

Rebalancing the Global Economy: A Primer for Policymaking

Edited by
Stijn Claessens, Simon Evenett
and Bernard Hoekman



A VoxEU.org Publication



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Foreword

As the world economy recovers, developing countries will need to rely on international markets – including dynamic emerging markets – as a source of demand to revitalize economic growth. Despite recent calls to reconsider the merits of openness, trade integration remains key to economic growth. It is well known that China and other emerging markets, which account for over 40 percent of the world’s population, are growing at an unprecedented pace, pulling much of Asia and the rest of the world with them. East Asia has become the third most integrated region in the world after North America and the European Union. South-South trade expansion is helping to drive global trade recovery.

A key lesson looking forward is that markets must remain open so that less developed countries tap into the more dynamic emerging markets. Resurgent global current account balances pose a threat in this regard. There is much debate about the importance of current account imbalances and the role they played in creating the preconditions for the global economic crisis that erupted in 2008. But it is clear that there are strong political forces and economic imperatives that require countries with large current account deficits and high levels of debt and fiscal stress to increase net exports substantially. Conversely, countries running persistent large current account surpluses need to take action to increase domestic absorption.

As is clear from the papers included in this eBook, there are strong differences in views regarding the global welfare implications of global imbalances and efforts to re-balance the world economy. Whatever one’s views, the implications of the policy responses to large imbalances will have major repercussions for developing economies. Recourse to protectionism on the part of large deficit countries should be avoided at all costs. Coordinated responses – such as a concerted effort to further liberalize access to goods and services markets – are among the options discussed in this volume that have not attracted much attention by policymakers to date, as illustrated by the impasse in the Doha Round negotiations.

We are delighted to have sponsored this eBook and are grateful to Stijn, Simon, and Bernard for their initiative in organizing it; and to Viv Davies, Anil Shamdasani and Samantha Reid for their help in seeing it through to publication. We should also acknowledge support from the “Global Trade and Financial Architecture”, a DFID-funded project; and from “Politics, Economics and Global Governance: The European Dimensions”, a collaborative research project funded by the European Commission under its Seventh Framework Programme for Research (contract no. SSH-CT-2008-217559).

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22 June 2010

1 Editors Overview

Stijn Claessens, Simon Evenett and Bernard Hoekman

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We recognise that the process to ensure more balanced global growth must be undertaken in an orderly manner. All G20 members agree to address the respective weaknesses of their economies.

- *G20 members with sustained, significant external deficits pledge to undertake policies to support private savings and undertake fiscal consolidation while maintaining open markets and strengthening export sectors.*
- *G20 members with sustained, significant external surpluses pledge to strengthen domestic sources of growth. According to national circumstances this could include increasing investment, reducing financial markets distortions, boosting productivity in service sectors, improving social safety nets, and lifting constraints on demand growth.*

**G20 Framework for Strong, Sustainable, and Balanced Growth
G20 Pittsburgh Summit, 24/25 September 2009**

Such was the concern about the adverse consequences for the world economy of “imbalances” that G20 Leaders, meeting in Pittsburgh in September 2009, adopted a framework that contained a number of pledges to take action at the national and international level (see text above). This action followed a growing body of expert opinion that took the view that large, persistent current account imbalances in the major industrialised economies and emerging markets since 2000 had, at the very least, contributed to the global financial crisis witnessed in 2007-8 and to the subsequent Great Recession.

The purpose of this eBook is to provide policymakers and their advisers with up-to-date, comprehensive analyses of the central facets of global economic imbalances and to identify and evaluate potential national and systemic responses to this challenge. As will become clear, the world economy has experienced substantial current account surpluses and deficits before, and several of our contributors discuss the contemporary relevance of these episodes. Most contributors focus on important very recent developments, such as the pressures for fiscal retrenchment experienced in Europe during the second quarter of 2010.

These developments may well shape how global economic imbalances are tackled in the months and years ahead.

Since expert opinion remains divided on some critical aspects of the rebalancing question, we have not sought to present a single view. Given the diversity in national economic circumstances it would be surprising if a single set of policy prescriptions was valid across the board. Consequently, drawing upon different areas of expertise concerning the international economy, we have assembled cutting-edge analyses of all of the key questions raised by challenge of global economic imbalances. Many of our contributors have advanced proposals for reform that could usefully be explored in national and international fora.

The multi-faceted nature of global economic rebalancing

A challenge facing senior officials and analysts is to comprehend the many different dimensions of the rebalancing of the global economy and how they might relate to one another. A first order of business is to define terms. What constitutes an imbalance? How is it measured? Second, causal and normative considerations arise. What factors cause imbalances? Since it is the persistence of these imbalances that is regarded as detrimental to national economies, it is necessary to understand the factors that account for persistent imbalances. Comprehending the different types of harm created by persistent imbalances is a distinct matter made all the more interesting given claims advanced over the past two years that global economic imbalances contributed to the worldwide financial paralysis and subsequent output collapse in 2008 and 2009, respectively. Ascertaining whether there are systemic costs to global imbalances is a necessary first step in any discussion of potential national, regional, or multilateral responses.

If one is convinced that imbalances are bad for a national economy or systemically, attention then turns to normative prescriptions. While these can and should be informed by conceptual analysis, surely it is helpful to turn to the historical record to examine how previous instances of serious global imbalances have played out. Such evidence plus other considerations can inform an assessment of what public policies must change and whether collective actions are needed. Such an assessment ought to consider the political viability of reform proposals in all of the major affected jurisdictions. Given the constellations of interests often invested around existing sets of national institutions and policies, politically viable reforms may fall far short of the first-best or preferred technocratic option.

Lastly, moving from the national to the systemic level, questions arise as to whether new international rules, conventions or processes are needed to discourage the creation of persistent imbalances in the first place or to correct imbalances when they occur. Such analyses have to take into account the operation of any self-correcting mechanisms at work in the global economy as well as instances where global markets fail to deliver optimal adjustment by leading nations.

The contributions to this volume

With these considerations in mind, we organised the contributions to this volume around six questions. Doing so allows authors to focus on different aspects of the global rebalancing challenge, and helps each element of the policy challenge to be appreciated more easily. Of course, decision-makers need to take a comprehensive view of the many facets of global economic imbalances, recognising the connections between the national, regional, and multilateral levels, between the politics and economics of the challenge, as well as drawing from contemporary circumstances and historical experience. The six questions are:

1. How large are contemporary current account imbalances? Why do they persist?
2. What are the systemic costs of imbalances?
3. What are the lessons from previous attempts to rebalance the global economy?
4. What would rebalancing entail? Which policies must change? Is collective action needed?
5. What is the political viability of proposals to rebalance national economies?
6. Are new system-wide accords needed to promote rebalancing or to discourage persistent imbalances?

Implications for policymaking

While the answers to these questions vary and there is no clear consensus, we draw out ten implications for policymaking from the contributions to this book. No doubt, further analysis and deliberation will refine—and possibly contradict—some of the suggested implications. Still, given the high profile attached to global imbalances, it is worth stating them, not least to demonstrate how different facets of the rebalancing challenge relate to one another.

1. Many analysts subscribe to the view that the large current account imbalances of the past decade were, at least in part, a contributing factor to the recent global financial crisis. Even if imbalances do not represent a threat to the operation of an open global economy, they risk undermining public support for such openness.
2. While imbalances are typically viewed as a macroeconomic phenomenon, their persistence in recent years suggests that there may be underlying structural features of national economies and the international financial system that influence their magnitude.
3. To the extent that such structural features are important causes of national imbalances, the optimal policy mix extends beyond demand management tools. Shifts in expenditure patterns of the magnitude necessary to eliminate some of the current account imbalances must imply inter-sectoral shifts in resources within economies. This process of reallocation will undoubtedly be affected by supply side measures (see Box 1 for a discussion of the relevance

- of this observation for national service sectors). And at the international level, governance and other reforms are needed to reduce the incentives of some countries to accumulate foreign exchange reserves beyond what is reasonably needed.
4. Making sure imbalance-related policy reforms are not hijacked by vested interests is vital. Deficit countries, for example, should not succumb to a patchwork of industrial policies dressed up as a national reindustrialisation strategy.¹ Neither can large imbalances serve as an excuse to impose capital controls beyond what is prudent from a domestic financial stability perspective.
 5. The fact that certain vested interests benefit from the same structural determinants of imbalances strongly suggests that international exhortation, monitoring, and peer pressure processes alone are unlikely to succeed. The limited success of the IMF's consultation exercise on global imbalances in the middle of the last decade bears out this point.
 6. Their limited (in principle, zero) financing needs means there is little automatic external pressure on surplus countries to adjust, besides a fear of a low return on foreign savings. A long-standing asymmetry in the international economy is that the market-driven pressures to adjust fall disproportionately on deficit countries.
 7. While there has been much mention of coordinated action to address global imbalances, to date the substantive basis of any inter-governmental deal, its political viability in each leading jurisdiction, and the trigger needed to bring such deliberations to a close remain elusive. Nor have reforms of the international financial system proceeded far enough to remove the incentives on the part of some countries to accumulate official reserves.
 8. In the absence of an international accord, policymakers must not succumb to fallacies of composition in assessing national policy options. The allure of deflationary solutions to current account deficits is far less when major trading partners are all taking similar steps.
 9. Other policy imperatives—such as fiscal retrenchment brought about by financial market fears regarding the sovereign solvency—can counteract measures to reduce or limit imbalances. Some surplus countries are cutting their government budget deficits which, everything else equal, will expand their current account surplus.
 10. Measures to promote private sector investment and to reduce personal and corporate savings will need to complement any fiscal retrenchment in surplus countries. Conversely, measures to increase savings have to be adopted in deficit countries. More generally, governments will have to decide how much priority to attach to reducing imbalances compared to other macroeconomic and structural objectives.

¹ Followers of the rebalancing debate in the UK and the US, two countries with current accounts that are large shares of their national incomes, will recognise the contemporary resonance of this particular example.

Box 1: Rebalancing and national service sectors

Any serious effort to rebalance the world economy must involve policies that will result in a significant expansion of the variety and quality of the services sector in both the rising economic powers and in deficit countries. It is a truism that modern economies are service economies. Over the last three decades, services have grown from roughly 55% of global GDP to some 70% for the world as a whole. The sector is also important by other measures, including employment shares, cost shares for industry, and sector share of overall FDI. But even though already large, much can and should be done to increase the productivity of services industries in both the OECD and the emerging markets. And much can and should be done to expand the scope for international trade in services.

Given that services are already – by far – the largest component of GDP, rebalancing by definition must involve services. Boosting manufacturing in high-income deficit countries can only make a marginal difference in terms of creating employment given that the sector accounts for only a small share of total value added. Moreover, the competitiveness of manufacturing firms in open economies is determined in (large) part by their access to low-cost and high-quality producer services inputs such as telecommunications, transport and distribution services, financial intermediation, etc. To a significant extent the boost to competitiveness that is needed in deficit countries such as Greece that cannot adjust the exchange rate will have to come through adjustments in real wages and through reductions in costs. As services account for most non-labour input costs, action to improve the efficiency of services must be a major focus of policy.

Boosting domestic consumption in surplus countries must also involve an expansion of demand for services – such as the retail sector, construction, the logistics needed to support consumption of a wider range of differentiated products, or services that improve the productivity of workers and firms: education, R&D services, health insurance, etc... This is not just an agenda to increase domestic final consumption. Improving the productivity and efficiency of national services industries can contribute to sustaining high rates of economic growth (Francois and Hoekman, 2010). Information technology and managerial innovations – such as outsourcing – and (then) new concepts of retailing such as the “big box” store format helped to transform and accelerate US productivity in these sectors. Differences in overall productivity growth of OECD countries can be explained to a large extent by variation in business services performance across countries.

Policy variables such as regulation, limits on entry into or scaling up of business services, investment restrictions, etc. affect services performance. Of particular importance is that barriers to trade and international investment are much higher in services than in goods. World Bank analysis has revealed that services barriers are much higher than those for trade in goods in many

countries (Gootiiz and Mattoo, 2009). Moreover, high-income countries are more open than developing countries, although some sectors such as transport and professional services are subject to high discriminatory barriers. Some of the most restrictive policies are found in the fast growing economies of Asia, including China, India, Indonesia, and Malaysia. Lowering these barriers would benefit consumers (households and firms) in these countries by increasing access to lower priced and/or new, differentiated services.

Services are on the table in the WTO Doha round of trade negotiations. As is well known, these negotiations have been at an impasse for several years now. One reason is that the talks have been almost exclusively on trade in goods – policies affecting market access for agricultural and non-agricultural products. Services have not been the focus of a concerted, serious effort to reduce barriers to trade and investment. Given that barriers to trade in manufactured products are low, and that more than 70% of GDP and employment is in services, it is perhaps not too surprising that strong business interest and support for the negotiations has not been very visible. The case for taking action to increase the contestability of services markets is strong in and of itself. But the need for action to rebalance the global economy greatly increases the salience and urgency of making progress in improving services trade and regulatory policies in high-income and emerging markets alike.

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**PART 1: How large are
contemporary current account
imbalances? Why do they persist?**

2 Adjustment in global imbalances and the future of trade growth

Caroline Freund
World Bank

Trade collapsed after the onset of the financial crisis. So too did global trade imbalances, falling 26% from 2007 to 2009. This article disentangles the direct effect of the trade drop on imbalances from the effect of rebalancing export and import growth. Measured several different ways, the bulk of the decline in global imbalances is a result of countries rebalancing export and import growth. This is good news because direct effects are very likely to be reversed as trade growth resumes, while rebalancing is more likely to be sustainable. Trade fell in most countries from 2007 to 2009, but four large emerging markets bucked this trend. In particular, Brazil, China, India, and Indonesia recorded positive import growth. These big, rapidly-growing countries are likely to be the engine for robust global trade growth in the coming years. This shift is consistent with investment seeking high returns in fast-growing economies—a more conventional pattern of capital flows.

Introduction

Global trade imbalances have surged since the early 1990s. Figure 1 shows an index of global trade imbalances—the sum of the absolute values of real trade balances across countries—and real global trade from 1970-2007.¹ Global imbalances grew by 11% a year on average from 1990 until 2007; in the previous 20 years, average annual growth was only 1%. In contrast, global trade grew at a strong and steady pace of about 6% a year over the whole period.

The expansion in global imbalances became a cause for concern in the new millennium, when they rose well above previous levels. The fear was that the immense capital flows associated with these imbalances could rapidly shift, leading to disruptive adjustments in importing countries. More recently, concern that imbalances reflected a global savings glut, resulting in an underpricing of risk, took center stage. This puts global imbalances as an important factor in the severity of the financial crisis (eg. Bernanke 2009 and Obstfeld and Rogoff 2009), and implies that a more stable financial system must involve more balanced capital flows.

¹ Data are from the World Bank's World Development Indicators and are in constant dollars. They are available from 1970-2007 for a balanced sample of 73 countries that made up about 85% of global trade in recent years. Data are in logs and normalised to start from zero.

A world with more balanced capital flows has important implications for bilateral trade flows and global trade growth. With more balanced capital flows, the US can no longer be a rapidly growing market for the world's production and China cannot maintain export growth at pre-crisis levels. While the focus on global imbalances has been largely on the US and China, they are not alone in the recent pattern of capital flowing from the developing to the developed world. Many other East Asian nations, oil exporting countries, as well as a few Latin American countries have had large and rising surpluses in recent years; while several other high-income countries, such as Greece, Spain and the UK, have been running large and growing trade deficits. With more balanced capital flows, it is not obvious which countries will drive future trade growth.

Indeed, the financial crisis has already shocked trade patterns, leading to a reduction in real trade of 12.2% in 2009 (WTO 2010), a magnitude unseen since the great depression.² As trade fell global imbalances also retreated. An important question is whether this is a short-run phenomenon or a structural change brought about by the crisis.³ If it is a short-run change, many of the same issues that plagued the financial system in recent years are likely to reemerge. If it is a shift to more balanced flows, it likely represents a move to a more stable global financial system. But in this case, trade patterns will look very different in the future and trade growth will need a new driver.

In this article, we examine the extent of rebalancing of trade that the crisis has generated and whether it is sustainable. Unlike other papers on current account adjustment, we approach the question from the real side.⁴ First, we examine how trade balances have adjusted following the financial crisis. Specifically, we calculate how much of the adjustment is a result of the drop in trade and how much is a result of rebalancing between export and import growth. We argue that rebalancing likely reflects shifts in attitudes to saving and investment in these countries, while a shift due to the drop in trade is likely to be reversed as global income expands. We find that the bulk of adjustment is a result of rebalancing.

Second, we examine which countries are well positioned to drive future trade growth. We find four large emerging market countries have fared remarkably well in the crisis: Brazil, China, India and Indonesia. In these countries, imports in 2009 increased above pre-crisis levels. Standard economic models imply that these rapidly-growing emerging markets should be net importers of capital and goods; however, all but India have been running sizable trade surpluses in recent years. Conditions may have now changed such that more typical patterns of global trade and investment reemerge. This would imply rapid growth in imports in these large emerging markets, as they become the future of trade growth.

2 This drop so stunned trade economists that a good deal of research has gone into understanding why the decline was so spectacular (Francois and Woerz (2009), Freund (2009), Eaton et. Al. (2010)).

3 Baldwin and Taglioni (2009) argue that a strong recovery has followed the sharp drop in trade, and that it is likely to be accompanied by the same worrisome global imbalances that defined previous years.

4 For example, Blanchard and Milesi-Ferretti (2009) examine how imbalances have adjusted based on changes in savings and investment patterns across countries.

The decline in global imbalances: Rebalancing versus the trade collapse

The financial crisis brought about a reversal in the large and growing global imbalances that characterised trade in the years that preceded it. In part, this is purely mechanical. The large drop in trade that occurred in 2009 will cause trade imbalances to retreat if it affects exports and imports proportionately. This suggests that if conditions improve, the worrisome pattern of growing imbalances is likely to re-emerge.

Part of the contraction in imbalances is not mechanical but is due to rebalancing of imports and exports. Countries with large trade deficits have reduced imports to a far greater extent than exports, while countries with large surpluses have reduced exports by relatively more. This type of adjustment is more likely to be sustainable, as it reflects changes to rates of savings and investment.

Finally, in some countries trade flows continued diverging as global trade fell (eg. the smaller flow shrank by relatively more). To examine the importance of the drop in trade, rebalancing and diverging flows, we calculate the contribution of each to the decline in global and country imbalances.

We use aggregate trade data from various sources in nominal dollars for 86 countries, with data through 2009, which together account for over 85% of world trade. Total exports from this group dropped by 11% and total imports by 12%, suggesting that net exports should also drop by at least 11% in the average country.

First, we examine how the global trade imbalance was affected. As noted in the introduction, the global trade imbalance is defined as the sum across countries of the absolute values of their trade balances. For the sample, the global trade imbalance fell by 26%, from 2007 to 2009. Given that aggregate trade fell by about 11%, the trade drop contributed to about 42% of the decline in the global trade imbalance. This means that together rebalancing and diverging flows made up the other 58%. If we separate diverging trade growth from rebalancing, we find that rebalancing contributed to 78% of the reduction of the global trade imbalance. Diverging trade growth contributed to expanding the global trade imbalance by 20%.

Looking at the global trade balance puts more weight on large countries. It also reflects the magnitude of the “global savings glut” well. However, it could be that only large countries are adjusting, and others countries are still increasing imbalances. We next examine what adjustments look like across countries and in the typical country.

Table 1 shows for each country how much of the adjustment in the trade balance is due to the drop in trade, how much is a result of rebalancing, and how much is a result of diverging trade flows. We split the countries into two groups, those where trade imbalances improved and those where they worsened from 2007 to 2009.

In 59 out of 86 countries (or 69%) there was a reduction of imbalances, i.e. smaller surplus or smaller deficit following the crisis. We find that in the typical country, over two-thirds of the improvement in the trade imbalance is a result of

rebalancing, no matter if we define the trade drop as a country's average change in trade ($(\% \Delta \text{imports} + \% \Delta \text{exports})/2$) or the average change in global trade. Moreover, in countries of special interest, such as the US and China, we observe significant rebalancing occurring. Several other large surplus countries, such as Chile, Germany, Indonesia and Singapore, also recorded sharp rebalancing effects; while large deficit countries, such as Spain, the UK, and many Eastern European countries saw major shifts away from imports. These are positive signs because as trade expands after the crisis, rebalancing is required to maintain global balances. An adjustment in trade balances that is entirely a result of the drop in trade is unlikely to be sustainable.

In the remaining 27 countries imbalances swelled. In these countries, the trade drop caused imbalances to shrink by 10-34% in the typical country, but this was more than offset by diverging trade growth.

Overall the news on rebalancing is positive. In over 75% of the countries for which 2009 trade data are available, imbalances improved. For these countries, about two thirds of the reduction in global imbalances that has occurred in the typical country is a result of rebalancing. This is not just a small country phenomenon. Examining the global trade imbalance, which puts more weight on larger imbalances, we also see that three-quarters of its decline stems from rebalancing. In sum, the trade drop was not the main reason behind the improvement in trade balances in 2009; rather, the majority of countries tended to rebalance trade flows significantly.⁵

Rebalancing across countries and future trade growth

This section examines how rebalancing is happening and the implications for future trade growth. Rebalancing can happen in three different ways. (i) both imports and exports decline, and the larger flow decreases by relatively more than the smaller flow, (ii) the larger flow declines and the smaller flow increases, or (iii) both flows expand, and the large flow expands by relatively less than the smaller flow. The three modes have different impacts on global trade growth. The first and second suggest that trade growth may stagnate in the near term as trade flows adjust, while the third offers a future with both positive trade growth and declining imbalances.

Table 2 shows the change in exports and imports from 2007 to 2009, for deficit and surplus countries separately. For most countries, both flows decreased and trade imbalances declined by relatively more because the bigger flow fell by a larger amount, the rebalancing effect. However, in some countries, we observe an increase in exports, imports, or both exports and imports following the crisis. And several of these are big countries. Imports increased in Brazil and China. And in India and Indonesia both exports and imports increased. These are four of the five largest countries in the world by population, and together make up

⁵ This is consistent with Blanchard and Milesi-Ferretti (2009). They examine global imbalances during the crisis from a macro perspective and find that significant adjustment in savings and investment patterns have occurred.

over 40% of the World's population. These are fast growing countries that should (in theory) be running external deficits and importing heavily for future growth. Together, they account for 15% of the global trade imbalance in 2009.

To see how these countries diverged from the rest of the world, Figure 2 shows imports on a log scale and adjusted to begin at the same point in 2006. These four countries have seen a strong and similar bounce back in imports, one that is much sharper than has been observed in the rest of the world.

Together with the rebalancing of imports and exports that has occurred, this is a very positive sign. These large emerging markets are the future for trade growth. In a textbook world, capital should flow from rich to poor countries. These fast-growing emerging economies should be importing raw materials, intermediate inputs, and machinery to fuel their growth—and, as they grow, ever more consumer goods. More reliance on domestic demand and less on export-led growth is likely to be good for their economies as well as for global trade.

Conclusion

In the coming years, global imbalances must be limited to ensure financial stability. This has important implications for trade patterns and trade growth.

Fortunately, a new system of global trade is already emerging, with large and growing emerging markets absorbing capital and goods from the rest of the world. In particular, Brazil, China, India, and Indonesia have demonstrated resilient import growth through the financial crisis. They have done this despite sizeable exchange rate depreciation in some countries when the crisis began (e.g. Brazil, Indonesia), and without extensive fiscal support.⁶ Financial stability and continued trade growth rely on this being the beginning of a new and more conventional global system. The fast growing economies will attract global investment with higher yields, and increasingly import raw materials and machinery for future growth.

While the adjustment process from a trade perspective is moving in a positive direction, some risks remain. Among these are a return to low savings in the US and a reemergence of large imbalances. In China, there is a danger that the import strength is temporary, as relatively cheap natural resources are purchased for future use, and domestic consumption does not expand in a sustainable way. Without these two countries participation, the new pattern of trade cannot take hold.

A market-driven exchange rate in China would help reduce these risks. A real appreciation of the Renminbi would make imports more affordable and exports less competitive, and China's large trade surplus would decline. China has already facilitated some real appreciation during the crisis through fiscal stimulus and ultimately rising wages and prices (Barboza 2010). A gradual move to more exchange rate flexibility will keep domestic demand on track and promote stable prices. This would be a win-win for both China and the rest of the world.

⁶ Only China has a large stimulus in 2009 (2.% of 2008 GDP). In Brazil, India, and Indonesia rates are 0.3, 0.5, and 1.3, respectively (Prasad and Sorkin 2009).

