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A better way to settle global economic disputes

There are two ways to address some of the tensions that globalisation is producing in the world economy, particularly between advanced and emerging market countries. The first is a bilateral approach, using preferential treatment and retaliatory action – or carrots and sticks – to resolve disputes with trading partners. The second is a multilateral approach in the context of institutions such as the International Monetary Fund, deploying rigorous monitoring and enforcement to ensure that commonly agreed rules are upheld.

Which of the two approaches is most likely to address problems posed by the large balance of payments surpluses and deficits recorded in some of the biggest economies?

A bilateral approach can be tailored to individual countries' needs, especially if, like the US, they can exert strong pressure on trade partners or if access to their domestic market is a big attraction. It has certain limits, however, and might even backfire.

A bilateral approach has to be politically expedient for both sides, requiring the alignment of political cycles or election calendars – which seldom occurs. It is also unclear why one country – especially if, as is the case with China, it is emerging as a stronger player on the international stage – should modify policies or make concessions simply as a result of a request from another economy, albeit the largest. Moreover if, as often happens, the process descends into a vicious spiral of retaliation and counter-retaliation, the end result might be even worse.

A multilateral approach could be more fruitful, with all countries sharing rights and responsibilities to address the issues at stake. For this to succeed, however, international institutions have to be recognised universally as legitimate and *super partes* and have at their disposal effective instruments of surveillance and enforcement. This is not always the case. IMF shareholders are currently discussing the reform of its governance and mandate to strengthen its role in the international financial system. Some progress has been achieved in the past few months, but not yet an agreement. At some stage there will have to be a deal between advanced and emerging economies.

For their part, the advanced economies need to agree to give a greater role to the more dynamic emerging economies in the governance of the IMF. Emerging economies, meanwhile, should accept the need to give the IMF a stronger role in monitoring domestic macroeconomic policies, including exchange rate regimes.

An important step in this direction has been taken by the multilateral consultations on global imbalances, launched by the IMF last year in Singapore and involving the US, the eurozone, Japan, China and Saudi Arabia. The consultations have stressed that "reducing global imbalances is fundamentally a multilateral challenge, and resolving them in a manner compatible with sustained robust growth is a shared responsibility".

The participants have agreed that external imbalances often reflect internal problems that pose risks for themselves, as well as international partners. Policy commitments have been offered that serve countries' own interests as well as the strategic goal agreed at the IMF to reduce global imbalances. The Chinese authorities, for instance, have indicated their intention to make the "reduction of external imbalances a major objective of economic and social development for 2007". They have announced measures to achieve this objective, such as increasing the flexibility of the exchange rate. The US has also announced several steps, including tax incentives to support private saving, and measures to enhance energy efficiency.

The strategy has started to produce results, as the US current account deficit seems to have peaked and is projected by the IMF to fall this year, while the surpluses of oil-exporting countries and Asian economies, with the exception of China, are expected to decrease. The further adjustment of imbalances requires not only that the main participants continue to implement their respective policy commitments. The role of the IMF in monitoring the agreed strategy also needs to be strengthened. That demands firm steps on the reform of the IMF at its annual meeting in October.

Failure to agree on IMF reform could undermine the framework for multilateral co-operation. The only alternative left might then be to revert to the old "carrot and stick" bilateral approach. This would involve substantial risk for the world economy.

The writer is a member of the European Central Bank's executive board