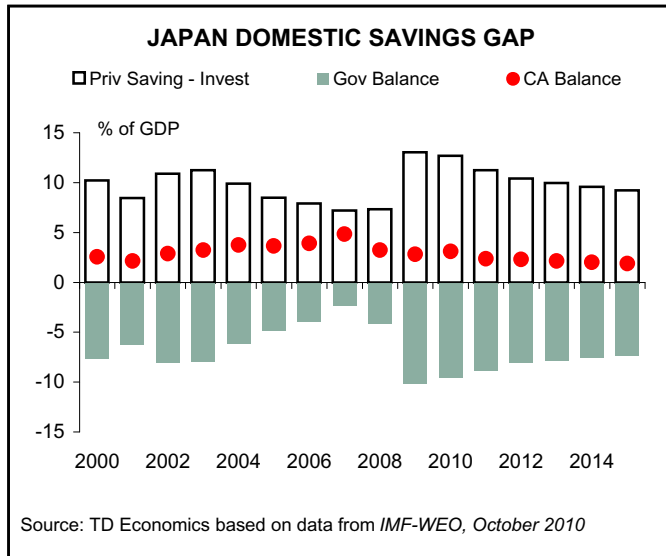
On the issue of size, China provides the best illustration. China’s trade surplus with the U.S. was US\$226.9 billion, which represents 1.6% of U.S. nominal GDP and 4.6% of China’s Nominal GDP. Recurring current account surpluses have corresponded with a build-up in foreign exchange (FX) reserves. Measured by nominal GDP, China is 8.6% of the world economy, but holds 33% of world FX reserves. The growth in China’s FX reserves has been astonishing, rising from 13% of GDP in 2000 to a whopping 44% in 2010. While China has become the poster child of global imbalances, the tables show that it is not alone.

On the issue of structural roots, continuing with China’s situation, there are two main issues that have led to the recurring current account surpluses and massive foreign exchange accumulation. First, economic activity is dependent on an export-led growth model because domestic consumption represents an abnormally low share of GDP (at 35% versus 65% for most other developed and developing nations). This model requires continuous intervention in FX markets in order to keep the renminbi from appreciating too strongly and eroding export competitiveness. As a result, this has yielded massive accumulation of FX reserves. If China wanted to increase domestic consumption, it would need to incent reduced saving behavior. However, this won’t happen unless China enhances its social security system. Clearly this is something that doesn’t happen overnight, even when

	Current Account Balance (% of Country's GDP)			
	Avg. 2000-08	2009	2010 (f)	Avg. 2011-15 (f)
U.S.	-4.89	-2.68	-3.19	-2.90
U.K.	-2.26	-1.11	-2.23	-1.49
Brazil	-0.64	-1.54	-2.56	-3.21
India	-0.30	-2.88	-3.08	-2.71
France	0.19	-1.93	-1.79	-1.76
Canada	1.64	-2.85	-2.83	-2.20
Japan	3.35	2.80	3.09	2.13
Germany	3.64	<b>4.89</b>	<b>6.06</b>	<b>4.86</b>
China	<b>5.40</b>	<b>5.96</b>	<b>4.70</b>	<b>6.30</b>
Oil Exporters	<b>8.64</b>	<b>4.65</b>	<b>6.26</b>	<b>7.07</b>
Russia	<b>9.84</b>	<b>4.02</b>	<b>4.73</b>	2.25
Rest of Europe	-0.67	-1.09	-0.77	-0.05
Rest of World	0.47	0.74	0.39	-0.45

Source: TD Economics based on IMF's data and forecast (f)





world, the story is a little different. Households are saving, but it is because of inadequate social security systems, culturally high savings rates or underdeveloped retail/wholesale markets.

As the graphs demonstrate, the general theme reflects pronounced net saving or lending positions within the private sector versus net borrowing by the public sector – be it China, the U.S., Germany or Japan. China’s net saving position tells us that the issue is about excess private saving. The U.S. net borrowing position tells us that while the issue used to be about inadequate household saving, it is now about inadequate savings on the part of government. The problem is that these issues cannot be addressed quickly. As we mentioned before, China’s private saving will only be unlocked by the development of a social security system that encourages personal consumption. For the U.S., in the wake of the recent mid-term elections and the fragile economic recovery, the fiscal deficit will likely not be tackled in any material way over the next two years. Yet, America’s current account and trade imbalances cannot be reversed without fiscal rebalancing.

Given the immense challenges and complexities, the most that can be hoped for is that the global imbalances are tempered in the coming years. However, this is opposite to what the IMF is forecasting for 2015, in which current account imbalances become larger.