Lastly, a comment on trade policy and imbalances. While some policymakers see protectionism as a tool against trade deficits, it is highly unlikely to be effective. Unless trade barriers affect savings and investment, they cannot alter the trade balance. In a similar vein, more trade liberalisation will not lead to expanding imbalances. As shown in Figure 1, trade has expanded steadily with and without growing imbalances. Opening markets to goods and services facilitates the movement of resources to their most productive uses, raising income levels. It also raises income growth by expanding returns to investment in high-productivity firms and sectors. It is important that efforts to liberalise—unilaterally, multilaterally, and regionally—are kept on track during this period of global uncertainty.

The views presented here are the views of the author and not the views of the Board of the World Bank.

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Table 1. Change in imbalances due to trade drop, rebalancing, and diverging growth

| Share calculated using: Country | Country average trade growth | | Global trade growth | | dNX (MI U\$) | dNX/ NX | NX07/ GDP07 |
|------------------------------------|------------------------------|-------------|---------------------|-------------|-----------------|------------|----------------|
| | Trade Drop | Rebalancing | Trade Drop | Rebalancing | | | |
| Algeria | -10.5 | 110.5 | 14.3 | 85.7 | -26,600 | -82 | 23.21 |
| Australia | -7.2 | 107.2 | 16.6 | 83.4 | 11,600 | -70 | -2.01 |
| Austria | 1.4 | 98.6 | 1.1 | 98.9 | -5,564 | -1,044 | 0.14 |
| Bolivia | -56.4 | 156.4 | 37.5 | 62.5 | -403 | -31 | 9.93 |
| Bosnia and Herzegovina | 58.1 | 41.9 | 90.0 | 10.0 | 724 | -13 | -37.12 |
| Brazil | -0.7 | 100.7 | 30.6 | 69.4 | -15,300 | -38 | 3.08 |
| Bulgaria | 38.8 | 61.2 | 26.8 | 73.2 | 4,392 | -44 | -25.00 |
| Canada | 17.7 | 82.3 | 10.4 | 89.6 | -44,600 | -113 | 2.83 |
| Cape Verde | -334.9 | 434.9 | 102.3 | -2.3 | 82 | -11 | -51.29 |
| Chile | 36.8 | 63.2 | 28.1 | 71.9 | -9,960 | -42 | 14.94 |
| China | -7.5 | 107.5 | 47.5 | 52.5 | -64,600 | -25 | 7.71 |
| Colombia | -4.4 | 104.4 | 12.1 | 87.9 | 2,804 | -97 | -1.38 |
| Croatia | 81.8 | 18.2 | 57.4 | 42.6 | 2,746 | -20 | -22.88 |
| Cyprus | 98.1 | 1.9 | 119.4 | -19.4 | 709 | -10 | -34.45 |
| Dominican Republic | 164.9 | -64.9 | 129.0 | -29.0 | 735 | -9 | -19.75 |
| Ecuador | -0.6 | 100.6 | 2.9 | 97.1 | -1,724 | -403 | 0.93 |
| El Salvador | 39.8 | 60.2 | 43.6 | 56.4 | 1,270 | -27 | -23.64 |
| Estonia | 34.8 | 65.2 | 15.2 | 84.8 | 3,580 | -77 | -22.19 |
| Faroe Islands | 11.3 | 88.7 | 12.7 | 87.3 | 248 | -92 | n.a. |
| Finland | 38.4 | 61.6 | 16.0 | 84.0 | -6,105 | -73 | 3.33 |
| Germany | 47.5 | 52.5 | 40.8 | 59.2 | -76,800 | -29 | 8.09 |
| Honduras | -2.7 | 102.7 | 59.5 | 40.5 | 814 | -20 | -34.49 |
| Hungary | 0.4 | 99.6 | 0.3 | 99.7 | 5,758 | -4,089 | -0.10 |
| Iceland | 25.5 | 74.5 | 9.6 | 90.4 | 2,378 | -122 | -9.73 |
| Indonesia | -31.9 | 131.9 | 23.3 | 76.7 | -19,900 | -50 | 9.21 |
| Israel | 26.3 | 73.7 | 24.1 | 75.9 | 4,951 | -49 | -6.00 |
| Italy | 37.5 | 62.5 | 22.5 | 77.5 | 6,024 | -52 | -0.55 |
| Japan | 21.3 | 78.7 | 17.0 | 83.0 | -63,200 | -69 | 2.09 |
| Jordan | -18149.9 | 18249.9 | 26152.3 | -26052.3 | 4 | 0 | -53.21 |
| Kazakhstan | 807.7 | -707.7 | 828.5 | -728.5 | -212 | -1 | 15.00 |
| Latvia | 34.9 | 65.1 | 16.4 | 83.6 | 5,208 | -71 | -25.23 |
| Lithuania | 19.4 | 80.6 | 15.5 | 84.5 | 5,498 | -76 | -18.65 |
| Luxembourg | 379.4 | -279.4 | 231.1 | -131.1 | 310 | -5 | -12.24 |
| Malta | 289.1 | -189.1 | 143.1 | -43.1 | 145 | -8 | -23.90 |
| Mexico | 30.2 | 69.8 | 21.9 | 78.1 | 5,396 | -54 | -1.01 |
| Moldova | 77.6 | 22.4 | 95.5 | 4.5 | 348 | -12 | -64.60 |
| Netherlands | 62.2 | 37.8 | 79.6 | 20.4 | -8130.3 | -15 | 7.09 |

| Share calculated using: Country | Country average trade growth | | Global trade growth | | dNX (MI U\$) | dNX/ NX | NX07/ GDP07 |
|------------------------------------|------------------------------|-------------|---------------------|-------------|-----------------|------------|----------------|
| | Trade Drop | Rebalancing | Trade Drop | Rebalancing | | | |
| New Zealand | 14.7 | 85.3 | 14.0 | 86.0 | 3274.1 | -83 | -3.02 |
| Norway | 190.3 | -90.3 | 166.7 | -66.7 | -3925.9 | -7 | 14.33 |
| Pakistan | 8.4 | 91.6 | 151.1 | -51.1 | 1,189 | -8 | -11.00 |
| Peru | -6.3 | 106.3 | 40.2 | 59.8 | -2,413 | -29 | 7.53 |
| Philippines | 297.4 | -197.4 | 150.7 | -50.7 | 392 | -8 | -3.61 |
| Poland | 14.1 | 85.9 | 22.2 | 77.8 | 13,500 | -53 | -5.98 |
| Portugal | 1269.0 | -1169.0 | 1115.6 | -1015.6 | 281 | -1 | -12.18 |
| Romania | 20.7 | 79.3 | 21.5 | 78.5 | 16,300 | -54 | -17.59 |
| Russian Federation | 96.7 | 3.3 | 79.3 | 20.7 | -19,300 | -15 | 10.08 |
| Senegal | -71.9 | 171.9 | 61.8 | 38.2 | 630 | -19 | -30.23 |
| Singapore | 24.3 | 75.7 | 35.0 | 65.0 | -12,100 | -33 | 21.24 |
| Slovakia | 6.3 | 93.7 | 4.4 | 95.6 | 2,766 | -263 | -1.25 |
| Slovenia | 34.4 | 65.6 | 22.8 | 77.2 | 1,494 | -51 | -6.19 |
| South Africa | 18.4 | 81.6 | 14.6 | 85.4 | 7,796 | -80 | -3.47 |
| Spain | 36.8 | 63.2 | 24.1 | 75.9 | 66,000 | -49 | -9.71 |
| Sweden | 80.2 | 19.8 | 42.4 | 57.6 | -4,280 | -28 | 3.44 |
| Tanzania, United Republic of | -302.7 | 402.7 | 114.1 | -14.1 | 406 | -10 | -23.26 |
| Turkey | 28.7 | 71.3 | 30.6 | 69.4 | 24,000 | -38 | -9.66 |
| United Kingdom | 71.6 | 28.4 | 39.9 | 60.1 | 53,200 | -29 | -6.46 |
| United States | 40.0 | 60.0 | 31.9 | 68.1 | 290,000 | -37 | -5.65 |
| Yugoslavia | 45.5 | 54.5 | 56.2 | 43.8 | 2,027 | -21 | n.a. |
| Zambia | 40.1 | 59.9 | 78.5 | 21.5 | -91 | -15 | 5.55 |
| Median | 28.7 | 71.3 | 31.9 | 68.1 | 629.6 | -36.7 | -3.6 |

| Imbalance-Widening Countries | Trade Drop | Diverging Growth | Trade Drop | Diverging Growth | | | |
|------------------------------|------------|------------------|------------|------------------|---------|-------|--------|
| Albania | 42.6 | 57.4 | -106.9 | 206.9 | -341 | 11 | -28.35 |
| Argentina | -13.9 | 113.9 | -23.5 | 123.5 | 5,614 | 50 | 4.35 |
| Armenia | -83.0 | 183.0 | -78.5 | 178.5 | -333 | 15 | -24.30 |
| Azerbaijan | 3.1 | 96.9 | -0.5 | 100.5 | 8,224 | 2,376 | 1.05 |
| Belarus | -9.9 | 109.9 | -18.1 | 118.1 | -2,863 | 65 | -9.82 |
| Belgium | -352.7 | 452.7 | -284.4 | 384.4 | 718 | 4 | 3.80 |
| Czech Republic | -11.4 | 111.4 | -13.5 | 113.5 | 3,716 | 86 | 2.53 |
| Denmark | -9.8 | 109.8 | -9.2 | 109.2 | 5,685 | 128 | 1.44 |
| Egypt | 53.4 | 46.6 | -11.5 | 111.5 | -11,000 | 101 | -8.38 |
| Ethiopia | 83.3 | 16.7 | -12.5 | 112.5 | -4,238 | 94 | -23.85 |
| France | -350.4 | 450.4 | -322.8 | 422.8 | -2,116 | 4 | -2.25 |
| French Polynesia | -19.7 | 119.7 | -121.6 | 221.6 | -138 | 10 | n.a. |
| Hong Kong | -28.3 | 128.3 | -50.6 | 150.6 | -5,426 | 23 | -11.19 |
| India | 41.9 | 58.1 | -81.5 | 181.5 | -10,000 | 14 | -5.81 |

| Share calculated using: Country | Country average trade growth | | Global trade growth | | dNX (MI U\$) | dNX/ NX | NX07/ GDP07 |
|------------------------------------|------------------------------|-------------|---------------------|-------------|-----------------|------------|----------------|
| | Trade Drop | Rebalancing | Trade Drop | Rebalancing | | | |
| Ireland | -33.0 | 133.0 | -23.2 | 123.2 | 18,000 | 50 | 13.73 |
| Korea, Republic of | -3.3 | 103.3 | -6.6 | 106.6 | 25,800 | 176 | 1.46 |
| Macao | -299.3 | 399.3 | -76.3 | 176.3 | -565 | 15 | -19.39 |
| Macedonia, FYR | -45.5 | 145.5 | -45.6 | 145.6 | -480 | 26 | -23.69 |
| Malaysia | -100.0 | 200.0 | -91.1 | 191.1 | 3,825 | 13 | 15.68 |
| Mauritius | -154.8 | 254.8 | -203.1 | 303.1 | -96 | 6 | -22.30 |
| Mozambique | 4.1 | 95.9 | -7.6 | 107.6 | -979 | 154 | -7.97 |
| Paraguay | 78.2 | 21.8 | -53.5 | 153.5 | -677 | 22 | -25.80 |
| Switzerland | -2.3 | 102.3 | -19.9 | 119.9 | 6,348 | 59 | 2.51 |
| Taiwan, Province of China | -246.5 | 346.5 | -153.0 | 253.0 | 2,044 | 8 | 6.79 |
| Thailand | -7.7 | 107.7 | -33.9 | 133.9 | 4,796 | 34 | 5.56 |
| Uruguay | 44.7 | 55.3 | -24.6 | 124.6 | -369 | 48 | -3.23 |
| Zimbabwe | -3.4 | 103.4 | -2.8 | 102.8 | -1,092 | 425 | n.a. |
| Median | -9.9 | 109.9 | -33.9 | 133.9 | -333.3 | 34.5 | -3.2 |
| Median Full Sample | 18.0 | 82.0 | 16.8 | 83.2 | 370.2 | -14.8 | -3.5 |

Source: Datastream, WITS, World Development Indicators, National Statistics-Republic of China (Taiwan), and author's calculations.

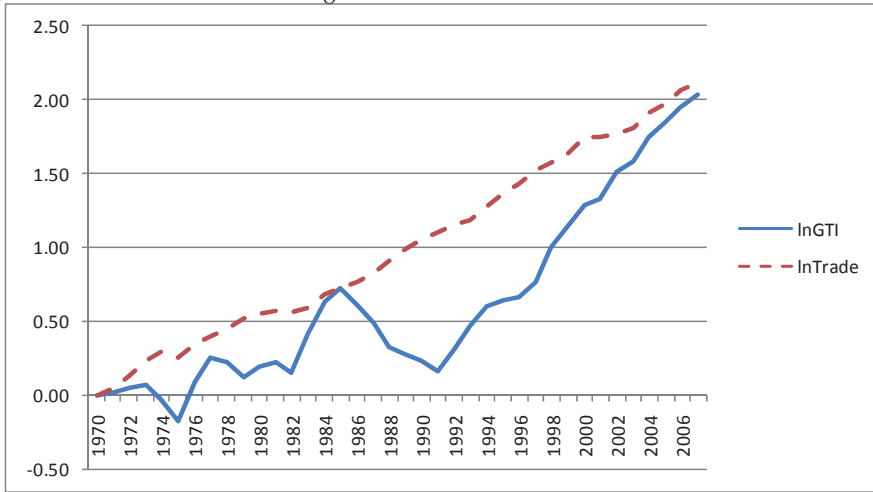
Table 2. Import and export growth 2007-2009, by country (sorted by import growth)

| Deficit Country | NX07/ GDP07 | dx/x | dm/m | Surplus Country | NX07/ GDP07 | dx/x | dm/m |
|-----------------|----------------|--------|--------|--------------------|----------------|--------|--------|
| Iceland | -9.59 | -15.78 | -46.60 | Ireland | 13.67 | -5.18 | -28.11 |
| Latvia | -25.43 | -10.20 | -39.49 | Finland | 3.39 | -30.35 | -25.96 |
| Estonia | -21.73 | -17.98 | -35.49 | Faroe Islands | 0.00 | 2.08 | -22.88 |
| Lithuania | -18.71 | -4.01 | -25.34 | Sweden | 3.42 | -22.42 | -21.89 |
| Spain | -9.44 | -11.32 | -24.49 | Taiwan | 6.79 | -17.34 | -20.39 |
| Romania | -17.69 | 0.40 | -22.92 | Denmark | 1.44 | -9.36 | -15.64 |
| Bulgaria | -25.40 | -11.24 | -22.65 | Canada | 2.77 | -24.52 | -15.31 |
| United Kingdom | -6.47 | -19.58 | -22.43 | Malaysia | 15.94 | -10.47 | -15.23 |
| Philippines | -3.50 | -23.84 | -22.38 | Norway | 14.39 | -11.73 | -15.01 |
| United States | -5.76 | -9.10 | -20.26 | Belgium | 3.81 | -14.13 | -14.90 |
| Malta | -23.74 | -27.05 | -20.25 | Russian Federation | 10.11 | -14.39 | -14.18 |
| Italy | -0.55 | -19.17 | -19.92 | Yugoslavia | 0.00 | -5.44 | -13.51 |
| Slovenia | -6.17 | -15.91 | -19.41 | Kazakhstan | 14.30 | -9.55 | -13.27 |
| South Africa | -3.42 | -10.53 | -19.04 | Argentina | 4.30 | -0.56 | -13.26 |
| Slovakia | -1.25 | -14.61 | -18.57 | Austria | 0.14 | -16.09 | -12.58 |
| Hungary | -0.10 | -12.31 | -18.36 | Germany | 8.07 | -15.34 | -11.94 |
| Croatia | -23.00 | -15.35 | -17.98 | Czech Republic | 2.47 | -8.16 | -11.60 |
| Turkey | -9.69 | -4.79 | -17.13 | Japan | 2.10 | -18.42 | -10.96 |
| New Zealand | -2.92 | -7.42 | -17.08 | Chile | 14.61 | -20.94 | -9.71 |
| Luxembourg | -12.28 | -21.47 | -16.97 | Korea, Republic of | 1.40 | -2.14 | -9.46 |
| Mexico | -0.99 | -15.51 | -16.87 | Netherlands | 7.12 | -9.49 | -8.81 |

| Deficit Country | NX07/ GDP07 | dx/x | dm/m | Surplus Country | NX07/ GDP07 | dx/x | dm/m |
|----------------------|----------------|--------|--------|------------------|----------------|--------|--------|
| El Salvador | -23.21 | -4.69 | -16.72 | Singapore | 21.62 | -9.75 | -6.51 |
| Israel | -6.10 | -9.23 | -16.38 | Zambia | 5.35 | -6.61 | -5.35 |
| Macao | -19.80 | -77.88 | -13.89 | Thailand | 5.63 | -0.89 | -4.40 |
| Dominican Republic | -19.59 | -17.41 | -12.51 | Switzerland | 2.53 | 0.59 | -3.32 |
| France | -2.25 | -13.52 | -11.89 | Mayotte | 0.00 | -13.22 | 0.51 |
| Moldova | -64.56 | -7.78 | -11.23 | Zimbabwe | 0.00 | -31.60 | 2.47 |
| Poland | -6.04 | -3.61 | -11.20 | China | 7.76 | -1.34 | 5.05 |
| Portugal | -11.98 | -15.85 | -10.78 | Brazil | 3.00 | -5.22 | 5.75 |
| Cyprus | -33.73 | -9.48 | -9.75 | Azerbaijan | 1.05 | 142.46 | 7.12 |
| Bosnia & Herzegovina | -36.57 | -5.36 | -9.74 | Peru | 7.71 | -3.58 | 7.23 |
| Cape Verde | -52.87 | 85.62 | -8.95 | French Polynesia | 0.00 | -11.24 | 7.44 |
| Honduras | -34.53 | 9.90 | -8.83 | Ecuador | 0.93 | -3.66 | 8.63 |
| Hong Kong | -11.34 | -7.52 | -5.57 | Bolivia | 9.84 | 10.06 | 25.19 |
| Mauritius | -22.21 | -12.93 | -4.92 | Indonesia | 9.17 | 2.11 | 30.02 |
| Macedonia | -23.61 | -19.81 | -3.53 | Algeria | 23.91 | -24.88 | 42.08 |
| Senegal | -29.37 | 30.47 | -3.25 | Median | 4.06 | -9.52 | -10.34 |
| Pakistan | -10.72 | 1.53 | -2.84 | | | | |
| Belarus | -9.76 | -12.33 | -0.45 | | | | |
| Colombia | -1.40 | 8.94 | -0.38 | | | | |
| Australia | -2.01 | 9.26 | 0.93 | | | | |
| Armenia | -24.29 | -28.15 | 3.41 | | | | |
| Jordan | -53.20 | 12.23 | 4.02 | | | | |
| India | -5.92 | 4.42 | 7.62 | | | | |
| Albania | -28.79 | 0.95 | 8.38 | | | | |
| Tanzania | -23.50 | 51.78 | 10.34 | | | | |
| Paraguay | -25.33 | 15.37 | 18.81 | | | | |
| Uruguay | -3.19 | 19.21 | 23.37 | | | | |
| Mozambique | -7.93 | -10.98 | 23.43 | | | | |
| Egypt | -8.33 | 42.35 | 66.07 | | | | |
| Ethiopia | -23.64 | 67.99 | 87.91 | | | | |
| Median | -11.98 | -9.48 | -11.89 | | | | |

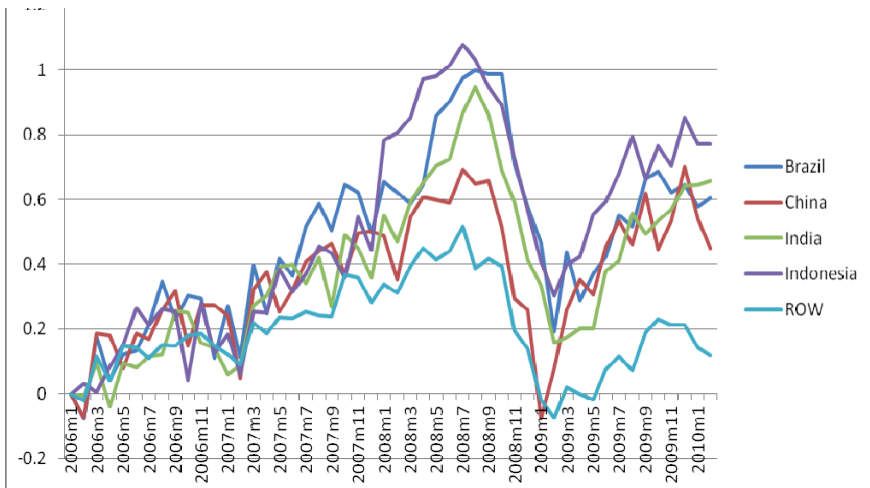
Source: Datastream, WITS, World Development Indicators, National Statistics-Republic of China (Taiwan), and author's calculations.

Figure 1. Global imbalances and global trade



Source: World Development Indicators.

Figure 2, Import growth in Brazil, China, Indonesia, and India versus rest of the World (ROW)



Source: Datastream, data in current dollars.

About the Author

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3 On the causes of global imbalances and their persistence: Myths, facts and conjectures

Joshua Aizenman
UCSC and NBER

This article discusses several myths related to the sources, desirability and sustainability of global imbalances, and their future. Higher volatility of economic growth, higher and more volatile risk premium, and demographic transitions towards aging populations and lower fertility rates imply that past patterns of global imbalances became even less sustainable following the end of the illusive great moderation.

Myth: *The dollar standard (i.e., the dominance of the dollar as the global currency) necessitates growing global imbalances, where the US runs current-account deficits.¹ Large current-accounts run by the US are not new, the US ran sizeable deficits from the onset of the Bretton Woods system, thereby funding the growing demand for the dollar as a reserves currency.*

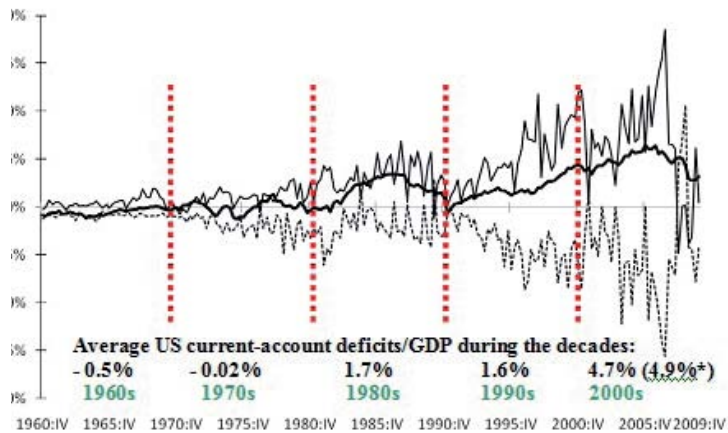
Not really. To illustrate, Figure 1 plots the US current-account/GDP deficit and private flows of capital during 1960-2009. The decade averages of the US current-account deficits/GDP are reported below the curves. During the 1960s, at a time when the dollar was the undisputed global currency, the US current account position was on average close to zero (or running small surpluses). The US current-account deficits started growing in the mid 1980s, a trend magnified during the 1990s, with deficits reaching a peak of 6% in 2006. The figure shows the fallacy of regarding global imbalances as a necessary requisite and consequence of the dollar role as global currency. Yet, the exorbitant privilege associated with the status of the dollar as a global currency (i.e., easy access of the US to foreign funding), the secular decline of public saving due to tax cuts that were not met with public spending cuts, reduction in private savings, and robust US investment induced larger global imbalances in recent decades.

Global imbalances deal with current-account patterns, whereas the dollar standard impacts the US balance of payments. With globalized capital flows, a

¹ These concerns are modern incarnation of the “Triffin dilemma,” – having the demand for global liquidity met by public asset issuance of one country makes it more challenging to achieve fiscal and external balance while providing an adequate amount of safe assets to the rest of the world. Improper management may lead to deflationary bias if insufficient reserves are provided or accumulation of an unsustainable debt overhang if too many reserves are supplied. See IMF (2009) for further discussion.

single country that provides the global asset could supply reserves to the rest of the world, while investing a similar gross amount in assets abroad and running a balanced current-account. This is vividly illustrated in countries where reserves have been accumulated in the face of strong capital inflows in recent years, without running significant current-account imbalances. Given central banks' preferences for government bonds, external balance would require that in the reserve-currency issuing country (dominated in recent years by the US), either the public sector accumulates foreign assets to balance foreign purchases or the

Figure 1. US current-account/GDP and private flows/GDP patterns, 1960-2010.



