TD Bank Financial Group

Observation

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TD Economics
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HIGHLIGHTS

- The G20 statement provided no substantive surprises.
- A formal agreement to resist protectionism was made, but risk of future currency tensions may have increased.
- G20 recognizes that resolving global imbalances is key to sustainable growth, but the suggestion of putting a spotlight on countries with imbalances could raise tensions.
- G20 failed to adequately signal that the unwinding of imbalances could take many years.
- G20 guidance on foreign exchange arrangements is also contradictory.
- The bottom line is that good progress made in several areas, like financial regulatory reform. However, G20 members must now move from rhetoric to actions in order to ground market expectations on addressing global imbalances and in order to prevent currency tensions.

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G20 STATEMENT SIGNALS GLOBAL IMBALANCES NOW A TOP PRIORITY

The G20 statement provided no substantive surprises and was aligned with our expectations prior to the meeting, which were laid out in our report "Tackling Global Imbalances Is A Tall Order For G20". In terms of concrete actions, G20 leaders agreed upon reform proposals put forward ahead of the Seoul meeting by G20 Finance ministers on Basel III financial regulation and IMF governance. Although there is still ground to cover regarding the full implementation of these policy measures, both are positive developments that should not be overlooked. In addition, the commitment of continued cooperation with the goal of moving towards strong, sustainable, and balanced growth set out at the Pittsburgh G20 meeting was reaffirmed. Similarly, there is a commitment to fiscal consolidation where necessary. However, the wording on this front is far less precise than in the G20 statement in Toronto, which indicated that advanced economies would halve their deficits over the next three years.

The key unresolved theme that came out of this summit was centered on global imbalances. World leaders acknowledged that uneven growth and widening imbalances are threatening to result in uncoordinated individual action and that this would be an undesirable outcome. In response, there was a formal agreement to resist protectionism. G20 leaders agreed to "pursue the full range of policies conducive to reducing excessive imbalances and maintaining current account imbalances at sustainable levels." However, TD Economics has some concerns regarding the recommendation for the IMF and other international organizations to develop a range of indicators to identify large imbalances so that corrective actions can be taken. The goal is to have this done in the first half of 2011. While the G20 is correct in noting that global imbalances must be dealt with, once explicit rules are established that could be used to put a spotlight on selected countries with outsized imbalances, political tensions could escalate. The challenge is that unwinding the imbalances may take years, and even decades, and some countries could prove impatient with the progress by other nations. If so, protectionist policies become a greater risk.

Given the heated debate regarding currency valuations that preceded the meeting, there was considerable commentary in the G20 statement on foreign exchange markets. Once again, there was a commitment to move towards more flexible foreign exchange arrangements in the member countries. Although markets may interpret this as pressure on China to allow its currency to appreciate, there were much broader messages as well. There was a promise to refrain from competitive devaluation – in other words, resist the temptation to enter into a currency war. To strike a balance on this key area, two objectives were outlined. First, countries with reserve currencies should be vigilant against excess volatility in exchange rates, which might be read as suggesting that the U.S. should be careful that its QE policy does not dramatically weaken the greenback. Second, the Seoul Summit Document notes that, "in circumstances where countries are facing undue burden of adjustment, policy responses in emerging market economies with adequate reserves and increasingly overvalued flexible exchange rates may also include carefully designed macro-prudential measures." This seems to create a glaring contradiction in the G20 message. On the one hand, there is support for market-based exchange rates. Simultaneously, the door appears open for emerging market economies to put in place policies to influence their exchange rates, such as capital controls.

Conclusion

All in all, the G20 statement largely delivers on what TD Economics anticipated in our G20 preview published on Wednesday. The most interesting development was the priority on dealing with global imbalances. However, while the G20 members have correctly diagnosed the main challenge facing the world economy, we are not optimistic about how quickly these imbalances can be unwound. There is no magic wand to make them disappear and progress could take many years. Indeed, China's current account surplus will remain enormous until a social security safety net is put in place to reduce saving and boost consumption. Meanwhile, the U.S. current account deficit will also remain substantial until the federal government deficit is tackled. Neither of the illustrations above will occur soon. In future G20 summits, we need to see some emphasis on realistic timeframes for these adjustments. This will be particularly important if current account targets are developed. It was certainly a positive development that G20 members are still committed to cooperation and resisting protectionism and competitive currency devaluations, but actions always speak louder than words. The bottom line is that G20 participants must now move from rhetoric to action in order to ground market expectations. A clear understanding is needed that addressing global imbalances will be glacial. And, that means the risk of further currency tensions is high.