**What does this mean for the outcome of this week’s G20 meeting?**

Given the discussion above, we believe the G20 statement this week will likely correctly diagnose the central challenges; however, it is unlikely to identify a clear and

convincing path towards resolution. There are two areas, however, in which the G20 meeting will likely make progress. First, there will be agreement on the implementation and timeframe of the new bank capital and liquidity framework designed by the Basel Committee on Banking Supervision and the Governors and Heads Of Supervision. The salient aspects of this framework are:

- 1) There will be several changes to capital requirements. First, the total capital ratio will be raised from 4% to 8% of risk-weighted assets (RWA). Second, Tier 1 capital will be raised to 4.5% of RWA, and within Tier 1, common equity will have to account for 3.5% of RWA. The minimum common equity and Tier 1 requirements will be phased in between 1 January 2013 and 1 January 2015. Third, there will be a capital conservation buffer of 2.5% of RWA. Lastly, a countercyclical buffer within a range of 0% to 2.5% of common equity will be implemented to achieve the broader macro prudential goal of protecting the banking sector from periods of excessive aggregate credit growth.
- 2) A Tier 1 leverage ratio of 3%, which is aimed at capturing both on- and off-balance sheet exposures and derivatives will be tested beginning in 2013.
- 3) A liquidity coverage ratio and a net stable funding ratio will be introduced as minimum standards on January 1st of 2015 and 2018, respectively.
- 4) To improve transparency and market discipline, banks will be required to disclose all elements of the regulatory capital base, the deductions applied and full reconciliation to their financial accounts. Moreover, banks will need to publish on their websites the full

	Foreign Exchange Reserves			
	(% of Country's GDP)		(% of Global Reserves)	
	2000	2010	2000	2010
China	13.29	44.35	9.85	32.75
Japan	6.90	18.82	19.91	13.04
Oil Exporters	5.93	16.83	5.46	7.86
Russia	6.71	29.56	1.08	5.61
Brazil	5.04	12.91	2.00	3.36
India	7.07	17.95	2.10	3.30
United States	0.31	0.34	1.90	0.64
Canada	3.72	2.96	1.67	0.60
United Kingdom	1.86	1.99	1.70	0.58
Germany	2.65	1.15	3.13	0.49
France	2.58	1.23	2.13	0.41
Rest of Europe	5.67	7.27	14.18	7.96
R.o.W.	14.19	19.32	34.89	23.41

Source: TD Economics based on IMF's data and forecast (f)



terms and conditions of all instruments included in regulatory capital.

Progress on financial regulatory reform will be a positive development, even if a debate lingers on whether the appropriate measures were taken. The bottom line is that providing clear guidelines on regulatory changes reduces financial market uncertainty, which should help improve global capital flows.

The second area of progress we expect to see is in changes to IMF governance practices and the quota mechanism, which will give emerging markets more representation and access to funding. Emerging markets will capture a larger quota share of 6%, while the voting shares of the poorest will be maintained. Moreover, developing countries will get greater representation on the Executive Board through 2 more seats at the expense of European chairs by advanced countries. Finally, there was agreement to move to an all-elected Board, along with a commitment by the Fund's membership to maintain the Board size at 24 chairs and a review of the Board's composition every 8 years. These changes were already agreed to by G20 Finance Ministers, so the G20 leaders now need to put their stamp of approval on the changes, which would come into effect in 2012.

### **Conclusion**

To wrap up, the G20 is likely to make some progress in key areas, but expectations have to be kept realistic. Important announcements will be made over financial reform.

While many of the details are already known, the fact that uncertainty over regulatory changes will diminish is a clear positive for the functioning of the global financial system. Announcements over IMF governance will also be positive, as developing nations deserve better representation. The G20 leaders are likely to make the correct diagnosis on the need to resolve global imbalances, but progress here is likely to be limited. There is simply no magic wand to make them disappear or become smaller. And, there is no uniform approach to dealing with the imbalances. Even with the correct diagnosis, the required changes imply that it will be a slow, multi-year (or even multi-decade) process. The best we can hope for is a renewed commitment from G20 leaders to address the issue. A slow pace of unwinding the imbalances does, however, risk continued currency frictions and the possibility of periodic political tensions. Although world leaders have promised not to allow protectionism to rear its ugly head since the financial crisis erupted, there are no guarantees, especially if public and political pressures continue to escalate. However, it is essential that this commitment is maintained and implemented, because the imposition of trade and capital barriers could undermine the global recovery. And, this is perhaps one of the key reasons why the G20 meetings are important. The forum provides the opportunity for open face-to-face discussions that help avoid problems or help to resolve them.