* The current-account deficit/GDP of the US during 2000-2007 (excluding the crisis years).

private sector offsets public sector dis-saving through increased net saving.²

Conjecture: Figure 1 is consistent with the view that global imbalances were of a second order magnitude at times of limited financial integration, as has been the case during 1950s-1970s. Quite trivially, global imbalances were close to zero with stringent capital controls. The growing global imbalances were the result of the growing financial integration among the OECD countries in the aftermath of the Bretton Woods system, and the gradual financial integration of emerging markets (starting in the 1990s), during decades of secular declines in US net saving (saving minus investment).

Figure 1 also alludes to the potential risk of growing global imbalances: financial integration has often been associated with heightened volatility of private capital inflows and outflows, thereby exposing the sustainability of global imbalances to market sentiments. As the recent years vividly demonstrated, orderly markets are subject to occasional unpredictable vertigos and freezes. Black Monday of 1987 was a small hiccup relative to the crisis that propagated globally from the

² The reluctance of the global reserve issuing country to follow these options tends to reduce the real interest rates in the reserve issuer. Should the reserve issuer's public sector be unwilling to accommodate the foreign demand, alternative reserve assets could arise.

US during the second half of 2008. Financial integration increased manifold the inter-connectivity of financial markets. Deeper networking of financial markets is good news in stable times, providing the illusion that short-term risk diversification implies long-term risk reduction (see Rajan (2005)).

The growing beliefs in the efficiency of private financial intermediation, and the redundancy of cumbersome public regulations contributed to the acceptance of global imbalances as an efficient allocation. The growing acceptance of global imbalances and US deficits perhaps reflected the belief that “the great moderation” is here to stay, implying that the downside risk of global imbalances is negligible. US was considered to have a “comparative advantage” in consumption and financial intermediation, while China and other emerging markets were considered to have a “comparative advantage” in net savings, in search of outside financial intermediation (Dooley et al. 2003). To recall, the great moderation referred to the drop in volatility and risk premium during the late 1990s and early 2000s. During that period, the risk-free interest rate declined substantially, reflecting a ‘savings glut’ as the US increased its net dis-saving while Asia increased its net saving (= saving minus investment, see Chinn and Ito (2008)). The remarkable increase in the relative prices of commodities and minerals during the early 2000s resulted in further increases in net savings of oil and commodity exporters, thereby reducing the real interest rate. The lower cost of risk, and lower interest rate, induced larger current account deficits by countries that were restrained from borrowing binges at times of higher interest rates, resulting in gradual build up of growing external liabilities of OECD countries (Portugal, Spain, Greece, US, etc.). In contrast, experience of countries is replete with examples of nations where inflows of capital and easy access to borrowing have not succeeded in delivering sustainable growth, and in due course led to crisis (Argentina in the 1990s, and Spain and Greece being the latest example).

Myth: *Low growth countries are not taking off due to shortage of foreign currency and saving. Hence, inflows of capital inducing larger currency account deficits (or smaller surpluses) would facilitate higher growth of poor countries.*

Not necessarily. Obstacles to growth include barriers to entry of new producers, labour market rigidities, and inflexible economic structures inhibiting financing and the proliferation of new activities. Numerous successful takeoffs were triggered by domestic reforms dismantling these barriers, allowing sizeable efficiency gains associated with rationalising the use of given resources. China’s and India’s remarkable growth takeoffs are the latest illustration of such factors. More than 90% of the capital dependence of emerging markets has been self financed (see Aizenman et al (2007) and Prasad et al. (2007)). Within a lag of less than a decade, successful takeoffs increase domestic saving, at rates that frequently are more than enough to finance capital deepening, resulting in current-account surpluses. In contrast, numerous countries that experienced inflows of capital and easy access to borrowing have not succeeded in delivering sustainable growth, inflows that led in due course to crises (Argentina in the 1990s, Greece being the latest example).

Myth: *Financial integration is a necessary condition for higher growth rates in developing countries.*

No clear cut evidence support this view. The first few decades of remarkable takeoffs of Japan, Korea, China and India took place during a time of financial repression, with scanty access to the global financial system. While multinationals have been important contributors to growth in several countries (including Ireland and China), Japan and Korea were and remain relatively closed to FDI. Greater financial integration seems to emerge endogenously as a part of the maturing process associated with a successful takeoff after several decades of convergence, possibly facilitating higher growth down the road, at the potential cost of higher exposure to volatility.

Myth: *Deepening financial integration is welfare improving.*

While financial integration is welfare improving in the absence of distortions, financial integration may reduce welfare if it ends up intensifying the cost of pre-existing distortions. A common distortion affecting financial intermediation is the 'moral hazard' and the 'too big to fail' doctrine, whereby large banks and shadow banks are bailed out during systemic crises. Under such circumstances, in the absence of proper banking supervision and proper leverage regulations, financial flows may increase the magnitude of distortions, thereby leading to deeper crises down the road and larger, costlier bailouts. During financial autarky, the resources funding such domestic activities are capped by the domestic wealth and local GDP. In contrast, with financial integration, the resources funding domestic activities are determined by the willingness of foreign parties to finance them. Availability of foreign funds frequently increases the pool of resources supporting domestic distorted activities, at a possible cost of larger external debt overhang, and deeper and more prolonged crisis down the road (Iceland being the latest example of this second best principle). See Aizenman (2004) for literature review.

Conjecture: Had the US been in financial autarky in 2000s, the massive tax cuts of the early 2000s would have resulted in significantly higher real interest rate in the US. To recall, these tax cuts took place at a time when taxes in the US were high enough to induce predictions of repaying the public debt of the US within two decades (sounds like a fairy tale today, but in 1999 the economic outlook for fiscal year 2000-2009 projected repaying the public debt within less than two decades). These tax cuts combined with lower growth rates during the 2000s led to growing US fiscal deficits, at times of declining US private saving, growing inflows of foreign funds, and low real interest rates.

The combination of financial deregulation, proliferation of growing leverage in the housing market, and floating interest-rate mortgages induced higher real estate demand in the US, thereby appreciating the US real estate evaluation, and

encouraging lower saving by households that treated housing capital gains as permanent. Had the US been in financial autarky, the real interest rate during the 2000s would have been higher, mitigating the increase in real estate valuation, and forcing a combination of higher private saving, lower investment, and fiscal adjustment. Related factors played a role in other countries – evidence points out that current-account deficits have been associated with more appreciated real estate valuation in the deficit countries, controlling for conventional factors affecting for real estate valuation (Aizenman and Jinjark, 2009).

The inflows of capital to the US prolonged the period of low saving in the US, and magnified the duration of the real estate appreciation, deepening the global crisis induced down the road by the growing weaknesses in the US housing market in 2007. Financial distortions in the US were manifested by the growing laxity of borrowing standards, exemplified by the proliferation of mortgages with zero (even negative) down payments. The rise of bundling and securitisation of mortgages reduced the “skin in the game” of mortgage suppliers, changing the business model of mortgage originating banks from risk assessors providing enduring financial intermediation to a commission-based business. In this new environment, profits were determined by the volume of mortgages initiated, and not by its quality (i.e., the successful service of these mortgages). These developments intensified the moral hazard and the exposure to vulnerabilities associated with lower quality of financial intermediation in the US. While all these developments could very well have happened during financial autarky, the resultant real estate appreciation and the duration of the spell of easy borrowing were magnified by financial openness, leading to a deeper, costlier and globalised crisis down the road.

Conclusion: the welfare effects of financial integration and financial innovations follow an inverted U shaped curve – moving too fast towards deepening financial integration without the proper regulatory supervision tends to backfire.

Myth: *Global imbalances caused the crisis of 2008-9.*

Causal associations in macroeconomics are conjectural, at best. Banking and financial crises may happen in closed economies, as they stem from maturity and liquidity mismatches that exist independently of global imbalances. Having noted these caveats, the discussion above suggests that global imbalances played a role in prolonging the pre-crisis period. The pre-crisis period was a time when easier availability of finance in the US and prevalence of financial deregulation facilitated a longer spell of growing fiscal imbalances and easier real estate financing, which in turn contributed to a longer duration of real estate appreciation, implying a deeper crisis down the road. What could have been a local crisis in the US during financial autarky with global transmission effects operating via relatively slow trade linkages, turned out to be a major global crisis in a financially integrated world, propagated globally through trade and fast moving financial channels (see Obstfeld 2010)).

Myth: *The return to global imbalances once the global recovery will take place is inevitable. Current-account trends are persistent, and don't change overnight.*

The US current-account/GDP deficit was halved during the crisis, dropping from about 6% in 2006 to 3% in 2009. Economic recovery in the US would increase investment, with uncertain effects on saving. The relaxation of forced private saving due to reduced access to borrowing during the peak of the crisis would reduce private saving, probably leading to larger US current-account deficits/GDP in future quarters. The ultimate intermediate-run trends of global imbalances would be determined by complex factors, including the possibility of fiscal adjustment needed to confront the growing fiscal imbalances, and the degree to which a shallow recovery will lead to higher private saving in order to replenish declining wealth.

The prospects for global imbalances

Looking forward, the prospect of sustaining the pre-crisis patterns of global imbalances after the crisis is dim. To recall, prior to the global crisis, the Chinese growth rate accelerated to 10% a year, at times when its current-account/GDP surplus increased in tandem to about 10%, and the US current-account deficits was about 5%. These trends were unsustainable - sustaining growth by China at rates largely exceeding that of all other countries, supported by large Chinese current account/GDP surpluses (of the 10% growth, 10% surplus variety) implies that all other countries should increase over time their current account/GDP deficits to match the Chinese surpluses (see Aizenman and Sun (2010) and Edwards (2007)). High debt overhangs have been associated with crises throughout history, and there is no reason to expect the 'end of history' (see Reinhart and Rogoff (2008)).

The persistence of current-account patterns does not imply that these patterns are unchangeable when market and political forces induce a rapid adjustment. To illustrate, South Korea made more than 10% adjustment of its current-account/GDP ratio within two years following the 1997-8 crisis. Similar adjustment was experienced in numerous countries forced by sudden-stop crises to adjust abruptly. This in turn suggests that countries experiencing current-account surpluses (China, Germany), or countries deemed as safe havens (the US) are subject to less abrupt changes in their current-accounts. Yet, political changes and crises would impact these countries as well.

After running close to a balanced current-account from 1960 to 1982, the US increased gradually its current-account/GDP deficits to 6% in 2006. This took place at a time when the illusive "great moderation" and the sharp decline in the price of risk allowed the market to take stock of rising global imbalances. The current global crisis illustrated that the spell of great moderation was a transitory hiatus. The end of the global moderation has profound implications on the future of global imbalances.

Prolonged global imbalances expose the global economy to greater vulnerabilities, as they increase the external debt of the deficit countries. Higher debt increases the odds that future volatility associated with spells of lower economic growth rates, or higher real interest rates would lead to sovereign debt crises.³ The end of the illusive great moderation implies that countries should be more vigilant in preventing prolonged global imbalances that might magnify future instability. Moreover, aging populations at times of lower birth rates would impose future challenges on countries running current-account deficits. While the current-account deficits of countries like Ireland, Spain and others were viewed as sustainable during the era of great moderation, the renewed volatility has increased the riskiness of these countries, calling for an adjustment that would mitigate the prospect of future costly crises.

It is tempting to argue that financial markets that underestimated the risk of current-account deficits, abruptly switched to overestimation of these risks (see the recent experience of Greece, Portugal and Spain). Yet, a more constructive interpretation of the recent events is that these countries serve as the “canary in the coalmine of global imbalance.” In the absence of proper adjustment in the next decade, the fiscal trajectory of the US and Europe are unsustainable. The low real interest that prevailed in the US during the past decade delays the time when market pressure would induce adjustment, at the cost of prolonging the illusion that global imbalances are sustainable and desirable. Once the real interest rate facing the US reaches levels comparable to the late 1990s, the rapidly growing flow costs of serving the US public debt/GDP and its external debt/GDP may lead to a funding crisis with adverse global ripple effects. Short of finding the political will to start the needed adjustment at times of low real interest rates, countries like the US may need a crisis to put in motion the needed fiscal adjustment. The choice facing the US in the next decades is stark. Either there will be an earlier internal adjustment under more controlled conditions, or there will be a deeper adjustment induced by a future funding crisis.

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4 Rebalancing in East Asia

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This chapter considers Asia's contribution to the global imbalances and the financial crisis as well as the sources of the region's imbalances. It suggests that its imbalances were caused by the combined effect of demographics, precautionary savings, high costs of residential property, underdeveloped financial sectors, widening income inequality, and high corporate savings. But still, the solution will require multilateral collective action as well as national rebalancing.

Asia's contribution to global macroeconomic imbalances and the financial crisis

After recovering from the Asian Financial Crisis of 1997-98, East Asian countries as a whole began running consistently large current account surpluses. The accumulated foreign exchange reserves served as a buffer against potential speculative attacks on their now-floating currencies, and as a means to manage those currencies in order to reduce volatility and maintain the international competitiveness of their heavily export-oriented economies.

Because the US was the largest final destination market for their exports—including intermediate exports routed through a regional manufacturing supply-chain vertically integrated across national borders—as well as home of the world's reserve currency, a large proportion of these Asian reserves were invested in US dollar assets. These included particularly US Treasuries, but also, via Asia's sovereign wealth funds, corporate assets.

The resultant capital inflow into the US and global markets, together with the US Fed's easy money policy, kept US and world interest rates low, funding ever-increasing US and some European government budget deficits and household debt. Cheap money also fuelled “financial innovations” such as subprime mortgages and other risky assets aimed at securing higher returns for investors and their financial intermediaries, which subsequently led to crisis.

The capital flow from Asia (and other e.g. commodity-exporting economies) also propped up the dollar and depressed Asian currencies, maintaining Asian export competitiveness, current account surpluses and reserve accumulations, while expanding US current account deficits and national indebtedness.

Sources of the Asian imbalances: Why do Asians save so much?

The serving US Fed chairman Ben Bernanke identified a “global savings glut” as the cause of these global macroeconomic imbalances. With only a few exceptions (most significantly, Singapore), excess public sector savings in the form of persistent government budget surpluses are not the source of the high savings in East Asia which lead to the observed current account surpluses. Japan notably runs large government budget deficits and has a huge national debt but still exports more than it imports from abroad, due to high savings in the private sector. The basic question is: Why do East Asians save so much, particularly at low levels of income?

Demographic profile is a major reason. Half a century of rapid economic growth at least initially predicated on female-labour-intensive export manufacturing resulted in sharp declines in fertility. With the bulk of the population in the prime working-age years, and high rates of female labour force participation, dependency ratios have been relatively low, leading to high household savings and correspondingly low shares of consumption in GDP.

With few descendants to support them in retirement (and high life expectancy in many Asian countries), as well as weak or non-existent social safety nets, there is a *high rate of precautionary savings* not only for retirement, but also for health care and children’s education. Some economies—Singapore, Malaysia, Hong Kong—have forced-saving schemes or national “provident funds” with high rates of mandatory contributions out of earned income.

Some researchers (e.g. Abeyasinghe and Choy 2004 for Singapore) have also identified the *high cost of residential property*—as measured by ratios of housing prices to years of annual income much higher than international norms at given per capita income levels—as a contributing factor to high savings and low current consumption rates. This is particularly exaggerated in China due to the extreme gender ratio imbalance resulting from its one-child policy, leading to what Wei and Zhang (2009) call “competitive savings” (among households with sons seeking scarce female spouses) which push up property prices for society as a whole.

Underdeveloped and inefficient (e.g. monopolistic) financial sectors in many Asian countries also ensure low returns for savers, necessitating a larger quantum of savings to yield the income required for retirement support and precautionary reasons. *Widening income inequality*, with China, Hong Kong, and Singapore now at the US levels of Gini coefficient (e.g. Lim and Lim 2010), also concentrates income among high-income earners who tend to be high savers.

Finally, *high corporate savings* are a major contributor to high aggregate national savings. In Asia these result from a number of structural features of the corporate sector. Large low-income China and small high-income Singapore represent the two extreme cases, with the lowest shares of labour (wages) in national income, and consumption ratios at or below only 40% of GDP (versus the Asian average of 55%). Moreover, in each case these shares have steadily declined over the past two decades. Malaysia ranks a close third.

Both China and Singapore are correspondingly characterised by high and rising shares in GDP of state-owned enterprises or government-linked corporations, and of multinational corporations—none of which have built-in incentives to distribute corporate income where it is produced, preferring reinvestment for growth. Multinationals are often beneficiaries of host country tax breaks or other investment incentives that reduce local income distribution, and are obligated to remit income overseas to their predominantly home-country shareholders.

In particular, in single- or dominant-party corporatist states like China, Singapore, and Malaysia, there is also little political pressure on state-owned enterprises and government-linked corporations to distribute their income to boost domestic consumption, or to privatise their holdings to local entrepreneurs who might present a challenge to continued state power. Elsewhere, the private sector is often dominated by closely-held public companies or family-owned conglomerates, both of which have little shareholder pressure or motivation to distribute rather than accumulate and reinvest corporate income for growth and expanded market share.

Policy solutions and their limitations

Most of the causes of high Asian household and corporate savings are structural rather than policy-driven, and thus cannot be easily or quickly unwound by government policy. Demographics obviously take a long time to change but have an impact when they do. As a population ages and large cohorts retire, they dissave, while gender imbalances narrow and disappear as affluence and education levels increase.

Financial sector reform should help rebalancing by increasing the efficiency and diversity of financial instruments, so that less savings are required to earn a target return for the investor. After the Asian financial crisis, privatisation and liberalisation of this sector was recommended to increase competition and develop capital markets. This did occur in some countries, most notably South Korea. Elsewhere banks remain dominant and became more conservative in their lending practices after the AFC. Furthermore, the experience of the Asian financial crisis made China reluctant to pursue capital account liberalisation.

Still, demographics and financial sector reform are probably responsible for the increased share of private consumption in GDP between 1990 and 2008 in the largely domestic private sector economies of Japan (rising from 53.2% to 57.8%), Taiwan (54.6% to 61.4%), Korea (50.9% to 54.5%) and Hong Kong (57.1% to 60.5%), whose populations aged significantly (and gender imbalances almost disappeared) over this period as their financial markets were liberalised. Consumption also increased (41.6% to 45.2%), but remained low, in Malaysia over this period.

The difference between Hong Kong and Singapore is striking, with private consumption in the latter declining from 46.3% of GDP in 1990 to 38.6% in 2007 (surpassed only by the decline in China from 50.6% to 36.4%). Besides the much higher share of state ownership and the practice of running surplus

government budgets in Singapore compared to Hong Kong, the decline in the wage and consumption share is probably due to the large and rising share of foreign labour—which (like multinationals) has an expected higher propensity to save its income for repatriation rather than domestic consumption (Lim and Lee, 2010).

The lack of a social safety net might partly explain high savings in relatively low-income China, but cannot explain continued high savings in high-income Singapore and Japan, where safety nets are adequate and financial markets relatively well-developed. Forced-savings schemes also do not seem to reduce rates of overall or voluntary private savings. In any event, developing a social safety net, especially for a vast and diverse country like China with administrative and perhaps political constraints, will take a long time, as will any attempt at reducing income inequality.

What about currency appreciation? In theory this should reduce the relative share of export to domestic market production, while increasing the share of imports for consumption, thus shrinking current account surpluses and foreign exchange reserve accumulation. However this has not happened despite the near-continuous appreciation of Asian currencies against the dollar over the last three decades, particularly in Japan and Singapore.

Political Constraints

The last two decades in East Asia have seen savings' high share of GDP decline in the “more democratic” countries of Japan, Korea, and Taiwan, but also in non-democratic Hong Kong. This is probably mostly due to demographic reasons largely beyond the control of government policy, with the exception of Singapore's migrant labour policy. But the inevitable acceleration of ageing and retirement will eventually make a major contribution to lower savings and thus to macroeconomic rebalancing away from export production and toward domestic consumption.

Financial sector liberalisation has helped rebalancing, but is still incomplete and likely to continue being retarded by a combination of post-Asian financial crisis and post- Global Crisis risk-aversion and ideological scepticism, nationalist objections, and resistance by domestic financial institutions to increased competition. Witness, for example, Japan's backtracking from the proposed privatisation of its postal savings institution, Korea's legal attacks on foreign transactions in its financial sector, and the continued dominance and even expansion of China's state-owned banks.

There is no evidence from East Asia to date that expanding social safety nets will significantly reduce savings, given that they have not done so in Japan and Singapore. There may also be governmental hesitation to do so, given ageing populations and the recent negative demonstration effect of fiscally unsustainable safety nets in Europe.

But it is the corporate restructuring necessary to reduce high corporate savings rates that is likely to prove most politically intractable, requiring authoritarian

and semi-authoritarian governments to relinquish state control of economic resources and activity on which their political power is partly based. At the same time there are risks that rapid privatisation especially in developing economies may simply give rise to private monopolies with a similar lack of incentive to distribute rather than save their earnings (e.g. as in the Gulf States and Russia).

On the other hand, the experience of the Global Crisis and international pressure to rebalance to prevent further crises, provide an external political stimulus and awareness of the necessity of multilateral collective action as well as national rebalancing. Domestic political pressures can also build from the popular criticism in both China and Singapore of the poor performance of sovereign wealth funds in their international investments, which have also raised some concerns in foreign host countries.

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PART 2: What are the systemic costs of imbalances?

5 The costs of global imbalances

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As global imbalances have receded among policymakers' priorities, this chapter warns they are no less a systemic threat to financial stability in the medium and longer term. Moreover, while deficit countries may accumulate unsustainable external debts, surplus countries face the unpalatable choice between inflationary pressures and extensive sterilisation. Policymakers should thus return with renewed vigour to implement the Pittsburgh framework

The global imbalances have receded among policymakers' priorities. Financial regulation has generated an epic legislative and lobbying battle in Washington as well as Europe, with significant transatlantic differences. Bank tax proposals have divided the G20. The sovereign debt crisis in the Eurozone has been at the top of macroeconomic policy concerns. Current account deficits and surpluses may seem less important. But they are no less a threat to financial stability in the medium and longer term.

The global imbalances are set to rise. The April 2010 World Economic Outlook probably understates the future path. The latest OECD outlook suggests that the sum of absolute values of current accounts as a percentage of world GDP will go back to about four-fifths of its 2007 level. The OECD baseline scenario shows the US current account deficit rising again to over 4% of GDP, with the Chinese surplus at 4%. The latter is again likely to be an underestimate. Chinese exports have been rising very sharply recently. Even if China allows some flexibility in the dollar-renminbi rate and it appreciates somewhat, this is likely to have only a small effect on the Chinese surplus.

Moreover, the euro is falling against the dollar, and the US is likely to recover faster than Europe. So the euro area and Chinese (more broadly, East Asian) surpluses will rise, and the US deficit will rise. The main uncertainty is the oil price and the surpluses of energy exporters, but the price is unlikely to fall from its current level, so those surpluses will continue. Note also that the OECD argues that fiscal consolidation alone would have little effect on the global imbalances.

There are few truly exogenous variables in economics. The costs of the global imbalances are costs associated with the factors that create them. These too are all endogenous. But the focus would be on savings-investment imbalances and exchange-rate misalignments. In China, we see an extremely low share of household disposable income in GDP, but despite this, high household savings ratios, as well as high corporate and government savings. There are signs of

serious pressure for major wage increases in China, and if these were generalised, they could have a substantial effect on household consumption, but it is too early to forecast this with confidence.

Germany too has low household consumption relative to GDP. The US, on the other hand, has a very large government deficit and relatively high consumption. US household savings ratios, which had risen somewhat with the crisis, now seem to be falling again.

Gruber and Kamin (2008) forcefully contest the view that imbalances arise from cross-country differences in financial development or the attractiveness of financial assets. And their view is consistent with the imbalances within the Eurozone and their consequences. Germany's financial system is not less developed than those of Ireland, Italy, Spain and Portugal. But the position of Germany in relation to these countries is otherwise analogous to that of China in relation to the US – the same macroeconomic differences, similar current account and capital flow patterns, the same dire consequences.

By far the major systemic cost of the global imbalances is the continuing threat they pose to financial stability. I have argued that global imbalances were the fundamental cause of the crisis (in Dewatripont et al., 2009). They interacted with the weaknesses of the financial sector, to be sure, but many of these long pre-date the developments of the period 2004-2007. The huge capital flows associated with the global imbalances simply overwhelmed the capacity of even the most sophisticated financial systems to intermediate them. And these capital inflows continue to make US markets very liquid, to keep interest rates down, and thereby contribute to underpricing risk (see also Bini-Smaghi 2009, Obstfeld and Rogoff 2009, Reinhart and Rogoff 2009¹). Again, German capital flows to the 'peripheral' countries of the Eurozone went to financial systems that could not intermediate them effectively and safely.

Everything is endogenous, so we cannot say that global imbalances 'cause' prolonged exchange rate misalignments, any more than those who blame undervaluation of the renminbi can claim that this is the cause of the global imbalances. Nor is it as obvious as many would argue that the renminbi is indeed significantly undervalued relative to some 'equilibrium' rate. But if exchange rates really are far from long-run equilibrium rates, we can count another systemic cost of the associated global imbalances: distortions of investment allocation both across and within countries.

Globally, capital exporters have been poor countries with high marginal productivities of capital (although Germany and Japan do not fit this story). The intermediation process has not channelled emerging market savings into emerging market investment, but rather into consumption and government expenditure in rich countries. Within countries, overvalued (undervalued) exchange rates generate overinvestment (underinvestment) in non-tradeables. Such distortions can have major long-run consequences.

1 A representative quote is, 'The US conceit that its financial and regulatory system could withstand massive capital inflows on a sustained basis without any problems arguably laid the foundations for the global financial crisis of the late 2000s. The thinking that "this time is different" – because this time the US had a superior system – once again proved false... Capital inflows pushed up borrowing and asset prices while reducing spreads on all sorts of risky assets...' (Reinhart and Rogoff, 2009)

If the global imbalances do settle even at the lower level forecast by the OECD, i.e., only 20% lower than in 2007, there will be growing trade tensions. So far, the G20's emphatic stand against protectionism may have had some effect. Although each of the major G20 countries has introduced significant trade restrictions since 2007, they have been limited relative to what had been feared.² But if the US trade deficit and unemployment both remain stubbornly high, this restraint is unlikely to continue. The calls for antidumping duties and other measures against China, in particular, are getting louder and more widespread by the day. US protectionism could get nasty. If the euro does continue to fall, however, there will at least be less protectionist pressure in the EU.

If the US deficits do rise, American growth rates do not recover strongly, interest rates rise in due course, and the dollar does not depreciate gradually, then the US' external debt dynamics will again look unsustainable. The imbalances will then raise the danger of a future large, abrupt drop in the dollar, which could be very destabilising to the world economy. This was the crisis that many macroeconomists did fear (Ferguson et al., 2007, Krugman 2007), but it did not happen. It still could.

Finally, we have two symmetrical problems for individual surplus and deficit countries. The former accumulate excess foreign exchange reserves. These have low yield and, for poor and emerging market countries, high opportunity costs. If the surplus country manages its exchange rate, it also faces the unpalatable choice between inflationary pressures and extensive sterilisation. Sterilisation typically has a high 'quasi-fiscal' cost, and forcing domestic banks to accumulate sterilisation bonds is not a way towards a healthy financial system.

Conversely, countries running sustained deficits – not just the US, but also, for example, some of the peripheral Eurozone countries – accumulate external debts. At some point, as for the US, these may appear unsustainable, and the markets will punish them.

Thus the costs of global imbalances are systemic and country specific, numerous, and very high. The imbalances are not benign reflections of underlying long-run equilibrium relationships. Policymakers should return with renewed vigour to implement the Pittsburgh framework.

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6 External imbalances: Costs and consequences of unsustainable trajectories

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Over the next several years, will recovery among the world's economies and regions portend a return to the wider and unsustainable external imbalances of the mid-2000s, or will the more sustainable path re-emerge? This chapter argues that if policymakers return to the familiar tools of undervaluing the currency and depending on the US consumer to support growth, global imbalances, resource misallocations, and future costs will all increase. What is required is a return to the dollar path pre-financial crisis and a continued focus on domestic demand, particularly in the US and China, but also on investment in emerging markets.

Before the 2008-09 financial crisis, global rebalancing was underway, albeit fragile and incomplete. The crisis itself, of course, shocked aggregate demand and raised risk aversion, together yielding a dramatic narrowing of the US external imbalance in particular (from \$706 billion in 2008 to \$420 billion in 2009). An important question for policymakers is: Over the next several years, will recovery among the world's economies and regions portend a return to the wider and unsustainable external imbalances of the mid-2000s, or will the more sustainable path re-emerge?

Why is global rebalancing important? In short, for both deficit and surplus nations, persistent external imbalances, and even more important, trajectories that widen those imbalances, imply demand and resource misallocations and a divorce of key relative prices (specifically the real exchange rate) from equilibrating forces. At some point, when relative prices do adjust, so too will consumption, investment, and production. Misallocations will unwind, which will be costly to wealth, production, employment, and overall domestic economic wellbeing. Adjustment costs are unlikely to be equally distributed across all countries and regions, nor within countries. Therefore, to the extent that persistent and widening external imbalances indicate underlying relative price, demand, and resource misallocations, policymakers should take note and should move toward global rebalancing.

Evidence of rebalancing before the crisis from three perspectives

Why focus on external imbalances? After all, whether in deficit or surplus, or as measured by composition of exports, imports, or financial flows, a country's external balance is not a fundamental economic force in itself, but is a manifestation of the general equilibrium interaction between many factors: domestic consumption and investment and production; prices, rates of return, and the exchange rate; international financial portfolio choice and capital flows; and fiscal, monetary, and development policies.

However, as in the parable of the blind men and the elephant, looking at external balances from several different perspectives does illuminate aspects of the more fundamental drivers over which policymakers exert some control. The three perspectives are: (1) savings and investment based on national income and product accounts; (2) international trade flows in goods and services and the current account; (3) international capital flows and holdings of financial assets (Mann 2002). Taken together, the three perspectives present a consistent, coherent, and mutually reinforcing view of the sources and consequences of external imbalances.

Looking through these lenses, before the onset of the financial crisis, evidence pointed to some progress toward global rebalancing. For example, for the US, the real trade-weighted exchange value of the dollar had depreciated nearly 25% from early 2002, and the current account as a share of GDP had narrowed from its high of nearly 6% in 2005-2006 to less than 5% as of mid-2007. The domestic savings-investment lens showed a more mixed picture, with less adjustment. household savings still hovered near 0-1% of GDP, and the fiscal deficit had turned from narrowing through 2006 to widening again, to close to 2% of GDP by the end of 2007. On the other hand, international capital flows of more than \$2 trillion remained robust across all types of instruments, and easily 'over-financed' the current account deficit (Mann 2008, 2005).

In other parts of the world, some efforts to rebalance also were apparent. For example, in China, the renminbi peg was loosened in mid-2005 and had appreciated 12% against the dollar in nominal terms. China's net exports were diversifying toward Europe as well as to the US. On the other hand, over that time period, China's current account continued to widen from about 7 to 11% of GDP (even more dramatic considering that the current account/GDP was less than 4% in 2004) and, whereas household consumption was growing rapidly, as a share of GDP, it fell to around 35% of GDP (from 45% in 2000) (Bergsten, Freeman, Lardy, Mitchell 2009). Even with the adjustment in the renminbi peg, China's holdings of US treasury and agency securities nearly doubled from 2005 to 2007 (US Treasury, various years).

From the standpoint of these two large economies, while some rebalancing was underway before the financial crisis, the adjustment was fragile and incomplete. Trajectories of household consumption, too much in the US and too little in China, proved resilient to change, as is generally the case for habits. Policymakers only fitfully faced the challenges of fiscal discipline and moving to a neutral monetary policy in the US and international reserves management

and exchange rate policy in China. As the financial wreckage clears in mid-2010, these fundamental habits and policy issues remain key to whether global rebalancing will resume.

Consequences of persistent global external imbalances

Why does global rebalancing matter? If surplus countries willingly finance deficit countries—the co-dependency of the 2000s—is there really a problem to be addressed by policy? Codependency is stable and this apparent stability can produce policymaker and private decision-maker complacency about assessing risks (Mann 2004, 2008). More importantly, this apparently stable situation masks undesirable economic trajectories for the individual countries as well as globally: specifically, resource misallocations that damage potential growth, may imply future substantial resource transfers, and create vulnerable financial positions.

The internal mirror is one way to measure the potential cost of a persistent external imbalance. To the extent that the external imbalance is a function of relative prices measured in particular by the real exchange rate, a persistent external imbalance points to persistent resource misallocation inside the economy. Theory tells us that an undervalued exchange rate guides investment into the tradable sector (manufacturing) relative to the ‘non-tradable’ sector (services). Indeed, in China, the services share of urban investment fell from 63% in 1999 to 55% in 2007, while the manufacturing share of urban investment increased from 15 to 30% (Bergsten, Freeman, Lardy, Mitchell, p111). Other evidence of resource misallocations include property price bubbles in main urban production centers, a rising geographical-and-income Gini coefficient (Chen, Dai, Hou, Feng 2010), excess capacity and falling profit margins at export-driven firms, and potential for rising non-performing loans in the banking sector; as well as the falling share of consumption in GDP, already noted.

Second, the persistent external imbalance and domestic resource misallocations yield financially vulnerable international reserves. China’s international reserves include nearly \$1.5 trillion of US obligations, nearly all of which are denominated in dollars. These reserves represent about 30% of dollar-valued GDP (large, but down from total international reserves accounting for 43% of China’s GDP in 2005 (Truman and Wong). Is this the highest value use for this wealth? Perhaps so, perhaps not. A depreciation of the global dollar of some 10% (according to Cline and Williamson as of January 2010, a 7% real depreciation brings the dollar to its fundamental equilibrium value) reduces the international purchasing power value of these reserves only some 3% of GDP—not a big deal. On the other hand, a 30% appreciation of the renminbi against the dollar (which is the undervaluation as calculated by Subramanian in January 2010) would hit China’s dollar store of wealth in renminbi terms much harder.

So, also for the US, a persistent external imbalance points to unsustainable trajectories of both domestic spending and international financial obligations. The dollar relative price, along with spending habits exacerbated by domestic policies of tax cuts and accommodative monetary stance, has contributed to a

systematic external deficit heavily concentrated in consumer-oriented products (and, of course, oil); net imports of consumer goods generally account for about 50% of the overall trade deficit. Once production facilities move abroad, hysteresis and pricing-to-market tends to keep them there, cementing an external deficit in consumer goods and autos that has never been offset by capital goods or services net exports.

The consequence of generations of trade deficits (systematically since the beginning of the floating rate period) is a build-up of international financial obligations of nearly \$4 trillion, 30% of GDP. While not presumptive of crisis, once interest rates start to rise worldwide, the vulnerability of the magnitude and composition of the NIIP to interest changes will become apparent (Plück and Mann, 2006). Net payments abroad on the outstanding obligations, at some point, will cut into domestic consumption, investment, and/or government spending. While not a large percentage on an individual basis, on an economy-wide basis, some estimates for these payments loom rather large given that an increase in household savings of 3 to 4% (just to repay international obligations) will prolong weak GDP growth and/or an 11 to 17% shift in government spending (which is the equivalent of how much would have to be paid to foreign investors) is nowhere in US historical experience (Mann 2009).¹

In addition to considering the costs to US domestic demand of net investment payments on external obligations, another question is, how vulnerable is the US to the foreign investor's wealth allocation decision? Important issues of risk and return, diversification, financial leverage, home bias, and flight to safety all affect foreign purchases of US assets. Moreover, it matters whether the threshold of vulnerability to foreigners' preference for US assets is measured in stock terms (i.e. as the share of US assets in the portfolio of wealth) or in flow terms (i.e. as the share of US assets purchased out of the increase in foreign wealth). By all accounts, the flow vulnerability is what might matter, at which point, either returns (interest rates) on US assets must rise, or the dollar depreciate, which is what happened in 2002 (Mann 2009, 2003). More recent calculations of foreign investor wealth and preferences suggest that, even before the financial crisis, this marginal investment threshold would again be breached around 2014.

Finally, the magnitude of the US fiscal deficit implies substantial new issuance of US treasury securities. Foreign investors hold 56% of all US Treasury securities outstanding; about 30% are held by China and Hong Kong. Therefore, China and Hong Kong hold somewhat more than 10% of US treasury securities.² Although the rolling global financial crisis has encouraged safe-haven investment in dollars and US treasury securities, there is a vulnerability to such a concentration of holdings of these assets.

Other countries are not mere spectators to the nature of external adjustment and policy choices by the US and China—they also face issues ranging from domestic demand and the structure of production, to exchange rate policy, to

1 The increase in household savings is calculated as 2 to 3 percent of GDP net investment income payment on the NIIP times 70 percent share of consumption in GDP. The increase in the budget position is calculated as 2 to 3 percent times 17 percent share of government spending in GDP.

2 Based on the FDI 10% threshold for controlling interest, on this basis China owns the US.

international wealth management. Given the brevity of this memo, the focus is on the largest players on the stage; but others too around the world face costs of persistent external imbalances—real resource misallocations and concentrated international financial investments.

For everyone, probably the more challenging problem is the misallocation and needed adjustment to domestic consumption, investment, production, and trade. Patterns of production and demand are slow to change, and adjustment to employment and factories probably more costly than the adjustments to wealth.

To the extent that a return to sustainable trajectories implies a return to the path of dollar depreciation, economies dependent on exports to the US and the holders of dollar-denominated international reserves will be relatively worse off. For the US, the shift toward net exports is a counterweight to the slowdown in domestic demand and the capital ‘gain’ on dollar denominated obligations is a counterweight to the loss in purchasing power (Mann 2005).

Prospects for policies to promote global rebalancing

Given that a return to the widening external imbalances and their associated resource misallocations and financial vulnerability should be viewed with some concern, what are the prospects for policies to promote global rebalancing? One partial-equilibrium approach is to consider only adjustment via changes in growth—a slowdown in US economic activity and a boom abroad in both cases focused substantially on consumers. At the other partial-equilibrium extreme, all adjustment could take place via movements in the exchange value of the dollar.

Based on parameters estimated in Mann and Plück (2007), an ‘average’ boom in foreign domestic demand improves somewhat the US trade deficit—surprisingly less than one might expect because nearly 60% of US exports go to mature industrial countries where even robust growth is relatively modest. On the other hand, modest growth in US consumption dramatically reduces the US component of the global imbalances because of very high short-run elasticities of consumer demand. With regard to exchange rate changes, estimates using the exchange rate scenario in Truman (2005) confirm that the significant real dollar adjustment, if broad-based to include all Asian currencies, shifts US consumer spending dramatically away from those imports and raises and shifts US exports away from Europe toward Asian markets. The total shift in net exports could be some 7% of GDP.

A combination of a return to the dollar path pre-financial crisis, and a continued focus on domestic demand, particularly private and public consumption in the US and China, but also domestic plant, equipment, and software investment in emerging markets are needed. If policymakers return to their familiar playbook—undervalue the currency and/or depend on the US consumer to support export-dominated GDP growth—global imbalances, resource misallocations, and future costs all will increase. Near term growth will be at the expense of sustainable and balanced long-term growth.

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7 International imbalances balance risk

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This chapter proposes an alternative view of international capital flows that can explain what has occurred in the international macroeconomy in the past fifteen years. It argues that successful economic development is powered by net savings flows from poor to rich countries. The current account imbalances of rich countries do not pull the periphery along by providing global net aggregate demand; they push the periphery by securing efficient capital formation. The US current account deficit is an integral and sustainable result of its role as the center country in the revived Bretton Woods system.

Because the US has been the dominant net importer of savings from international capital markets, conventional analysis suggests that this is an unnatural and unsustainable regime. The idea that capital should flow downhill from rich to poor countries seems to be an obvious theoretical result as well as appealing to normative opinions about the fair or proper role for international capital flows.

Nevertheless the performance of surplus Asian emerging markets in terms of economic growth, low inflation and financial stability has been remarkable under this “unnatural” regime. In a series of papers we have tried to understand the origins of this success and the stability of what has come to be known as Bretton Woods II.

In our framework a current account balance is not a measure of the change in a country’s international risk position. A balance of trade in assets creates an imbalance of risks for residents of the rich and poor countries. The rich country is not likely to seize foreigners’ assets. In fact, it probably got rich by respecting property rights. Governments of the poor countries often will be tempted to exercise their sovereign power to expropriate foreign investment for populist or geopolitical reasons.

Since a well-intentioned poor country government cannot be readily distinguished from a populist expropriator or prevent the future emergence of one, this creates a distortion that blocks the path to large gross capital inflows and rapid development. The system has to overcome this distortion before residents of poor countries can benefit from fully efficient international financial intermediation.

It is useful to compare the implicit contract between the center and the periphery to a standard derivative contract: a total return swap. A total return swap is a promise by one party to pay the total return (capital gains plus dividends)

on the notional amount of an asset such as an equity or equity index for some future interval in exchange for receipt of fixed income on notional principle over the same interval. The interesting aspect of such contracts for our argument is that the less creditworthy party to the contract is required to post collateral for actual and potential mark to market losses. Failure to provide the collateral terminates the contract, effectively a cancellation of principal on both sides and a taking of collateral to cover at least the current market value.

The application of this contractual arrangement to the international monetary system is straightforward. The emerging country receiving equity investment promises to pay the total return on the equity investment. Since there is a net capital outflow from the emerging country, the equity inflows are more than financed by a claim against the balance sheet of the rest of the world. In the simplest case, these claims take the form of fixed income liabilities of the rest of the world. This produces exactly the basic structure of a total return swap on equity.

The “original sin” of the emerging country is that it is born being a credit risk and that the expected present value of the swap will have to be matched by collateral, as well as some additional coverage for future valuation risk. But how much collateral is needed, and what form does it take?

In typical private sector total return swaps, collateral is determined by multiplying potential volatility of the underlying asset over the next ten days by a factor dependent on the credit risk of the counterparty. For a total return swap on a highly liquid US equity, a hedge fund (less creditworthy) would be asked for 15%, for the S+P index 10% collateral would be required, for swaps involving China equities 50% initial margin would be required.

But this is only the initial collateral required for new investment when the initial value of the swap contract is zero. If, as seems likely, the total return on direct investment exceeds the return on the fixed interest leg, 100% of the mark to market gain on private contracts must be collateralized every day. The implication is that, in addition to the collateral required for the new flow of direct investment, the mark to market gain on the stock of direct investment requires additional variation margin.

The temptation to seize foreign assets actually grows with the success of the investments associated with those assets. While an initially balanced trade in assets would be less of a target for seizure, the very success of a rapidly growing emerging market country creates an imbalance of claims and therefore credit risk as the equity grows in value. Hence, a balanced trade in assets means a growing imbalance in risk to the detriment of the industrial country.

The mechanical but important implication is that a successful development strategy—where investment pays off with large returns—generates capital gains on direct investment and therefore rapid growth of collateral balances. We can get a feel for the economic importance of these effects by estimating what collateral would be required by private investors for direct investment in China and other emerging markets. Our calculations (Dooley, Garber, Folkerts-Landau, 2008) suggest that in 2006 90% of China’s international reserves and 98% of the

reserves of all other emerging markets would have been required as collateral for gross inward direct investment.

The nature of the collateral is so obvious it is hard to see. If the center cannot seize goods or assets after a default, it has to import the goods and services *before* the default and create a net liability. If the periphery then defaults on its half of the implicit contract, the center can simply default on its gross liability and keep the collateral. *The periphery's current account surplus provides the collateral to support the financial intermediation that is at the heart of development strategies.* The interest paid on the net position is nothing more than the usual risk free interest paid on collateral.

A country that has not generated a net international investment position cannot offer collateral. Argentina for example clearly defaulted on its international obligations to private and official creditors yet none of its assets were seized. Why not? At the time of default the government's liabilities to foreign governments, largely in the form of liabilities to the IMF, exceeded the Argentine government's foreign assets. Argentina had no collateral.

Conclusion

Contrary to almost universal opinion, successful economic development is powered by net savings flows from poor to rich countries. The current account imbalances of the rich countries do not pull the periphery along by providing global net aggregate demand; they push the periphery by securing efficient capital formation. Seemingly balanced shifts within a country's capital account actually drive its current account through a need to collateralise resulting risk imbalances. The US current account deficit is an integral and sustainable result of its role as the center country in the revived Bretton Woods system.

We believe that this view of international capital flows is far more satisfying than the standard inter-temporal consumption theory of imbalances. This view has the advantage of actually explaining what has occurred in the international macroeconomy in the past fifteen years, while the textbook theory has nothing to say about this epoch other than that the reality got it wrong. Moreover, this view generates a number of testable hypotheses relating the size of net capital flow imbalances to the size of gross capital flows and the articulation of gross flows into equity and fixed income components, a subject on which the textbook model is silent.

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PART 3: What are the lessons from previous attempts to rebalance the global economy?

8 The history of tackling current account imbalances

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There is today a substantial consensus that large current account imbalances are at the root of macroeconomic problems. But, as this chapter reminds us, the history of policy-induced current account reversal looks like a poisoned chalice. The lesson of the past clearly indicates that a more sophisticated approach is required rather than exerting massive pressure for exchange rate adjustment and looser monetary and fiscal policy.

As in the 1930s, there is today a substantial consensus that large current account imbalances are at the root of past macroeconomic problems. In the 1920s, it had been a question of large surpluses in France and the US, with deficits elsewhere, especially in Central Europe and Latin America. The deficit countries were pushed into adjustment by deflation, while there was no similar pressure to expand in the surplus countries, with the result that the asymmetric adjustment created a worldwide deflationary pressure.

The consequences of general deflation during the Great Depression were so severe that devising mechanisms to prevent a recurrence were at the heart of postwar institutional designs. The necessity of tackling the problem was central to the design of the IMF. IMF facilities would be used to smooth adjustment in deficit countries; but there was also a “scarce currency clause” that required action by a country running a persistent surplus. Such calculations occurred not simply on the global level, however. The Treaty of Rome (1957) establishing the European Economic Community also specified in Article 104: “Each Member State shall pursue the economic policy necessary to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while ensuring a high level of employment and the stability of the level of prices.”

In practice, the idea of devising institutional mechanisms for changing policy and correcting surpluses was very difficult to realise. The “scarce currency” clause was never used, as at the beginning it would have required actions against the US, the largest member of the IMF and clearly the most powerful country in the world. IMF rulings that currencies were under-appreciated were made against Sweden and Korea in the 1980s, but never against the major countries that were at the center of discussions of adjustment in the 1970s and 1980s, Germany and Japan.

The major test cases that people regard as precedents for the problem of Chinese surpluses concern the two countries whose strategy of growth through the development of a powerful export sector is widely regarded as providing a

model for development elsewhere, especially in Asia. The surpluses look smaller than those of China today (Germany's current account surplus reached a peak of 4.8% in 1989; and Japan's stood at 4.3% in 1986); but they posed substantial problems for other industrial countries, who believed that both the major export economies were deliberately undervaluing their currencies in order to achieve export advantages.

A substantial German surplus began to appear in 1967. It was regarded as a problem only in part by the US, since the surplus could finance US deficits that might emerge as a consequence of the Great Society reform program and of the costs of the war in South-East Asia. But Germany's neighbours, especially France, were worried about the apparent German undervaluation.

An attempt to renegotiate exchange rates and achieve a revaluation of the Deutschmark at a G10 meeting in 1968 in Bonn proved to be a disaster. It was that experience that prompted the EEC Commission, and in particular the Economic and Financial Commissioner Raymond Barre to develop more concrete proposals for European monetary cooperation (and which eventually led to the 1970 Werner Plan for European monetary union). On February 12, 1969, Barre presented his own report, which started with some quite specific lessons from the November 1968 debacle. "Tax measures adopted by Federal Germany and France in November 1968 also show clearly that there can be no lasting harmonisation of indirect taxation unless economic policies are better coordinated to reduce imbalances."

Japan also developed a current account surplus from 1968, and it ballooned out in 1971 and 1972. Forcing Japan to tackle the surplus was the agenda behind President Nixon's unilateral suspension of gold convertibility on August 15, 1971, and of the exchange rate changes at the Smithsonian G10 meeting in December 1971, when a new parity system was devised. But there was no immediate correction, and the Japanese surpluses only disappeared in 1973 (the surplus had increased in 1972).

By the mid-1970s, Germany was once again running very substantial surpluses, and was pushed to correct them on both the European and the global level. The most dramatic instance of such pressure to act as a global "locomotive" came at the 1978 Bonn G7 Summit meeting, where Japan, which also had substantial surpluses (\$16.54 billion in 1978, when the German figure was \$9.16 billion). In both countries, the international pressure was used explicitly in internal debates to justify controversial fiscal and monetary expansion. By 1978, the Japanese government deficit reached 7.3% of GDP, while the German figure was much lower at 2.1%. When inflation surged in 1979 and 1980, the governments were vulnerable, and the international cooperation mechanism seemed to be discredited.

The third major episode of international pressure on Japan and Germany to take action against surpluses occurred in the framework of the G5/G7 Finance Ministers' meetings in the mid-1980s, between the 1985 Plaza and the 1987 Louvre agreements. The package involved exchange rate correction, since calculations showed a considerable currency undervaluation, but also a combination of fiscal and monetary measures. Again, as in the late 1960s, the

international pressure pushed Germany into looking for more European ways of dealing with its imbalances. The German surplus quickly disappeared after 1989, and not because of international coordination, but rather from 1990 in the aftermath of the massive costs of the unpredicted reunification of East Germany with West Germany.

The bitterest legacy of the mid-1980s coordination experience was felt in Japan, where there was a large fiscal expansion after 1986 and a monetary easing. The currency appreciated very rapidly after the Plaza agreement, and GDP growth fell off. In order to respond to the slowing of the Japanese economy, and in line with continued international pressure, government deficits continued. The aftermath of the experience of intensified “international cooperation” was seen as first the bubble economy of the late 1980s and then the collapse of the bubble and the “lost decade” of the 1990s.

Clearly the “bubble” and its bursting in Japan have a more complex explanation than simply the monetary and fiscal mix of 1985-1987, but the fact that this is the most dramatic instance of international engagement to tackle persistent current account surpluses overshadows current debates about what the appropriate response to Chinese surpluses should be.

The IMF’s current World Economic Outlook (April 2010) presents a substantial number of cases of adjustment in order to derive the conclusion that “policy-induced current account surplus reversals were not typically associated with lower growth.” But the list of specific examples, from Japan in 1973, Germany in 1970, Japan in 1988, to Switzerland in 1978, involve experiences that are considered in the domestic debates and literature of the countries concerned to be disastrous experiences, or at least precedents that should not easily or thoughtlessly be emulated. In that sense, the history of policy-induced current account reversal looks like a poisoned chalice.

The German Chancellor of the 1970s, Helmut Schmidt, felt that the process that began in 1978 in Bonn had undermined and eventually destroyed his government. His verdict on the process of seeing the world simply through the lens of current account imbalances is interesting: “There are bad exaggerations around when each views it through national spectacles. One side prattles about an inflationary community, the others, English and Italians in particular, prattle about a deflationary community which would be accomplished there and would disrupt their whole national economy.”

The debate between debtors and creditors in the international economy swings dangerously between two different ways of assessing legitimacy: power and morality. What irritates debtors is often that the creditors present their position as being fundamentally more virtuous: the Greeks are said to have excessively high pensions, excessively early retirement ages, and too many extra months’ salaries, while the Americans engage in consumer binges on the never never, financed in ever more ingenious ways. The creditors point to generations of Confucian or Protestant teaching on the virtues of thrift.

When history is thrown into the mix of arguments, the result can be explosive. Many people in Beijing will read the survey in the IMF World Economic Outlook as an invitation to follow Japan on the path to economic stagnation. That is not

a helpful message to send in the current state of the world economy. The lesson of the past clearly indicates that a more sophisticated approach is required rather than exerting massive pressure for exchange rate adjustment and looser monetary and fiscal policy – especially in circumstances in which China, like Japan in the late 1970s or mid 1980s, is already running substantial budget deficits.

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9 Surplus reversals in large nations: The cases of France and Great Britain in the interwar period

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By studying two important surplus reversals from the interwar period, the authors illuminate several lessons relevant for today. Global imbalances, as well as surplus reversals induced by policies and external forces, have been a part of the global economy for a long time. Imbalances and reversals that involve large players have important impacts at home and on the global economy, so remedying them before they get too large or last too long will lead to greater economic stability. Moreover, as key currency systems pose threats to global stability, greater monetary cooperation would be of great benefit.¹

Global imbalances are an enduring aspect of the international economy and a perennial subject of study for economists. Such imbalances have been theorised about since the 18th century when David Hume wrote about the price-specie flow mechanism.

Today, as in the past, surplus regions fund others' deficits, debt accumulates and exchange rate changes rebalance. In economic models without market failures and policy interventions distorting the behaviour of economic actors, such imbalances would be equilibrium phenomena and would naturally dissipate as fundamentals and prices evolved.

Naturally once fixed exchange rate policies, other policy interventions such as demographic controls, monetary sterilisation, capital controls, financial frictions, information problems, financial crises and uninsurable risk are introduced, the smooth adjustment process of equilibrium models fades, imbalances become more and more problematic as they impose costs on other nations and welfare losses are on the table for discussion.

In any event, the modest goal here is to illuminate several lessons from reversals from surplus to deficit in the past. Such reversals in systemically important countries have been rare in the past but are quite topical today given the nations involved in the current imbalances. We study two important reversals which occurred in France and Great Britain in the interwar period.

¹ The author would like to thank - without implicating - Abdul Abiad, Daniel Leigh and Marco Terrones for proposing his initial foray into surplus reversals and for useful dialogue on these issues.

The French franc was undervalued for several years prior to 1931 but it then appreciated sharply, which rapidly diminished the French trade surplus. The surplus reversal in the 1930s was also associated with sluggish economic growth. Importantly, France was a systemically important player on the global scene in terms of reserve accumulation. Exchange rate and monetary policy that sponsored surpluses and reserve accumulation led to great potential for instability and volatility in international capital markets. The French policy of undervaluation also helped diminish the British surplus. This led to accumulation of sterling reserves in France and ultimately large capital losses when Britain decided to devalue in 1931.

Britain experienced a secular decline in its current account surpluses, but the overvaluation of sterling in 1925 as the gold-standard was re-instated, led to exceptionally weak economic performance and high unemployment until after devaluation in 1931.

The case of Britain has one other lesson for countries experiencing large and persistent surpluses. In Britain, some evidence suggests that current account surpluses may eventually contain the seeds of their own demise, generating their own problems when they are eventually unwound.

A surplus reversal in France (1926-1938)

The franc was successfully stabilised in late 1926 at a historically low level against sterling and the dollar. The franc was widely viewed as being undervalued at this point. To keep the franc from appreciating, the Bank of France engaged in foreign exchange intervention - selling the domestic currency repeatedly as capital was repatriated in expectation of an appreciation (Cairncross and Eichengreen 2003).

Monetary policy in France remained far too restrictive after 1928, according to the influential British Treasury official Ralph Hawtrey. French policymakers disputed the British allegation that the franc was undervalued and denied that policy was too restrictive.

France experienced significant current account surpluses throughout the late 1920s (figure 1). The Bank of France also aimed to attract gold reserves to back the franc but it also accumulated a large volume of foreign exchange reserves especially dollars and sterling. These accumulations would prove to be problematic for the stability of the international financial system as described below.

During the surplus years, the French economy boomed posting growth rates of 6% or more, which was far superior to those of other industrial economies in Europe like Britain and Germany. However, significant inflation accompanied the surpluses of the late 1920s. Money wages increased by some 7% between the end of 1926 and the end of 1929. Low real interest rates, partially due to the inflationary environment, along with government incentives kept investment rates high (see figure 2).

The devaluation of sterling in 1931, the dollar in 1933, and restrictive foreign trade policy and economic depression abroad led to a major decline in the current account surplus after 1931.

France resolutely rejected devaluation and monetary expansion and continued to focus on currency stability as a means of attaining a global recovery. Its fear of monetary instability based on the experience of the 1920s cast a long shadow. In any case, tariff retaliation to a franc devaluation would have been likely. French policymakers unsuccessfully advocated an internationally coordinated policy of supply manipulation (Simmons, 1994). The French could not get assurances in early 1935 from the British or the Americans that their currencies would not be allowed to depreciate further in the face of a franc devaluation. In 1935 the Bank of France approached the US to provide a joint loan to stabilise sterling. This advance was rejected by the US, as were most other attempts at coordination during the period. It took until 1936 for the idea of devaluation to become acceptable in France. By then, France's gold reserves were draining rapidly and social unrest was on the rise. An internationally agreed upon devaluation of the franc of 20-25% was agreed in 1936. Recovery commenced from this point onwards.

Fiscal policy sustained economic growth if monetary policy could not in the early years of the surplus reversal. From 1926 to 1931 the government undertook major public works projects although the budget surplus actually grew. The net effect of this policy was a "crowding in" with increased investment concurrent with the deterioration of the current account (figure 2). This investment shock in fact helped delay the onset of the Great Depression which had begun affecting countries from 1929. Eventually, however export markets dried up and monetary orthodoxy- an unwillingness to abandon the gold standard like Britain in 1931 or the US in 1933 – led to a comparatively severe economic slowdown that persisted well into 1936 when the franc was finally devalued (see figure 3).

The roots of the staunch defence of the gold standard and the unwillingness to engage in expansionary monetary policy are found in the stabilisation program of 1928. This program prioritised monetary stability given a recent period of high inflation and uncertainty prior to 1926.

The Bank of France had its hands tied being prohibited from engaging in open market operations and unable to buy bills in the money market. Although changing the discount rate was a possibility, the thin money market of the period limited the effectiveness of this tool. These constraints were viewed as a precaution against 'loose' monetary policy that might have contributed once again to a return to inflation.

During the surplus years, the inability or unwillingness of the monetary authority to accommodate rising money demand through open market purchases helped spur a massive accumulation of gold in France, both by the public and by the Bank of France. By 1928, France held 20% of the world's monetary gold stock and it continued to hold a large amount of gold in 1929. By this point, the percentage of gold reserves held in France far outweighed its relative economic size. Another reason for the gold influx was that the Bank of France was worried about the value of its (large) foreign exchange reserves. It actively aimed to trade

its significant sterling reserves into gold in London in the late 1920s. It wished in some sense to push adjustment onto the British (Cairncross and Eichengreen 2003)

The build up of large foreign reserves (sterling and dollars mainly) and then gold stocks in the late 1920s bears a striking resemblance to the situation of financial globalisation today where surplus nations are highly exposed to the debt of deficit nations. And it highlights the potential for systemic instability in such a situation.

Accominotti (forthcoming) calls this situation a ‘sterling trap’. France accumulated large amounts of sterling and dollar reserves by 1928. From 1928 it ceased to acquire foreign exchange reserves, instead preferring to sell existing stocks of sterling for gold. The motivations were diverse. Worries about capital losses are cited, as well as a French insistence that holding foreign exchange reserves gave rise to a tendency for expansionary policy in reserves countries which could have been destabilising.

Because France was a large player in the market for sterling assets, it could not rapidly liquidate its sterling holdings without incurring devastating capital losses even in late 1930 and early 1931 when it became evident that a sterling devaluation was highly likely. Despite early attempts to extinguish its sterling holdings in late 1928 and 1929, by late 1930 and into 1931 it was playing an active role in supporting sterling (Accominotti 2009).

The dangers of accumulating large reserves during surplus periods are easily illustrated. Sterling’s devaluation in September of 1931, led to an immediate and large capital loss on existing sterling reserves. This was the equivalent of twice the amount of available capital and reserves of the Bank of France (Accominotti forthcoming). The capital loss was covered by the French government but it led to an extreme loss of autonomy of policy at the Bank of France. Having been burned badly by external policy changes in Britain, dollar and sterling reserves were liquidated and replaced by gold at the end of 1931 leading to increasing pressure on the dollar.

To summarise, the French case itself illustrates three important points in relation to imbalances.

- First, unbridled reserve accumulation arising from external surpluses can lead to significant losses for both the buyer and seller of such assets. There may also be systemic fallout from the shock when such losses come due to the fact that the parties involved are usually large key players in the global economy.
- Second, surplus countries that delay engaging in an adjustment process may have adjustment imposed on them by trading partners. The devaluation of sterling in 1931 strengthened the British balance of payments and forced capital losses on France. The US devaluation in 1933 had a similar impact although reserve losses were limited by early and anticipatory diversification out of dollars.
- Finally, in response to a surplus reversal, use of expansionary fiscal and monetary policy can offset the loss of foreign demand to obtain domestic balance. The investment boom sparked by government expenditure

and private sector incentives in 1929/1930 delayed the onset of the Great Depression that ravaged other industrial economies. From 1931, the opposite occurred. France avoided monetary expansion and fiscal expansion while other industrial nations did the opposite - many opting to leave the gold standard. Recovery in these countries commenced immediately despite the fact that export markets were not immediately recovered. Domestic demand took up the slack.

Great Britain's surplus reversal 1880-1930s

Great Britain suffered a long-term decline in its strong current account surplus between 1870 and the 1920s. The sharpest declines in the surpluses (ignoring the effects of World War I) were felt in the mid to late 1920s.

British surpluses arose out of industrial superiority and the rise of sterling as in international currency reflected dominance in international trade from the mid-nineteenth century. Sterling came to be a global reserve currency in the nineteenth century much like the dollar today. Some voices in China express the hope that the renminbi will become an international currency in a similar way in the future.

In the century ending in 1914, the British current account showed a deficit in only two years (Cairncross and Eichengreen 2003). Britain's surpluses emanated from strong exports of shipping and financial services (or invisibles) and income from earnings on earlier foreign investments. Surpluses remained but were diminishing in size throughout the 1920s and they finally evaporated totally in the early 1930s.

Between 1870 and 1914 the British economy ran a persistent and large trade deficit on goods but remained a world leader in exporting shipping insurance and financial services. British producers of industrial goods increasingly lost international market share after 1870 to the newly industrialising countries like Germany and the US. Still, invisible earnings reliably offset this deficit and a strong balance of payments position was reaped on the back of overseas long-term investments that exceeded large short-term capital inflows. During the heyday of the gold standard, 1880-1914, Britain was the world's largest trader. Britain also financed a large fraction of foreign infrastructure development aimed at primary commodity extraction within its formal empire in Africa (note the similarity between this and China's interactions with Africa today) and even outside of it in countries such as the US, Argentina and Brazil.

By becoming the world's largest exporter and largest economy in the mid-late nineteenth century, Britain's currency, the pound sterling, came into demand as a means to settle nearly all international transactions. Its financial sector, already strong, developed further to service international trade finance and also to provide long-term funds for development abroad. Britain came to play its central role in the global capital markets of the day and sterling became the international reserve currency. Increasingly, foreign agents kept a large amount of short-term sterling balances in London. This eventually had a debilitating impact on the real

economy (particularly the tradable sector) as demand for sterling assets rose. The events had a familiar ring to those following debate on global imbalances today and in the Bretton Woods period.

...foreigners (were) effectively giving Britain interest free loans by holding sterling and by sterling's enhancement of world liquidity... by analogy with the role of the US dollar after 1945, the key currency system contained the seeds of its own destruction... British industry had to export less in order to buy a given quantity of imports than if sterling had not been a reserve currency... The adjustments of prices in the British economy and of the industrial structure, necessary to maintain a balance of payments equilibrium, were reduced... If Britain had been forced to adjust faster the structure of her industry, not only would the eventual adjustment have been less wrenching, but the rate of industrial growth in the late 19th century might have been higher (Foreman Peck 1995).

In the event, adjustment occurred in the 'interwar' period. Britain faced numerous challenges between the wars. First, it was widely argued that sterling was overvalued from 1925 when it returned to the gold standard. Cairncross and Eichengreen (2003) note that even though the real effective exchange rate did not necessarily display a major overvaluation, significant price compression would have been required to regain market share. Competitors developed new products to suit changing industrial and consumer demands while British exporters had failed to make such changes (Eichengreen and Cairncross, 2003). Exports consequently suffered although long-term foreign investments proceeded apace. Further reliance on short term capital inflows in order to fund imports was the outcome. Invisibles payments also declined in the late 1920s and by the 1930s trade deficits, decreased invisibles, foreign defaults and economic depression abroad pushed the British current account into deficit.

During this process of decline in the 1920s, unemployment was high and showed little sign of decreasing. And although the government was wary of tight monetary policy, the Bank of England proved reticent to keep the discount rate too low as gold outflows mounted. Britain suffered critical losses of gold reserves repeatedly in the three years prior to 1931, which threatened their adherence to the gold standard and monetary orthodoxy which was a major policy goal. Britain also maintained a tight fiscal policy running budget surpluses in the 1920s even though rising unemployment outlays threatened fiscal orthodoxy. As the world sank into Depression in 1929, British exports collapsed in 1930-31. A political battle raged over the appropriate monetary and fiscal policy response with loud voices calling for devaluation and an expansionary monetary policy. This led to further speculation that the pound would eventually be devalued. In September 1931 such speculation was vindicated when sterling was devalued.

Three lessons can be learned from the British case:

- The end of a surplus did not spell an economic disaster precisely because of the policy response. In 1931 the British current account went into deficit—a singular event in over 130 years of economic history. Due to devaluation and expansionary monetary policy (though not to

expansionary fiscal policy which Britain resisted) and economic recovery abroad, the current account improved greatly by the mid-1930s. Britain's relative and even absolute economic performance in the 1930s was superior to many countries especially France which kept a tight monetary policy (see Figure 3).

- Did the long-standing surplus position of Britain contain the seeds of its own demise as Foreman-Peck suggests? This is a crucial possibility to be considered for countries like China and other countries running persistent surpluses as part of a development strategy even though the historical circumstances are not exactly parallel to those today. In some respects the British experience outlines one possible future if Chinese policymakers carry out plans to internationalise the renminbi in a bid to de-throne the dollar. Such a policy would entail an increase in the use of the renminbi in international transactions, more development capital and assistance for commodity producers, and making Shanghai a global financial centre with obvious benefits. However, the costs imposed on the tradable sector may be notable especially in the long run.
- Key currency nations are exposed to international sales of their liabilities much like emerging markets are exposed to sudden stops. If the renminbi achieves the status of a global reserve currency in the coming decades due to China's size and importance in world markets, China, like Britain and the US before it, could eventually face the prospect of unexpected foreign sales of renminbi held by foreign actors. Such pressures aggravated monetary policy in the late 1920s when France attempted to sell sterling in exchange for the gold reserves of the Bank of England. Britain could not maintain its commitment to a sound currency and full employment and eventually devalued in 1931. It is argued that the US may face similar constraints today and it is one reason that Japan has shied from pushing for a global role for the yen.

Conclusions

Global imbalances induced by policies and other distortions have been a part of the global economy for a long time. Deficit countries often are portrayed as those that bear the burden of adjustment due to external forces. This is so since small developing economies are usually perpetrating such deficits, and so large countries are spared much of the pain of adjustment. But history shows that surplus reversals in large systemic countries have also occurred due to policy changes and external forces in the past.

As these case studies show, imbalances and reversals that involve large players have important economic impacts at home and on the global economy. Such reversals have not always been painless or smooth. If surpluses and imbalances persist due to intervention in the world's economies it is likely to be the case

that remedying them before they get too large or last too long will lead to greater economic stability.

History also shows that key currency systems pose threats to global stability. In this regard more thought could be put into the design of mechanisms to enhance the international monetary system. Specifically, greater international monetary cooperation would be of great benefit, as Frieden (2009) amongst others, has highlighted.

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Figure 1. France, current account to GDP ratio and the real effective exchange rate, 1925-1938

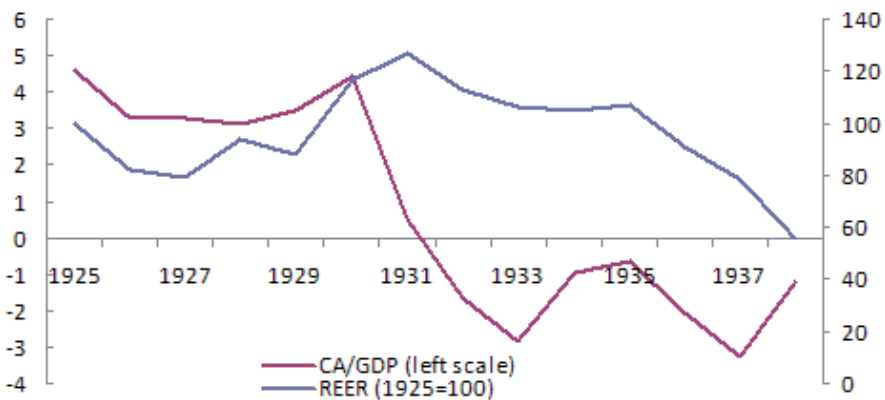


Figure 2. Investment in France, 1926-1936 (1913=100)

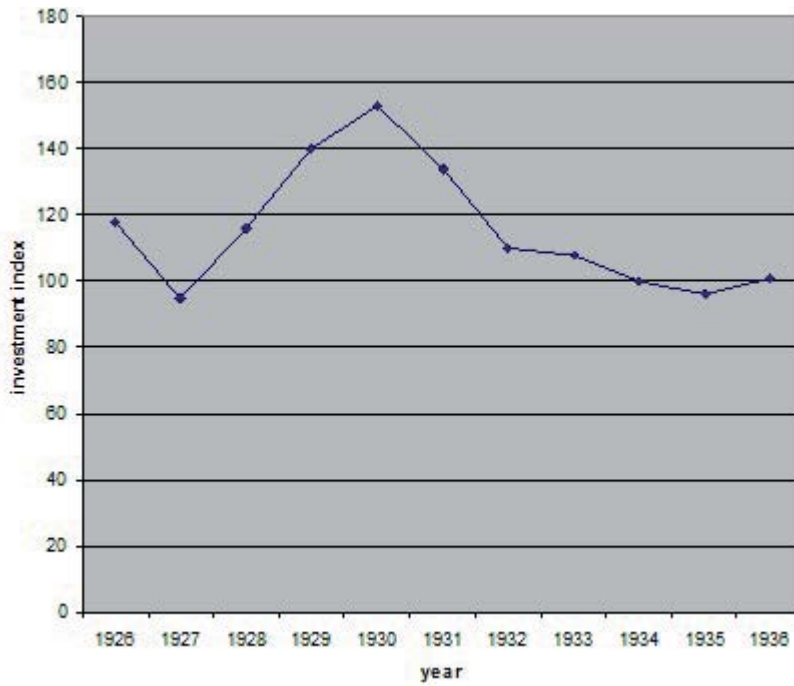


Figure 3. Real GDP per capita in France and Great Britain, 1927-1938

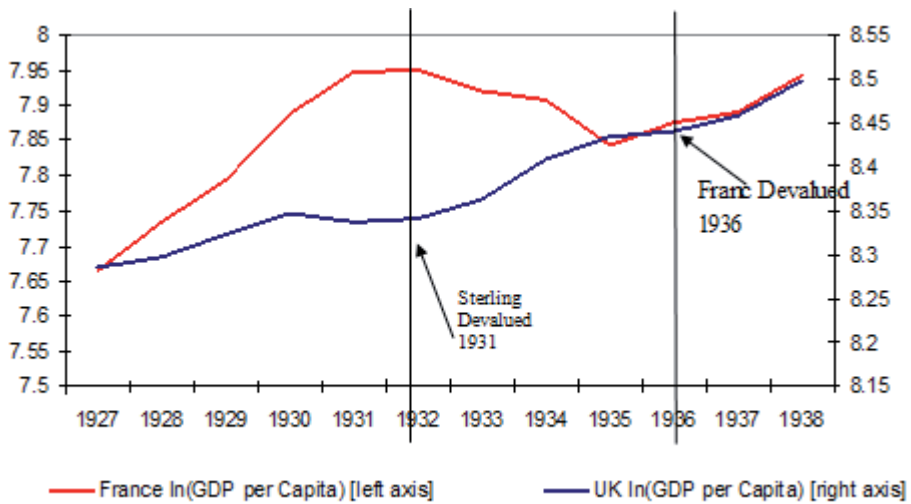
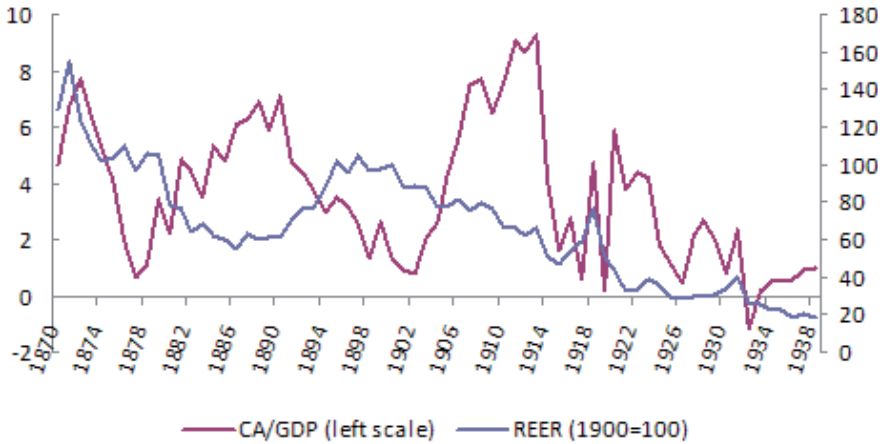


Figure 4. Great Britain, current account to GDP ratio and the real effective exchange rate 1870-1938



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PART 4: What would rebalancing entail? Which policies must change? Is collective action needed?

10 Does the rise of the BRICs and the credit crisis make it easier to rebalance the world economy? Yes!

Jim O'Neill
Goldman Sachs

The global credit crisis, by halting the growth in imbalances, may actually be quite useful for leading us to a more balanced world. As Chinese consumption could be growing by 15% in real terms and US savings starting to pick up, this chapter argues that G20 leaders should encourage this process to continue by supporting a world where the US consumer has adjusted to at most 15% of the world's consumption, and China somewhere close to 10%.

Since early 2009, I have been of the rather unfashionable opinion that perhaps, the global credit crisis, especially at its worst in late 2008, is actually quite useful for leading us to a more balanced world, and certainly a world of lesser imbalances. What would be helpful, as we approach the middle of 2010, is if G20 leaders encouraged this process to continue.

At the core of this rationale, is that the credit crisis itself was influenced to some degree -possibly substantially - by the growth in imbalances. If correct, their reversal would presumably help reduce the likelihood of such a repeat in the future. At the core of the imbalance problem, was the seemingly never ending shift of US personal household savings towards zero, and the possibly not directly related strength of personal savings elsewhere, especially in the biggest of the BRICs, China. A world in which, financial intermediaries (and governments) dreamed up increasingly exotic ways for the US weak savings position to be supplemented by foreign savings seemingly suited many. US consumers could continue to over consume and Chinese consumers under consume. Many other countries had "bit part" in this global pattern (Germany and Japan, excess savers, the UK, some parts of Club Med Eurozone, excess spenders, other BRIC and important developing countries mixed roles too), but at the core of it, has been this dilemma. The US, with a population of around 300 million people, less than 5% of the world's population -up until the crisis-was consuming more than 20% of the world's output. China, with about 20% of the world's population was consuming somewhere between 2-3%.

The prime goal of G20 policymakers should be to help, cajole, support a world in the future, where the US consumer has adjusted to at most 15% of the world's consumption, maybe beyond this decade, less, and China somewhere close to

10%, and beyond this decade more. If this can be achieved, then no doubt there will be some other form of global imbalances, but this one, that has dogged the world for the past decade (and in the US's case for the previous two decades), will be behind us.

There are some signs that key G20 policymakers are starting to recognise that steps along these paths have occurred, and if so, it might be easier for them to create an environment in which it continues. US Treasury Secretary Tim Geithner, speaking in China recently, publicly acknowledged the evidence that Chinese consumption was becoming a larger share of their GDP, and with it, the balance of payments current account surplus much smaller. According to the data we track, in fact, Chinese consumption could be growing by somewhere close to 15% in real terms, which if so, must indeed, mean that it is starting to increase from its- probably underreported- low share of around 35% of GDP. Similarly, the data for the first 4 months of 2010 show that the annualized trade balance is currently in surplus of somewhere between 1-2% of GDP, nearly five times less than its peak before the crisis. Indeed, one of the most impressive things in data so far this year, is that China's imports year to date have risen by around \$500 billion on an annualized basis compared to the same period in 2009. This amount incidentally is equal to about 1.4 times the size of Greece's total economy, i.e. China's has been importing the equivalent of another Greece every 8 months.

At the core of this, is a realisation amongst Chinese policymakers that they cannot rely on the export machine for future economic growth. At one stage before the worst of the crisis, China had around 12% of its GDP equivalent in exports to the US. Those days are behind us. Chinese policies designed initially to boost domestic demand, and increasingly to focus on domestic consumption are, increasingly in vogue in China, and this is to be highly welcomed.

While other BRIC countries don't have the same degree of need for change, awareness that it is dangerous to be over reliant on exporting as a means of growth is no bad thing for them all. According to our projections for the next decade up to 2020, the possible increase in the aggregate GDP of the four BRIC countries will be about \$11 trillion, about three times more than the 3 trillion that the US is likely to grow by. In fact, if this occurs, the dollar size of the BRIC economies will match that of the US sometime before the end of the decade, both being around \$18 trillion. China will be about 2/3 of this, at 12 trillion, with the other BRIC countries, Brazil, India and Russia making up the rest. Of that 11 trillion increase, it is vital for the US, and other over levered economies who will be raising savings, reducing their budget and external deficits, that the lion's share of it will be in domestic consumption, much of which can be satisfied through imports.

Whether it is sensible for G20 policymakers to directly "target " these possible numbers as deliberate policy goals, I suppose is a debatable point, but this is the sort of underlying goals they should have.

From the US side, some of the evidence for a changing world post crisis, is also pretty clear. The trend of the balance of payments current account is better, currently around 3% of GDP on a 12 month annualized basis. Domestic personal

savings have increased notably, albeit from pitiful levels, but it is a start. Probably something in the vicinity of 8% of total income, a bit more than double where they currently are, will be necessary for the US to do its "bit" to help improve global imbalances, and support a world in which its own consumer will be less important. The related international part, i.e. dramatically boosting exports, is already a stated target of policy. In February, President Obama announced a goal of trying to double exports over the next 5 years, something which sounds ambitious but is exactly the sort of step the US, and world needs.

Other countries, including those within the developed G20 need to understand, and contribute to this broader world. This includes Japan and Germany, for whom contributing might be more of a challenge than the US or China. Germany in particular has some need from both a global and Eurozone perspective, in my opinion. Recent data shows a quite incredible trend involving German trade. A detailed breakdown of regional German export destinations shows a staggering degree of growth in exports to both China and India. To China in particular, things are so buoyant that if the current pace remained for the next 12 months, by this time in 2011, German trade with China could be as large as their trade with France. I have found myself thinking recently, that what goes on in China might be more important for the city of Munich- home to both BMW and Siemens- than anything going on in other Eurozone countries. Indeed, it might even be more important than anything going on elsewhere in Germany. While all of this speaks to the marvel of German exports, it is actually also a major problem, as Germany needs more domestic consumption, less personal savings. The rest of the Eurozone, especially those with US /UK style, need to raise domestic savings, and Germany to save less and spend and import more from them. The US, both in terms of its markets, and in terms of competition, probably needs Germany-and Japan- to spend more, import more and save less.

So should the G20 have a definite plan for targeting lower imbalances? It should certainly form part of the heightened multilateral, IMF led, surveillance of each G20 member country's view of the future. As the post crisis imbalance world is moving in this direction, as Mr. Geithner has observed, why not only consolidate these gains, but ensure that moving further in this helpful direction is at the heart of what the G20 sets itself as tasks when it meets in near future.

About the Author

Jim O'Neill is Head of Global Economics, Commodities and Strategy Research for Goldman Sachs which he became in 2008. He received his Ph.D. in 1982 from the University of Surrey after graduating in Economics from Sheffield University in 1978. Jim is the creator of the acronym BRICs and, together with his colleagues, he has published much research about BRICs, which has become synonymous with the emergence of Brazil, Russia, India and China as the growth opportunities of the future. Jim is a member of the board of the Royal Economic Society in the UK, of the European think-tank Bruegel, and Itinera, a Belgium think-tank. He is a member of the UK-India Round Table, and the UKIBC. Jim is one of the founding trustees, as well as the current Chairman, of the London-based charity SHINE. In 2009, Jim received an honorary doctorate from the Institute of Education, University of London, for his educational philanthropy. He also served as a non-executive director of Manchester United before it returned to private ownership in 2005.

11 Exchange rates to support global rebalancing

John Williamson and William R. Cline
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What exchange rates are appropriate for global rebalancing? This chapter suggests that an “immaculate adjustment” to the locus of expenditure requires a change in the pattern of exchange rates. By using a model developed with William R. Cline, the author notes that the the major disequilibrium in the world remains the overvaluation of the dollar and the undervaluation of the renminbi. Also, the depreciation of the euro has undoubtedly strengthened European trade prospects, the yen is still overvalued relative to the dollar, and the Swiss franc, which is monetarily important, is almost as undervalued as the renminbi.¹

The objective of global rebalancing is widely endorsed. Everyone knows that in order to be achieved without global deflation it will be necessary to expand domestic spending in the countries that have had payments surpluses in the past and to expand saving in the countries that have had payments deficits in the past. Unless one is content to see such an adjustment accompanied by inflation in the countries, like Germany, that have had past surpluses and falling prices in countries like the US that had past deficits (or believes in a process of what I have termed “immaculate adjustment”), such a reorientation in the locus of expenditure needs to be accompanied by a change in the pattern of exchange rates. The question is what exchange rates are appropriate.

It happens that in association with William R. Cline I have been studying exactly this topic (Cline and Williamson 2010). In our latest (just-published) iteration aiming to identify the set of “fundamental equilibrium exchange rates” implied by the latest IMF forecasts, we give every country an objective of achieving a current account that is at most 3% of GDP away from balance, taking the actual forecast as the target in the event that it is within +/- 3% of equilibrium. (In earlier studies we allowed countries with large net foreign asset positions, positive or negative, relative to GDP the possibility of a larger imbalance, but in view of the G20’s decision to call for global rebalancing this latest study has abolished such possibilities.) We then asked Cline’s model what set of exchange rates would be needed to achieve the current account targets given the forecasts for real growth and commodity prices in the latest IMF World Economic Outlook. The model applies export price elasticities to estimate the needed changes in effective exchange rates, and then uses a matrix inversion method to translate

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changes in effective rates into changes in bilateral rates against the dollar. The figures in the IMF's World Economic Outlook were based on a period largely in March, but we adjusted to a May base by using Cline's estimates of the impact of exchange rates on trade flows. (It is assumed throughout that all countries pursue fiscal-monetary policies to maintain full employment).

We got results for the G20 countries (plus Switzerland) presented in Table 1. Several comments seem in order.

Table 1. Estimates of the Disequilibrium of the G-20 Currencies, May 2010

| | Desirable change in REER | Desirable change in dollar rate |
|------------------------|--------------------------|---------------------------------|
| Argentina | 0 | +2 |
| Australia | -13 | -6 |
| Brazil | -3 | 0 |
| Canada | 0 | +2 |
| China | +15 | +24 |
| Euro | 0 | +5 |
| India | 0 | +8 |
| Indonesia | 0 | +15 |
| Japan | 0 | +9 |
| Korea | 0 | +10 |
| Mexico | 0 | +1 |
| Russia | n.a. | +5 |
| Saudi Arabia | n.a. | +7 |
| South Africa | -14 | -9 |
| United Kingdom | 0 | +5 |
| United States | -8 | 0 |
| Memo Item: Switzerland | +13 | +17 |

Notes: A plus sign before the figures indicates that the currency needed to appreciate (i.e. was undervalued), while a minus figure indicates that it needed to depreciate (i.e. was overvalued). N.a. = not applicable; no attempt was made to calculate desirable targets for oil exporters. The dollar changes given are those which would leave the REERs unaffected. Source: Cline and Williamson (2010, Table 2, columns 3 and 6).

First, there is no question that the major disequilibrium in the world remains the overvaluation of the dollar and the undervaluation of the renminbi. Because of the convention that exchange rates are quoted in terms of a national currency, the US dollar, it is up to the Chinese authorities to take action to remedy this disequilibrium, and in the absence of any action on their part the disequilibrium will persist. If and when China does correct its exchange rate, a number of other Asian currencies will need to appreciate too (India, Indonesia, Japan, and Korea among the G-20 currencies, although there would be several of the currencies of

smaller countries which would need to appreciate much more against the dollar) in order to avoid becoming undervalued.

Second, the depreciation of the euro has undoubtedly strengthened European trade prospects, but it has not yet become so extreme as to push the euro area into the prospect of large surplus. We allow for a swing of +/- 3% of GDP in the current account balance before we judge it would be appropriate for international pressures to adjust to be brought into play, and the euro area still falls comfortably within that range.

Third, the yen is still overvalued relative to the dollar, but this is now entirely a reflection of misvaluation elsewhere in Asia and no longer reflects a yen that is overvalued in REER terms resulting in a surplus above the acceptable range.

Finally, one may remark about the non-G20 currency in the table. I have included Switzerland because the Swiss franc is monetarily important. It is almost as undervalued as the Renminbi, and even after allowing for the fact that Swiss statistics probably overstate the magnitude of Switzerland's economically-relevant current account surplus by as much as 4 percent of GDP. (Swiss statistics attribute the whole retained earnings of Swiss-owned MNEs to Switzerland even though many of the owners are foreigners, and in the Swiss case this produces a strong bias.) Any reasonably-symmetrical effort to achieve rebalancing is going to have to include Switzerland and not simply Asians as those who need to adjust away excessive surpluses.

Reference

Cline, William R., and John Williamson. 2010. *Estimates of Fundamental Equilibrium Exchange Rates, May 2010*. (Washington: Peterson Institute for International Economics Policy Brief 10-_.)

About the Author

John Williamson is a senior fellow at the Peterson Institute of International Economics. He was project director for the UN High-Level Panel on Financing for Development (the Zedillo Report) in 2001; on leave as chief economist for South Asia at the World Bank during 1996–99; economics professor at Pontificia Universidade Católica do Rio de Janeiro (1978–81), University of Warwick (1970–77), Massachusetts Institute of Technology (1967, 1980), University of York (1963–68), and Princeton University (1962–63); adviser to the International Monetary Fund (1972–74); and economic consultant to the UK Treasury (1968–70). He is author, coauthor, editor, or coeditor of numerous studies on international monetary and development issues.

William R. Cline is a senior fellow at the Peterson Institute for International Economics. He has been associated with the Institute since 1981 and holds a joint appointment at the Center for Global Development. During 1996–2001

while on leave from the Institute, Dr. Cline was deputy managing director and chief economist of the Institute of International Finance (IIF) in Washington, DC. The IIF conducts research on emerging-market economies for its membership of over 300 international banks, investment banks, asset management companies, insurance companies, and other financial institutions. He has been a senior fellow at the Peterson Institute for International Economics since its inception in 1981. Previously he was senior fellow, the Brookings Institution (1973–81); deputy director of development and trade research, office of the assistant secretary for international affairs, US Treasury Department (1971–73); Ford Foundation visiting professor in Brazil (1970–71); and lecturer and assistant professor of economics at Princeton University (1967–70). He graduated summa cum laude from Princeton University in 1963, and received his MA (1964) and Ph.D. (1969) in economics from Yale University.

12 Why exchange rate changes will not correct global trade imbalances

Ronald I. McKinnon
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In this chapter the authors suggest that the prevailing wisdom that a country's exchange rate should be used to bring its external trade into better balance is based on faulty economic theorising and should not apply in a globalised financial system where capital flows freely internationally. Under financial globalisation, forcing a creditor country such as China to appreciate its currency is neither necessary, sufficient nor even helpful for reducing its trade surplus.

Nobody disputes that almost three decades of US trade (net saving) deficits have made the global system of finance and trade more accident-prone. Outstanding dollar debts have become huge, and threaten the US' own financial future. Insofar as the principal creditor countries in Asia (Japan in the 1980s and 1990s, China since 2000) are industrial countries relying heavily on exports of manufactures, the transfer of their surplus savings to the saving-deficient US requires that they collectively run large trade surpluses in manufactures. The resulting large American trade deficits have worsened the “natural” decline in the relative size of the American manufacturing sector, and eroded the US industrial base.

One unfortunate consequence of this industrial decline has been an outbreak of protectionism in the US, which is exacerbated by the conviction that foreigners have somehow been cheating with their exchange rate and other commercial policies. The most prominent of these have been associated with New York's Senator Charles Schumer. In March 2005, he co-sponsored a bill to impose a 27.5% tariff on all US imports from China until the renminbi was appreciated. His bill was withdrawn in October 2006, when shown to be obviously incompatible with America's obligations under the WTO. But Schumer threatens to craft a new China bill for 2010 that is WTO compatible.

Furthermore, Congressional legislation requires the Secretary of the Treasury to investigate any country that runs a trade surplus with the US and to pronounce on whether or not the surplus country is manipulating its exchange rate. So far in 2010, the current Secretary— Timothy Geithner— has narrowly avoided having to label China a “currency manipulator”, which would involve as yet unspecified sanctions that could lead to a trade war.

However, the prevailing idea that a country's exchange rate could, and indeed should, be used to bring its external trade into better balance is often wrong. Unfortunately, this conventional wisdom is based on faulty economic theorising.

It need not apply in a globalised financial system where capital flows freely internationally. Under financial globalisation, forcing a creditor country such as China to appreciate its currency is neither necessary nor sufficient—and need not be even helpful—for reducing its trade surplus. What are the issues involved?

The exchange rate and the trade balance: The debate

For a “home” country, consider the identity from the national income accounts:

$$X - M = S - I = \text{Trade (Saving) Surplus}$$

where X is exports and M is imports (both broadly defined), and S is gross national saving and I is gross domestic investment

Most economists and commentators focus just on the left-hand side of this accounting identity. It suggests that a depreciation of the home currency will make exports cheaper in world markets, and they will expand. Similarly, the home country’s imports will become more expensive in domestic currency, so they should contract. Thus conventional wisdom has it that the overall trade balance should improve if the underlying price elasticities for exporting and importing are even moderately high. This seemingly plausible result is very intuitive, so even journalists can understand and perpetuate it.

But this elasticities approach is basically microeconomic and quite deceptive. The export function X is looked at on its own— and so is the demand for imports M —even by supposedly sophisticated econometricians who purport to measure separately the price elasticities of exports, and of imports, to exchange rate changes. Thus it is called the elasticities approach to the trade balance.

However, if you analyse the right-hand side ($S - I$) of the identity, the emphasis is macroeconomic. For the trade balance to improve with exchange depreciation, overall domestic expenditures must fall relative to aggregate output. This is the same as saying that domestic saving must rise relative to domestic investment. Looked at this way, one cannot presume that US net saving will rise when the dollar is devalued.

Indeed, the presumption may go the other way when domestic investment (fueled in part by multinational firms) is sensitive to the exchange rate. Suppose the renminbi were to appreciate sharply against the dollar. Potential investors—either foreign or domestic, would now see China as a more expensive place in which to invest and the US less expensive. This might set off a minor investment boom in the US, where investment expenditures rise from a relatively small base, and a major slump in China’s huge investment sector— which is currently about 45% of GNP. Overall, investment-led expenditures in China would fall, the economy would contract, Chinese imports could fall.

This is what happened to Japan from the 1980s into the mid-1990s when the yen went ever higher. Japan became a higher-cost place in which to invest, so that large Japanese firms decamped to invest in lower cost Asian countries, and

in the US itself. Even though yen appreciation slowed Japan's export growth, the trade surplus of the slumping economy increased.

No wonder China is reluctant to appreciate! Like Japan in the 1980s and 90s, its trade (saving) surplus would likely not diminish because domestic saving is relatively insensitive to the exchange rate even though investment in a globalised financial-industrial world is sensitive. However, foreign critics in the US and Europe, with the misleading elasticities model (which doesn't take international investment choices into account) in their heads, would come back and say "you just didn't appreciate enough". With this adverse expectation of continual renminbi appreciation, the upshot would be further hot money inflows. The People's Bank of China would be, as it has been, forced to intervene to buy dollars on a grand scale to prevent an indefinite upward spiral in the renminbi. But the accumulation of dollar foreign exchange reserves threatens a loss of internal monetary control as base money in China's banking system expands at an equal rate, and somehow has to be sterilised.

Currency mismatches and the impossibility of a free renminbi/dollar float

While a discrete appreciation of the renminbi— by moving the government-controlled peg for the renminbi/ dollar rate—would be deleterious, isn't there an alternative market-based solution for determining the exchange rate?

It is China's decision about what to do with the exchange rate -- they're a sovereign country," Geithner said. "But I think it is enormously in their interest to move, over time, to let the exchange rate reflect market forces, and I am confident that they will do what is in their interest," he said while visiting Boeing and other exporters in Washington State.

Associated Press, May 23, 2010

Secretary Timothy Geithner's tone here is much more measured and careful than in previous episodes of US "China bashing" where various congressmen, journalists, industrialists, union officials, and economists— intellectually trapped by the elasticities model— have called for a large appreciation of the renminbi against the dollar. But would Secretary Geithner's more moderate and seemingly reasonable approach to let the renminbi/dollar rate reflect "market forces" i.e., by floating, work?

China has a large ongoing net saving (trade) surplus that somehow has to be financed by lending to foreigners. But the renminbi is not (yet) an internationally accepted currency. Thus the buildup of financial claims on foreigners is largely denominated in dollars—and not renminbi.

Moreover, with the threat that the renminbi might appreciate in the future, foreigners become even more loath to borrow in renminbi. So we have the making of a severe currency mismatch if the People's Bank of China were to withdraw

from the foreign exchange market, i.e., stop buying the dollars necessary to stabilise the renminbi/dollar rate.

Under such a free float, Chinese private (nonstate) financial institutions such as banks, insurance companies, and pension funds, would become responsible for financing the trade surplus. So they would have to build up dollar claims on the asset side of their balance sheets even though their liabilities—domestic bank deposits, annuity and pension obligations—were denominated in renminbi. Because of this mismatch, they would face the threat of bankruptcy should the dollar depreciate.

China's current account surpluses have been so large, between \$200 billion and \$300 billion per year, that when cumulated they would quickly dwarf the net worth of China's private financial institutions. Thus, except for transitory transacting, these private institutions would refuse to accumulate the dollar claims being thrown off by the current account surplus once the People's Bank of China left the market. Under such a free float with no willing buyers of dollars, the renminbi would just spiral upward indefinitely with no well-defined upper bound for its dollar exchange rate. (And remember that the appreciated renminbi need not reduce China's trade surplus.)

Of course the People's Bank of China could not just stand idly while a continually appreciating renminbi caused both exports and domestic investment to slump. So it would revoke its free float and re-enter the foreign exchange market to buy dollars to re-stabilise the renminbi/dollar rate. But this adventure in floating would have further undermined expectations, and make it more difficult to re-establish a credible renminbi/dollar rate from which hot money inflows were absent. The People's Bank of China and State Administration of Foreign Exchange could well find themselves with much larger dollar exchange reserves than the current incredibly high \$2.5 trillion, and with the economy knocked off its high growth path.

What is the more general lesson here? Suppose a creditor country continues with high net saving ($S - I$) leading to a large buildup of foreign currency claims. The resulting currency mismatch within its domestic financial system will cause a free float to break down. Unlike what Secretary Geithner suggests, there is no market solution. So the best that the country can do is to stabilise its exchange rate through official intervention sufficiently credibly that hot money flows are minimised. And this is the strategy that China has been trying to follow, but is continually knocked off course by US and European "China bashing" to appreciate the renminbi.

The way out

1. In the short term (and forever?), foreigners should stop bashing China on the exchange rate. A credibly stable exchange rate would eliminate hot money inflows into China and make it much easier for the People's Bank of China to continue with its huge domestic credit expansion, which has made China the leading force in global economic recovery.

2. In the medium term, better balance net saving in the US and China. The US should cut back on its huge fiscal deficits and constrain private consumption while China continues stimulating private consumption. With trade better balanced, American manufacturing could recover and protectionist pressures would lessen.
3. In the long term, China should continue to encourage the “internationalisation” of the renminbi. With a stable renminbi/dollar rate, foreigners would be more willing to borrow in renminbi from Chinese banks and even be willing to issue renminbi-denominated bonds in Shanghai. By gradually escaping from its internal currency mismatch, China would be well on the road to becoming a “mature” international creditor.

About the Author

Ronald I. McKinnon is William D. Eberle Professor of International Economics at Stanford University. He is an applied economist whose primary interests are international economics and economic development-with strong secondary interests in transitional economies and fiscal federalism. Understanding financial institutions in general, and monetary institutions in particular, is central to his teaching and research. His interests range from the proper regulation of banks and financial markets in poorer countries to the historical evolution of global and regional monetary systems. His books, numerous articles in professional journals, and op-eds in the financial press such as *The Economist*, *The Financial Times*, and *The Wall Street Journal* reflect this range of interests.

13 This time *will* be different? Addressing the unsound post-crisis drivers of global imbalances

Kati Suominen

German Marshall Fund of the United States

In this chapter, the author urges G20 members to bolster their previously agreed 'framework for strong, sustainable and balanced growth' so that nations adhere to it in good times as well as bad. Washington's goals must be fiscal policies that ensure US economic resilience and compel others to adjust; China needs to be both pressured and co-opted through institutions as well as recognise that cultivating new sources of growth is in its economic and political self-interest.¹

As the US current account deficit peaked at 6.5% of GDP in 2006, confidence in the US economy was feared to erode and the dollar deemed to fall. However, the 2008-09 crisis was not caused by a “sudden stop” in the US. Instead, as the crisis globalised, money flowed to the US in escape of turbulence elsewhere. While studies on the contribution of the imbalances or any of their drivers to the crisis remain inconclusive, they do not imply that imbalances are necessarily good for the world economy or that they could not perpetrate a crisis of different kind in the future. Policies to contain them could still be warranted.

At their Pittsburgh Summit in September 2009, the G20 committed to the US-sponsored “Framework for strong, sustainable and balanced growth,” a concerted effort to contain global imbalances. The Framework builds on the first G20 Summit declaration in November 2008, which blamed both regulatory failures and the drivers of the imbalances (“inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms”) for the crisis.² Under

1 This article draws on the author's recent contributions to VoxEU.org and on Suominen (forthcoming). The author would like to thank Richard Baldwin and Simon Evenett for constructive comments.

2 The Declaration (G20 2008) states: “During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policymakers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.

“Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption.”

the Framework, each G20 member is to subject its economic policies to a peer review managed by the IMF, which, in turn, determines whether the member's efforts are "collectively consistent" with global growth goals.

The G20 members will take the first look at their progress on the Framework at their 26-27 June Summit in Canada. The timing is opportune. With trade, credit, and commodity prices recovering, the IMF (2010) recently revised its projections of US current account deficit to 3.3% of GDP in 2010 and 3.4% in 2011. Also UK, Canada, Australia, India, Turkey, France, and southern European nations would run steep trade deficits. The mirroring surplus nations are familiar – China, Japan, emerging East Asia, Germany, and oil producing nations. What are the challenges to keeping the imbalances in check? How to make the Framework work?

Strengthened by the crisis: Unsound drivers of imbalances

National accounts do not need to be balanced, and imbalances do not have to result from distortive or unsustainable policies. Instead, they can reflect cross-national differences in rates of return on capital, propensity to save, and degree of risk.³ But if imbalances result from distortive regulatory, currency, and/or trade policies, or risking an unruly unwinding, they can, research suggests, impair macroeconomic performance. Cline and Williamson (2009) note that "[L]arge external imbalances can only aggravate not moderate, fragility in the financial system." Besides, regardless of their cause, imbalances sour trade politics: current account deficits are America's historic precursor of protectionism (Bergsten 1981, 2007).

The crisis exacerbated the unhealthy policy drivers of the imbalances – that are discounted in the IMF's imbalance projections. Emerging Asia saw the episode as validating reserve accumulation and is now reaffirming that strategy, even though it diverts investments from, say, infrastructure and education, and although pooling insurance globally would be much more efficient. US debt, ballooning on the back of the crisis-era deficits, is projected to rival the wartime record highs, and will in all likelihood require even more expansive foreign borrowing.

Europe's lackluster growth projections and post-crisis fiscal retrenchment – including Germany's €95 billion austerity measures through 2014 and belt-tightening in UK and southern Europe – re-emphasise US role as the consumer of last resort. Germans also tend to see the global imbalances as a US-China problem, and Berlin appears resolved to reclaim its place as the world's export champion, a drive facilitated by the weak euro (Der Spiegel 2009, Smith 2010).⁴

Meanwhile, China, the main surplus nation, continues catering to export lobbies and prodding state-owned enterprises as tools of political patronage. Neither builds a vibrant services economy or stokes consumer-led growth, and

³ See for example, Blanchard and Milesi-Ferretti (2009) and Kohn (2010).

⁴ To be sure, adjustment by Berlin would not necessarily significantly reduce global imbalances: even if Germany were to bring its overall trade surplus to zero, US trade deficit would be reduced by a mere 0.2 percentage points (Basasin 2009). But German support for global rebalancing would be useful for persuading China and other surplus nations to adjust.

both compel Beijing to undervalue the renminbi – as does the recent fall of the euro. Japan, battling its deflation, is unlikely to raise taxes or interests rates, let alone emerge as the global growth pole. Emerging Asian nations have scant incentives to revalue their currencies before China and Japan do so. In short, reversion to a policy *status quo ante* in the rest of the world is matched by a game-changer in the US, widened budget deficit.

Game changer: US debt

Dooley, Folkerts-Landau, and Garber (2004) have famously labeled the pre-crisis pattern of global demand as “Bretton Woods II.” Imbalances were portrayed as a symbiotic pattern that channeled surplus nation savings to safe and liquid destinations, which, in turn, enjoyed greater availability of credit. US current account deficit in that setting was viewed to be near-permanent, and, as long as fiscal deficits were kept in check, it would also be sustainable.⁵ The large pool of less sanguine analysts argued that at 5-6%, US current account deficit would be “unsustainable.” At such a point, America was argued to be in for a sudden stop and hard landing – capital flight followed by collapse of the dollar, rise in interest rates, and decline in output. Obstfeld and Rogoff (2004) argued “hard” landing meant more than a 30% drop in the dollar’s value.

Bibow (2010) suggests the next regime might be a “Bretton Woods III” where US current account deficits sustain US and global growth, only now fuelled by public rather than private spending. Such a regime would be perilous. Peterson Institute’s well-known studies show that even if US annual growth was a decent 2.75% and fiscal deficit “only” 2% of GDP through 2030, US current account deficit would still rise to 4-5% of GDP. Runaway deficits soaring to 10% of GDP by 2030 would widen the imbalances to 5.2% of GDP in 2015, 7.5% in 2020, and a breathtaking 16% in 2030, or 2.5 times the historic 2006 level (Cline 2009). Foreign nations would need to devote over 65% of all their offshore investments to dollar assets, more than double today’s figure (Mann 2009).⁶ The Institute concludes that the dollar and US economy would probably collapse before such an ominous endpoint.

Granted, America’s unique qualities that alleviate the implications of current account deficits are still in place: the dollar is peerless, US financial markets large and liquid, Europe’s travails and recent market shakeups have yet again revealed the resilience of US status as the global safe haven. But imbalances now risk growing for the wrong reasons, US debt buildup and persistent policy distortions in Asia.

Indeed, while questions about the implications of the imbalances polarised academia pre-crisis, concerns over the debt in particular are now widely shared among imbalance analysts and international institutions. The IMF (2010),

⁵ See Dooley, Folkerts-Landau, and Garber (2004) for the term “Bretton Woods II”. On the US fiscal deficits, they note that “as USA debts cumulate, US willingness to repay both Asia and Europe comes more naturally onto the radar screen, so the system that was previously stable could run into trouble.”

⁶ For further discussion, see, for example, Bergsten (2009).

seconded by the OECD (2010), stresses the need for fiscal consolidation in advanced nations and openness to capital inflows and exchange rate appreciations in emerging ones. The ECB (2010) sternly warns imbalances “pose a key risk for global macroeconomic and financial stability.”

Making the framework work

The task for the G20 is to see the Framework through against this challenging backdrop. Needed are cuts in US budget deficit, commitment by Asians and Germany to stimulate domestic demand, and an end to China’s currency mercantilism. The future of the G20 is at stake: how the group deals with the imbalances will be a key barometer of its performance and relevance. Unlike the other items on its agenda – financial regulations, IMF reform, global trade liberalisation, and so on – that will ultimately be dealt with in other forums, the imbalances are and have been the core competence of the G system since its founding in 1973. The collaboration, while grudging, had its successes, most notably the historic Plaza Accord of 1985 among the G5.⁷

Factors behind Plaza are again present: uncertain American demand, sour US trade politics, and a forum that encompasses all actors required for a solution. Positively, a more systematic process than in the 1980s for addressing the issue is in place. Further, besides the US, other main deficit nations should be keen to tackle the issue, and dozens of nations want to see changes in China’s trade and currency policies. The G20 agenda is broad enough to provide for bargaining across issues. And unlike just half a decade ago, the US now has a complementary forum, the Strategic and Economic Dialogue, for addressing the issue bilaterally with China, the necessary partner in the balancing act.

However, the surplus nations are unwilling to budge, and Washington’s carrots and sticks are in shorter supply than in the past. The surplus nations are not as concerned about the specter of US protectionism as Japan was in the 1980s, and Japan and Germany are perhaps less dependent on US security umbrella than in the past. G20 and the Strategic and Economic Dialogue are hostage to the precarious health of US-China relations. Politics jeopardise the Framework. China is loathe to offer detailed multi-year projections due to the domestic expectations they place on the government, and not all governments

⁷ The United States was to reign in the budget, Japan to boost private demand through tax reform, and Germany to cut taxes to stimulate its economy. All five were also to intervene in foreign exchange markets to bring down the value of the dollar. To be sure, Germany – Bundesbank in particular – resisted, and Plaza entailed practically no changes to German fiscal or monetary policies. Plaza had an immediate effect. The following day, the dollar fell 4.3 percent against other major currencies; in the next several months, it dropped by more than 30 percent, both thanks to Plaza and because of lower oil prices and flickers of growth in Japan and Europe. See Funabashi (1989), Henning (1994), Meyer et al. (2002), and Cline (2005). Kelin et al. (1991) show that it was indeed Plaza rather than some other factor that compelled governments to adopt policies that changed trade balances.

will necessarily interpret “sustainable” like Washington does – current account deficit no higher than 3.5% of GDP.⁸

To be sure, policy can go only so far. Even the best efforts to tackle the imbalances could be overwhelmed by factors beyond governments’ immediate control, such as commodity shocks or exchange rate instability. Conversely, some trends could create an appearance that the Framework worked. For example, low growth in the US and rapid growth in Asia could reduce the imbalances, but such a situation would be sub-optimal for everyone. Concurrent policies, such as stringent financial regulations, could help, but only in the longer-term.

That policy has its limitations does not mean it should not be pursued. The issue and its implications are global, and common responses are required. If each nation instead blindly pursues its own short-term interest, everyone loses at the end. Pushing exports at all costs, the surplus nations could send off rounds of trade protection and only perpetuate the imbalances. Trade barriers and fiscal deficits in the US would be similarly short-sighted and self-defeating.

The Framework is not a tool for shrinking US fiscal gap or changing the surplus nations’ political economy equilibria. Nor is it a means to a coordinated exchange rate adjustment. Reforms will inherently have to be made unilaterally. However, by requiring all players to show their hand simultaneously and by implying they synchronise policies, the Framework does lower informational costs and collective action problems. It is a coordination device to overcome a Prisoner’s Dilemma in international economic relations.

The Framework is up against a familiar dilemma in international financial affairs: while a binding pact would have bite, the specter of enforcement would preclude countries’ buy-in in such a pact to begin with. The odds of the Framework can, however, be fortified through four measures:

- The first is continuity. Rebalancing must be an on-going process rather than a result of agonised, ad hoc Plaza-like watersheds. The G20 leaders and finance ministers need to dedicate a regular time to the imbalances, issue bold language to single out laggards, and provide the IMF adequate resources for its assigned task. Sustained focus is particularly critical in the years ahead, as the G20 agenda is bound to broaden to issues of interest to its diverse membership.
- Progress needs to be measured and lack of it to automatically induce action. The G20 could adopt a “rebalancing trigger”, a threshold that if surpassed, would set off concerted action, such as a special finance ministerial or IMF consultation. One such threshold indicator could be six months of US current account deficits: if consistently above 3.5%, it would trigger action. Or, the trigger could be based on a set of indicators that includes the US trade balance.
- The end goal must be structural changes in the surplus economies. Large imbalances will cease no sooner than their leading cause is terminated.

⁸ The Canada Summit will start providing answers to further pending and potentially problematic questions – whether all G20 members will submit their plans to the IMF, and whether they will dutifully break down their growth projections into the various sub-components (domestic savings, governments spending, investment, and international trade) that allow the Fund to assess the prospects for rebalancing.

Asia's industry mix needs to change and policy bias against services end. While the deficit nations hold little sway over the politics of Chinese industry, they can encourage investment in Asian services industries.⁹ Such measures should be met by an Asian quid pro quo: greater market access in the region to US goods, capital, and services. For Asia, adjustment does need to be economically painful: IMF (2010) finds that countries that have enacted policies to end their current account surpluses have not lost any growth or exports, but gained in employment, capital, and imports.

- Given the global unhappiness with undervalued Chinese and Asian currency policies, exchange rates, even if they are arguably contingent on structural changes, need to be part of the Framework process lest they cloud it. The approach should be multilateralised so as to address the Asian nations that peg their currencies to the renminbi: not only will their actions affect China's policies; a coordinated adjustment across Asia would reduce exports from the region twice as much as an adjustment by China alone (Thorbecke and Smith 2010). A multilateral approach would also help avoid negative fallout on US-China relations.

US Policy

Critically, Washington needs to play by its initiative. Beijing's currency policy has tempted Congress and Paul Krugman (2010) to irresponsibly advocate tariffs against China. Protectionism would be counter-productive. Implying that the US sidesteps the Framework process it has promoted, trade barriers would only undermine the Framework, as well as damage the multilateral trading system America has championed for decades – and so right when steep trade deficits are feared to propel protectionism globally. Instead, the currency issue needs to be handled at the G20, IMF, and Strategic and Economic Dialogue and, if necessary, WTO dispute settlement body.

US fiscal discipline is another pre-requisite to progress. It is necessary for surplus nations' buy-in: fiscal stringency would signal US preparedness to do its share for the Framework, not shift the adjustment burden abroad or exclusively pursue the Obama Administration's export agenda. It would compel others to act: few motivators are as powerful for the surplus nations to re-examine their growth models as a saving America.

Self-restraint is also the simplest means for Washington to counter the loosened fiscal constraint entailed by foreign lending, and provide other nations assurances of US economic health. Cutting the fiscal deficits by 2 percentage points is estimated to lower current account deficits by only 0.6 percentage points (Bartolini and Lahiri 2006). However, fiscal discipline is crucial for fueling private

⁹ While greater social security benefits could disincentivize Chinese to save, an efficient services sector would incentivize them to spend. The impact could be powerful if combined with financial development. If Chinese savers had access to safe instruments guaranteeing higher rates of return, they would be likelier to spend a larger share of their incomes.

savings, which have rebounded to 5% of US incomes on the back of the past two years of deleveraging. The trade-offs are meager. Any negative effects from reduced public and private spending are consistently offset by greater availability of capital investment (Thornton 2009). Historically, robust investment and economic growth have been sustainable only on the back of domestic saving.

In the past, taxes and spending cuts have been used simultaneously to rein in deficits. Taxes must not curb growth, already because tax revenue hinges on robust growth.¹⁰ Containing the rising cost of health care and reforming Social Security are critical, as are pay-go rules and government exit from the marketplace. President Obama's commission on national debt must think bigger and for the longer haul than stopping at advocating a value added tax.

Conclusion

The challenge to the G20 is the very same one that has confronted each G from the G4 to G5, G7, G8 and, now, G20: implementing internationally agreed macroeconomic policy changes even when they clash with domestic political imperatives. The litmus test for the group's effectiveness in meeting its goals will come as global growth rebounds and the salience of crisis-induced cooperation dissipates. The Framework process needs to be bolstered in order for nations to stick to it also in good times. Imbalances need to be addressed regularly, not only when they grow too large and political to be undone only by a good crisis. Much of the work has to be done at home. Washington's goals must be fiscal policies that ensure US economic resilience and compel others to adjust. China needs to be both pressured and co-opted through institutions – G20, Strategic and Economic Dialogue, and IMF. For its part, Beijing must see that cultivating new sources of growth is in its economic and political self-interest. The magnitude of the potential problem requires nothing less.

¹⁰ For a discussion on optimal taxation, see Mankiw et al (2009).

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14 Asia's role in global rebalancing

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A positive outcome of the global economic crisis has been the narrowing of global imbalances. This chapter suggests that, post-crisis, Asia's key challenge is to rebalance their economies, shifting from excessive dependence on external sources toward domestic and regional sources in order to achieve a balanced and sustainable growth structure. Such rebalancing will also be good for the world economy, by offering a new source of global growth amid a stagnant recovery in industrialised countries.

Emerging Asia is now driving the global recovery. With the recovery gaining speed, many policymakers have initiated an 'exit' from accommodative policies adopted during the 2008–09 global economic crisis. Indeed, monetary authorities across the region have started to tighten monetary policies ahead of much of the rest of the world. But relatively higher yields and expectations of stronger currencies are encouraging currency carry trades. In fact, emerging Asia began to attract large capital inflows in the second half of 2009, before the 'exit' had even started.

While renewed investor confidence in emerging Asia is welcome, the hazards of large and volatile capital flows cannot be ignored. Vast inflows of foreign capital could trigger a surge in consumer and asset prices, whereas sudden outflows could spur a financial crisis in countries with inadequate foreign exchange reserves or weak financial systems. The region's experience during the 1997–98 financial crisis underscores the devastating economic effects of a sudden reversal in foreign capital.

A positive outcome of the global economic crisis has been the narrowing of global imbalances. The current account deficit of the US declined significantly in 2009 over the previous year. The flipside of this is the substantial reduction in the surpluses of the major oil exporting economies in the Middle East, North Africa, and Russia.

But this trend will not be sustainable if it is not accompanied by structural reforms. The latest IMF estimates suggest that by 2012 the current account surpluses of developing Asia, particularly in China, will surpass the previous peaks of 2008, and that world current account imbalances are likely to remain substantial through 2015.

Such potentially large imbalances pose the risk of sparking another financial crisis. Prior to the current global economic turmoil there was widespread concern that a "disorderly unwinding" of growing global imbalances would lead to crisis.

In the end, they did not directly cause the economic crisis that began in 2008. Instead, inadequate financial market regulation and lax monetary policy in industrialised countries, particularly in the US, were the primary causes. Current account excesses nevertheless underpinned the global turmoil of 2008–09, and Asia played a large role.

Together, the two crises, 1997–98 and 2008–09, exposed weaknesses in developing Asia's financial and real sectors. Now, Asia's key challenge is to distil the correct lessons and help avert another crisis. In the interest of its own growth and welfare, Asian countries should rebalance their economies, both collectively and individually, shifting from excessive dependence on external sources toward domestic and regional sources to achieve a balanced and sustainable growth structure. Such rebalancing will also be good for the world economy, by contributing to the orderly unwinding of global imbalances and offering a new source of global growth amid a stagnant recovery in industrialised countries.

Policies for Asia's rebalancing

Effective rebalancing will require a combination of policy measures that boost domestic and regional demand, and that bolster domestic and regional capacity to meet such demand. This means that consistent adjustments on both the demand and supply sides of the economy must be implemented.

Demand side adjustments are necessary to reduce developing Asia's heavy reliance on extra-regional demand for its exports. This involves expansion of domestic demand and broadening regional trade opportunities in final demand for goods and services. Authorities can target policies at either encouraging greater consumption or stimulating investment. Fiscal policy addressing social concerns can also strengthen domestic demand in both the short and long run.

Some specific policies for stimulating domestic demand in the region

First, strengthening domestic consumption requires policies that transfer more corporate savings to households. Emerging Asia has a huge pool of savings coming largely from the private sector and driven mostly by high corporate profitability. However, in countries such as China, these corporate profits are often used to finance investment rather than to pay dividends. Policies that encourage firms to pay out higher wages and dividends will strengthen the link among corporate profits, household income, and consumption.

Second, more government spending on health, education, and housing will reduce households' precautionary motive for savings, which have risen since the 1997–98 crisis. Policies that mitigate risk and reduce the uncertainties that households face will encourage them to save less and spend more. Greater public provision of social services and more extensive social safety nets will enhance consumer confidence and boost consumption.

Third, governments should give priority to enhancing the investment climate rather than quantitatively expanding investment. The surge of current account surpluses also reflects a paucity of domestic investment, especially long-term infrastructure investment, in many Asian economies. The business environment across the region lags behind the world's competitive economies because of serious shortcomings in regional institutions and skill shortages. Remedying these weaknesses will help translate domestic savings effectively into domestic investment.

Likewise, supply-side adjustments are needed to achieve more balanced growth. This will likely involve a shift in resources away from tradables to non-tradables. Export-led growth served Asia well. But it also raised the cost of economic vulnerability and introduced substantial economic distortions—its prospective benefits now look much diminished. Simply put, Asia has grown too big to maintain its pre-crisis shares of world exports and, as such, the global financial crisis presents authorities with a chance to implement structural reforms that can ensure a more balanced and sustainable growth pattern.

Policies to encourage these supply-side adjustments include eliminating subsidies and factor-price distortions that favour exporters and tend to suppress labour's share of income. Authorities should also deregulate and encourage investment in growth areas of the services sector, including health, education, information, and telecommunications. Removing regulatory distortions in services will raise productivity not only in the services sector, but also in other sectors for which services such as transportation or telecommunications are important production inputs.

Public policy has a key role to play in helping small- and medium-sized enterprises—where most Asian workers are employed—grow and become more productive. Governments should work with commercial forces to correct existing market failures, particularly in the provision of finance. Authorities should provide information services on technology and markets, vocational training, and technical support services, and foster links between small and medium and large enterprises.

In addition, policies pertaining to financial development can better balance domestic supply and demand. On the demand side, financial development can help channel domestic savings effectively into productive investment rather than into low-yielding foreign government bonds. At the same time, it lessens the need for precautionary household savings and thus encourages greater consumption. On the supply side, improvements in the financial sector can encourage business startups, which are essential to a dynamic domestic economy.

Asian countries must also review and strengthen their own financial regulatory systems to avoid future crises. Reforms must aim to reduce the disruptive potential of volatile capital flows and to develop domestic financial markets to enhance resilience to outside shocks.

It is also clear that emerging Asian economies cannot go on keeping exchange rates stable against the dollar and amassing international reserves. This path led to unsustainable global imbalances in the first place. Achieving global rebalancing and gaining greater domestic macroeconomic stability requires that authorities

allow their currencies to adjust in line with an economy's fundamentals. Greater exchange rate flexibility creates an automatic mechanism to absorb shocks and allocate resources efficiently between tradables and non-tradables.

Regional and global cooperation

Along with these policy prescriptions, there is need for greater policy cooperation and coordination and further integration of regional markets. Key elements include strengthening the Chiang Mai Initiative Multilateralisation Agreement, including the setting up of an Independent Surveillance Unit; establishing an Asian Financial Stability Dialogue to foster economic and financial coordination; promoting measures to support increased regional infrastructure investment; and establishing a region-wide economic partnership agreement to encourage intra-regional trade in goods and services and investment so Asia can benefit from the economies of scale and dynamic efficiency of a larger market.

Regional integration can also play a bigger role in bringing firms and consumers in the region together, an important step given Asia's burgeoning middle classes. An East Asia-wide free trade and investment agreement that covers goods and services could help regional firms reorient production more broadly toward the needs of Asian consumers. Cross-border infrastructure investment can also help boost productivity and connect demand and supply within the region.

As emerging Asia assumes a larger role in the global economy, it must actively participate in major global forums and policy dialogue, and ensure that its global voice as well as responsibility is commensurate with its growing economic and financial importance, and rising political influence. Ultimately, through a stronger, balanced, and more resilient Asian economy, the region can benefit and help lead the global economy.

The views expressed in this article are those of the author and do not necessarily reflect the views and policies of the Asian Development Bank or its Board of Governors or the governments they represent.

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15 Prospects for rebalancing growth in East Asia

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The global economic downturn has sharpened focus on the global imbalances, with policymakers in East Asia no exception. This chapter argues that the region's leaders are at a cross roads. On the one hand, they can make concerted efforts to restructure their economies. On the other, they can return to the pre-crisis regime of export promotion.

Throughout East Asia, there has been a reexamination of the viability of the region's export-led growth. Exports would not have been a major source of aggregate demand had it not been the voracious appetite of US consumers for East Asian exports. Now that demand for the region's exports by US and European consumers is likely to remain weak for years to come, even when the global economy recovers and financial stability is restored, export-led growth may no longer be a practical strategy. This awareness has led to an emerging consensus that East Asia needs to rebalance its growth to depend more on domestic demand than before. Some then expected that this consensus would lead emerging East Asia, which excludes Japan, to restructure its industries, to reform its policies to stimulate domestic demand, and to allocate more resources to the non-tradable sector.

In the eyes of many observers both within and outside the region, however, there have been few visible signs that East Asia has moved in the direction of growth recalibration. Worse yet, all economies in the region-ASEAN, China, Japan, Korea, Hong Kong SAR, and Taiwan-have continued to run large and growing surpluses on their current accounts and to accumulate foreign exchange reserves. Although it may be premature to initiate an exit strategy, some of the East Asian countries have begun unwinding their fiscal stimulation in order to safeguard their sovereign debt sustainability. Other countries are trying to return to the old export-led regime. Countries in East Asia are once again at a cross roads. On the one hand, they can make concerted efforts to restructure their economies. On the other, they can return to the pre-crisis regime of export promotion.

The treacherous road

Notwithstanding its urgency emerging, East Asia is likely to deviate from the rebalancing at the risk of being accused of delaying the recovery of the global economy and exacerbating the trade imbalance and hence escalating trade

frictions between East Asia and North America. Why is emerging East Asia taking such a treacherous road?

There are five reasons.

1. One reason is that neither Japan nor China is capable of providing leadership needed to help galvanise region-wide support for the growth rebalancing.
2. Another is that many countries in the region may have exhausted the arsenal of the tools for stimulation of domestic demand. Monetary easing reached its limit a long ago. Although there was a global chorus of approval for fiscal stimulation at the beginning of the current crisis, the effectiveness as well as sustainability of the fiscal-policy-led recovery strategy has been faced with growing skepticism.

East Asian economies have traditionally refrained from spending out of an economic downturn whenever possible. Ever since the 1997-98 Asian financial crisis they have been on guard over fiscal indiscretion as it could sow the seeds of another crisis. Since the eruption of the Eurozone sovereign debt crisis, many of them have become much more conscious about their government debt sustainability.

3. A third reason is the concern over the repeat of a liquidity crisis in the future. Default of any one of the southern European countries could quickly spill over to East Asia through the common link of Western European banks. Although it is highly unlikely that East Asian borrowers would be forced into large-scale defaults on external liabilities even when a reversal of capital flows takes place as a result of the European debt crisis emerging East Asia's policy authorities feel that they must be prepared for such an external shock.
4. A fourth reason has to do with the disagreement on the exchange rate policy appropriate to emerging economies in East Asia. Should they adopt free floating or should they just adjust the nominal exchange rate to prevent undervaluation of their real effective exchange rates in an intermediate regime? In a country like China how does currency appreciation work to reduce the saving-investment gap, if it does at all?
5. A final reason is the apparent confusion over the definition of rebalancing. However it is defined, rebalancing does not mean that East Asia should abandon its export-led growth altogether. The ultimate objective of the rebalancing is not reducing or eliminating East Asia's current account surplus. This is because the region's surplus does not necessarily come from the exceptional success of East Asia's outward-looking export-oriented growth strategy. The surplus may have more to do with high propensities to save in the region.

Moreover, in rebalancing growth it is important to make distinction between export promotion and export-led growth. The former is a strategy in which the underlying incentive structure is biased in favour of exports over non-tradables whereas in export-led growth it is not. Because of comparative advantage and other structural characteristics, some market-oriented open economies may rely more on external demand for growth than others, even though their incentive schemes are neutral. These countries may run either a deficit or a surplus on their current accounts, which is a cyclical phenomenon. In contrast, some of

the economies known for pursuing export promotion suffered from a chronic current account deficit during much of the post war period prior to the 1997-98 financial crisis.

So what are the prospects for the rebalancing in East Asia?

Most of East Asia's emerging economies have phased out much of subsidisation of exports including keeping the currency undervalued. Nevertheless the 2008-09 crisis provides an opportunity for these economies to reexamine whether or not its export-led growth is still biased in favour of tradables, that is, whether the relative prices of tradables are kept at artificially higher levels so as to induce allocation of resources to export oriented industries. To this end, rebalancing should be viewed as a process of removing the remnants of tax and other incentives of the old dirigiste regime that favour export-oriented industries.

But while the rebalancing strategy may make emerging East Asia less vulnerable to external shocks, the shift of resources to the less productive non-tradable sector runs the risk of bringing down total factor productivity of the economy. Rebalancing therefore needs to be complemented by measures such as market deregulation and opening that could narrow the productivity gap between the tradable and non-tradable sector. East Asia may have difficulties in finding such measures.

While vanishing export markets will add urgency to the rebalancing process, the prospects for reform to provide internal demand-driven growth in the region are not as promising as they may appear. Emerging East Asia's policymakers are not likely to take the risk of rebalancing unless they are persuaded that a new internal demand-led growth strategy would be as effective as the export-led one in sustaining rapid growth.

There is also institutional inertia. The region may not be able to turn around its export oriented economy through expansionary monetary and fiscal policy to fill the void created by the decline in external demand. In a region where exports account for anywhere between 40% to 70% of its GDP, exporters may well find it difficult to sell in domestic markets what they cannot ship abroad – especially when exports fall by more than 30% in a given year. In a country like Korea, where large industrial groups sell more of their products in foreign rather than domestic markets, rebalancing can hardly be an overriding reform objective as long as the incentive system is not skewed against non-tradables.

Finally, the European debt crisis together with the experience of managing the 2008-09 global economic crisis may have affected the mindset of policymakers in the region. They may have been persuaded to keep their foreign exchange reserve holdings beyond the adequacy level prescribed by the Greenspan-Guidotti-Fischer rule – which requires holding a reserve equal to the amount of short-term external liabilities. This would put emerging East Asia in a dilemma. It would need to continue to generate current account surpluses, which may in turn tempt its policy authorities to keep the real exchange rate undervalued.

The reserve accumulation could be a costly option because it means eschewing free floating in favour of an intermediate regime and returning to capital control. Despite the risks the regime change poses, emerging East Asia may not eschew the reserve option unless the central banks of reserve currency countries, international financial institutions, and regional cooperative arrangements could provide short term liquidity to countries suffering from short-term balance of payment difficulties.

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16 Global rebalancing: An Indian perspective

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NCAER

This chapter explores the story of global imbalances as told from the perspective of India. It argues that India should resist being labelled together with China as its interests are more fundamentally aligned with the deficit countries. India's fundamental policy challenge is less one of external adjustment than one of an internal adjustment facilitated by a buoyant global economy.

Before the global crash of 2008 there was wide divergence in opinion among professional economists on whether high and rising US trade and current account deficits represented a benign side effect of increased global economic integration, or whether they were a source of risk and instability for the world economy. Following the crash, however, it has become part of the policy consensus (articulated, for example, by the leaders of the G20 countries) that such imbalances are unsustainable, dangerous, and in need of attention.

The pre-crisis imbalances assumed several distinct, if inter-related, forms. At their most basic level, these had to do with the growing absolute size of current account deficits and surpluses across major economic blocs in the world, notably the US, Japan, the EU, the major oil exporters, and Asia (excluding Japan). The current account is conceptually the most useful measure of imbalances, as it offers an insight into the underlying saving and investment behaviour of the economy. An equally important focus of attention has in fact been merchandise trade imbalances, particularly in manufacturing, the most politically visible and sensitive sector.

These current account imbalances in turn have implied counterpart financing flows, the nature of which have also been important in the unfolding of the crisis. The combination of rising current account surpluses, capital account surpluses and competitiveness concerns meant that the financing counterpart of Asian imbalances was increasingly channelled through official intermediaries into US sovereign assets, requiring the Federal government in the US in turn to take on the transformation and credit risk associated with financing financial deficits elsewhere in the domestic economy, in particular the household sector.

It is also somewhat misleading to concentrate exclusively on net financing flows. One of the features of the build-up to the crisis was the large growth in gross flows, particularly from the private sector, which were sharply unwound as a result of the crisis, and provided a significant channel for transmission of shocks across financial systems.

This deconstruction of the various forms of “imbalance” is of particular relevance in discussing India’s role and interests in the rebalancing of the global economy. India’s growth model has been qualitatively different from East Asia’s, whether one considers the earlier wave of successful industrialisers, Japan and the “newly industrialised economies” of Korea, Taiwan, Hong Kong and Singapore (by now developed countries); the ASEAN countries which followed, notably Malaysia and Thailand; or more recently and spectacularly, the case of China. While the degree of openness to foreign direct investment has differed across these countries and over time, all of these countries have been characterised by fast growth in output and employment in manufacturing (on the supply side) and an important role for net exports as a source of demand.

The “honorary” member

India’s rapid growth in the first decade of the 21st century has caused it to be considered an “honorary” member of this Asian fraternity. While there are some characteristics which are similar, there are others, particularly in the last decade, which are distinctive and which have an important bearing on India’s participation in global rebalancing. India remains significantly poorer than most of its peers, despite sustained rapid growth for almost three decades. For the present discussion, the most relevant difference on the supply side is the relatively poor performance of manufacturing, particularly manufacturing in the so-called “formal” sector, and on the demand side the relatively unimportant share of net exports as a source of final demand. Over the last two decades India has emerged with a chronically weak fiscal position and a relatively high debt stock, one that remains tolerable only because of relatively rapid growth. These structural characteristics have an important bearing on India’s role in the global rebalancing that purportedly awaits us in the new decade.

These structural differences reflect themselves in the structure of India’s balance of payments. In the decade since the Asian financial crisis most of the countries of East Asia have tended to run surpluses on current account. In the case of the ASEAN countries, these surpluses reflect the fact that investment rates did not recover after the Asian crisis even as saving rates remained relatively strong. In the case of China they famously reflect the fact that despite a towering (and possibly inefficiently high) investment rate, corporate and household savings are even higher, generating a large surplus on current account.

With the exception of a couple of years in the middle of the last decade when it ran a small surplus, India has typically run a deficit on current account of around 2% of GDP, which is financed by a net surplus on private capital flows, particularly portfolio flows, and, more recently net foreign direct investment. Yet this relatively tranquil picture masks a large and growing deficit on merchandise trade, now approaching 10% of GDP, which is offset by a surplus on invisibles account including both services exports and large, relatively stable remittance flows. Given India’s dependence on imported oil – about 70% of domestic

consumption – the trade account is heavily affected by movements in the international oil price.

India has accumulated significant stocks of international reserves despite this deficit on the current account primarily because of a fluctuating surplus on the net private capital account. It has done so for the combination of motives characteristic of many emerging markets: as a financial safety-net in case of a “sudden stop” in capital flows, and to avoid nominal appreciation of the exchange rate.

Relatively little “rebalancing”

It is for these reasons that it is important for India that the debate on global rebalancing be conducted with greater precision. If the focus is on the adjustment of current account balances, India has little “rebalancing” to do. It may nonetheless have considerable and legitimate concerns on the impact of global policies designed to reduce imbalances elsewhere.

If the focus is more on imbalances in the trade account, however, (as seems to be the case, for example, in the bilateral dialogue between the US and China) then India’s interests are perhaps more closely aligned with those of the advanced countries, particularly the UK and the US, than with its peers in China. And if the focus of policy coordination is to reduce the accumulation of official reserves by emerging market countries, then India’s interests lie with those concerned to strengthen so-called “safety-net” policies and any associated disciplines on capital movements and exchange rate regimes, to avoid becoming a victim of sudden stops in net movements of foreign capital.

India’s fundamental policy challenge is accordingly less one of external adjustment than of internal adjustment, but it is an internal adjustment which would be greatly facilitated by a buoyant global economy. As reflected in the current account, both the absolute levels and the relationship between aggregate saving and aggregate investment are broadly appropriate and do not require change. Equally, aggregate growth is at healthy levels and is likely to be sustained. What is needed is therefore an improvement in the quality of this growth.

Much as with the deficit advanced countries (the US, the UK or the peripheral countries of Europe), India would move to a better development trajectory if it could depreciate its real exchange rate such as to improve the competitiveness of its tradables-producing sector. Yet the paradox, and the challenge for domestic economic management, is that it needs to do so even while improving the supply of key non-tradables, including infrastructure provision in both the public and private sector, as well as a broad range of human capital enhancing interventions, such as better public education and public health.

Switching without reduction

Thus the appropriate policy shift for India is one that promotes expenditure switching without requiring expenditure reduction. Political economy considerations aside, the most appropriate policy mix for achieving the desired outcome is through a combination of fiscal consolidation, public expenditure reform and additional trade liberalisation. Fiscal consolidation in turn could legitimately include both revenue and expenditure elements, along the lines of major reforms of the systems of direct and indirect taxation currently under consideration. Of perhaps greater importance is a fundamental restructuring of government subsidies on food and fuel, which has been endlessly talked about but which keeps foundering on the shoals of vested interests and political timidity. Reduction or removal of fuel subsidies in particular should help reduce the oil import bill, releasing resources for domestic expenditure. Finally, unilateral trade liberalisation, which has been of decisive importance in reducing anti-export bias in the last decade, has now ground to a halt, partly because of the desire to retain bargaining chips for the stalled multilateral negotiations, and partly out of fears, real or imagined, about unfair competition from China.

The hypothesis underlying this policy prescription is that the real exchange rate is more durably influenced by policies, such as taxation, that affect the real economy. The issue nonetheless arises: what is the role of nominal policies, such as the nominal exchange rate, in bringing about the desired shift? In the case of China, it has after all been argued that a nominal appreciation would be important in shifting demand impulses away from external to domestic. Shouldn't the same argument apply in reverse to India? While the argument is superficially attractive, my own inclination is to be cautious. The Reserve Bank of India has gained valuable experience and credibility in managing an increasingly flexible exchange rate, which gives it all-important freedom in conducting monetary policy for domestic Indian conditions. One important by-product of this flexibility is the shifting of exchange risk assessment to private agents, and the development of hedging instruments to allow them to do so.

To conclude, India's primordial interest as a member of the G20 is the restoration of buoyant global economic activity, as that will give it more space for the necessary domestic adjustments. It should resist being clubbed together with China in the debate on global rebalancing as its interests are more fundamentally aligned with the deficit countries. Its goal should be further trade deepening of its economy, if possible through multilateral trade liberalisation – avoiding protection in the advanced countries is therefore critical. But the fundamental economic challenges for India are domestic, and this is where the bulk of its attention must remain directed.

About the Author

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17 Rebalancing the global economy: A view from the BRICs

Ilan Goldfajn

PUC-Rio

This chapter argues that the emerging markets' days of export-led-growth are over and domestic driven growth is the "new normal". It suggests this means dealing with capital inflows, exchange rate appreciation, current account deficits, and bubbles and overheating economies. Nevertheless, it is a more pleasant task than the one faced by the mature economies.

The 2008 financial crisis will change the global economy; perhaps not as much as was expected during the worst of the crisis, but possibly much more than many of us would currently like to admit. We're no longer in Kansas, but we haven't found Dorothy's rainbow yet. The US economy will be forced to rely less on consumption demand and the eurozone will be forced to restructure in order to survive. The emerging markets' days of export-led-growth are over. Domestic driven growth is the "new normal". This means dealing with capital inflows, exchange rate appreciation, current account deficits (or smaller surpluses) and, occasionally, bubbles and overheating economies.

For some time, markets instinctively looked for familiar patterns. The bubble burst, destroying financial wealth? Assets are already recovering. Struggling banks? Credit will eventually rebound. Are public debts too high? There is nothing to fear, confidence in the mature economies debt still exists. A long lasting recession? US consumers are back and investment in China is stronger.

It is now becoming clear that the consequences of the 2008 global crisis are far from over. The aftershocks are already evident. Tough financial reform is underway in the US. Debt dynamics have become a matter of concern sooner than expected, at least in the peripheral European countries. Emerging markets are dealing with overheating and inflation and tightening policies, in contrast with the expansionary policies of the mature economies.

Global growth, especially after fiscal and monetary impulses die down, will be less intense for several reasons:

- the destruction of financial wealth,
- the challenge of credit revival in mature economies,
- the rise in US savings and
- the uncertain transformation of China into a consumers' economy.

Because it follows a sharp contraction, the current rebound may be quite vigorous; but the challenge of sustained growth will remain.

In this world, the emerging markets would likely sustain relative strength. The idea of decoupling lost appeal after the synchronised contraction of the 4Q08. But, differentiation is on the agenda again, as emerging markets could well lead global growth. Stronger growth in the emerging markets means that growth asymmetry could be one of the important characteristics of the new global order.

A new consumer of last resort

Another important characteristic is the future search for the global consumer of last resort. It is essential to assess what the world will look like after the retreat of the US consumer (affected by loss of wealth and credit shortages in a deleveraging process). A prolonged contraction in US consumption will reduce global demand. This will mean lower exports everywhere, smaller trade surpluses, and a weaker US dollar relative to previously surplus countries. It also means pressure for consumption growth outside the US. Some countries will tend to export less and consume more. China is a natural candidate, but reducing savings will be a slow, reform-dependent process. Other countries will have to play a role too. Those with large potential growth in domestic demand and low risk will likely be graced with capital inflows; their currencies should strengthen against the dollar.

In this scenario of moderate world growth and higher growth in the emerging markets, capital should flow to the emerging markets, strengthen their currencies and worsen their current account balances.

Step forward Brazil

Brazil is as a natural candidate. As such, its current account deficit should widen as the search for a consumer of last resort continues. This is not solely due to global factors. Brazil still faces the challenge of raising its savings ratio, as a country in which there is a large potential consumption growth, due to a growing middle class (in the past five years, 33 million people joined its ranks). New investment projects could track these new consumers, fuelled by a lower risk environment.

In this environment, what scenario will unfold for Brazil within the “new normal” world? True, uncertainty is everywhere, including. Some trends, however, are taking shape. When organised, they sketch out scenarios for the coming years. In fact, it is easier to consider the long-term prospects (10 years ahead) than the short-term prospects (the next few years).

In Brazil, investment should grow quickly over the coming years, resuming the path of recent years following a temporary disruption in 2009. There are several reasons for this:

1. the global context favours investment in the emerging economies with a high potential to expand domestic consumption (the “search for the consumer of last resort” to replace the US);
2. Brazil’s local market is buoyed by a growing middle class, with a greater propensity toward spending;

3. real interest rates will continue to fall in the medium run, favouring investment, particularly in real estate;
4. the investment required by the 2016 Olympics (our simulation suggests a 0.7 percentage point impact on GDP growth in each of the four years preceding the event);
5. investment in the sub-salt oil fields (we estimate about US\$55 billion over the next ten years); and
6. investment for the 2014 World Cup.

In short, this represents a huge commitment. Investment could be even greater (25% of GDP?), but global weaknesses as well as existing bottlenecks in Brazil will probably moderate the impulse to invest.

Greater investment should lift potential growth to about 5% throughout this period, which is higher than the 4.0%-4.5% most analysts tend to build into their business plan for the coming years.

It is not only higher investment that may push up potential growth. An increase in the share of working age population (aided by a rising labour force) and gains in total factor productivity will also help.

Apart from its impact on potential growth, investment will demand more financing (savings). Financing will come from two sources. First, increased external financing (current account deficits). Second, some increase in domestic savings (about 1.0pp of GDP) in order to replace part of the external financing with more public savings from 2011 onwards. We estimate a modest increase in the government's fiscal effort, to about 3%-4% of GDP (primary surplus) in the coming years, with greater public investment (and savings).

We believe that external savings will finance most of the new investment. The current account deficit should trend upward from the current 1%-2% of GDP to approximately 4%-5% of GDP in 2016, and then slide back to about 3.5% of GDP by the end of the decade as spending on global sports events comes to an end and pre-salt revenues start to hit the trade balance.

Capital inflows to finance the current account deficit should maintain the currency appreciated in real terms, possibly close to the current levels. Brazil could grow at an annual rate of about 5%.

However, the horizon is clouded with uncertainty. There are other possible scenarios. One scenario is more pessimistic. As in other emerging markets, Brazil faces several bottlenecks – such as shortage of infrastructure, education or savings – that it may not successfully resolve. A double dip recession may cause external financing to become scarce, hampering investment and inhibiting growth. But an alternative scenario, of more reforms and a more aggressive fiscal adjustment (to free savings), could spur investment and economic growth even further (toward about 7%).

Even without these alternative scenarios, the new world would imply challenges for Brazil and other emerging markets. Could this shift in demand toward domestic markets and greater capital inflows to emerging markets be accomplished in a smooth manner? Currently, only a small percentage of wealth and investment is allocated to the emerging markets. A sudden shift could imply more inflows, exchange rate pressures and asset bubbles. How to deal with this?

Luckily, the world is just rationalising the lessons from the excesses and bubbles of the mature economies. Leaning against the wind in both monetary policy and financial regulations seems to be one of the new lessons. Emerging markets would do well to heed this and other lessons learned from the excesses of mature economies.

Part of the capital inflows has a natural outflow through the widening current account deficits. But how much is sustainable? Past exchange rate crises and sudden stop experiences suggest that deficits above 5% tend to end badly. But is this true in the new normal world? Few emerging markets and investors would risk finding out

To summarise, in emerging economies such as Brazil and China, unless the existing risks lead to a new global recession, the task ahead is to avoid excesses and growth rates that are unsustainable in the medium and long term. That is, no doubt, a more pleasant task than the one faced by the mature economies.

About the Author

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18 Rebalancing the Eurozone and national competitiveness

Filippo di Mauro and Katrin Forster
European Central Bank

Eurozone exports were hit hard by the great trade collapse. This chapter argues that while the importance of restoring competitiveness and rebalancing current accounts is now widely recognised, there is also a need to take a broader view focussing not only on price competitiveness but also on productivity performance. It favours structural reforms and urges that rebalancing is not considered a purely demand-side phenomenon.¹

Although the global trade downturn was highly synchronised, Eurozone exports were particularly hit, with stronger losses in market shares than those of other main advanced economies. Partly owing to the relatively high openness of the Eurozone, structural competitiveness problems that predated the crisis may have been the most important cause. Understanding the nature of those problems and the differences in competitiveness across Eurozone countries is an important input into the rebalancing debate.

While the importance of restoring competitiveness and rebalancing current accounts is now widely recognised, we argue that there is a need to take a broader view on competitiveness, focussing not only on price competitiveness but also on productivity performance. To this end, we argue in favour of structural reforms aimed at enhancing the competitive environment within the European Union. Like others in this volume (Aggarwal and Evenett; Lim), rebalancing should not be considered a purely demand-side issue.

Measuring national competitiveness

In spite of being a widely used term in the public debate, there is no agreed-upon approach on how to define and measure national competitiveness. Opinions tend to diverge rather widely on which concept of competitiveness is more appropriate and under which circumstances. Partly as a result, a very broad range of indicators is available.

In general terms, competitiveness can be defined as the ability of a country to compete successfully in international markets. Focussing mostly on export performance, traditional approaches usually refer to standard indicators of price

¹ Comments by our ECB colleague, Chiara Osbat, are gratefully acknowledged.

and cost competitiveness, as measured by differently deflated effective exchange rate indicators. While developments in price competitiveness have always been important drivers of an economy's ability to compete in international markets, other factors have become increasingly important in the face of the structural changes engendered by globalisation. These relate, among others, to the export specialisation and to the geographical orientation of a country's exports.

An assessment based on traditional indicators is subject to a number of pitfalls. While acknowledged in general, the relevance of non-price factors for a country's export performance and their interaction with price competitiveness is rarely fully spelled out. Moreover, rather than being considered as a systematic critical element of export performance, non-price competitiveness is treated more as a residual. This is at odds with the casual observation that – in sophisticated economies – product quality and branding play an important role. More generally, the traditional approach tends to overemphasise export performance, while, at best, trade has to be considered just as a means to achieve welfare maximisation, as proxied by higher value added per capita or lower unemployment. Against this background, we complement the traditional analysis based on cost and price indicators with a model-based framework where national competitiveness is defined as the productivity of the firms located in a given country. In this context, the most competitive economy is considered to be the one with the best prospects for “generating” highly productive firms. Critical elements that enhance this broader competitiveness concept include (i) structural country characteristics, such as the degree of labour and product market flexibility, technological diffusion and innovation, as well as (ii) firm-level determinants such as organisational models. Furthermore, aggregate productivity will generally rise with the openness of a country to foreign competition.

Evidence from traditional competitiveness indicators

Developments in Eurozone trade and competitiveness over the last decade were markedly shaped by globalisation trends. In particular, the emergence of cost-competitive countries as major exporters has increased the degree of competition, resulting in export market share losses of the Eurozone and other advanced industrialised economies. Although the decline in shares is partly mechanical, the Eurozone registered stronger losses than other developed economies. This appears to be associated with unfavourable trends in price competitiveness. If measured in terms of relative export prices, Eurozone price competitiveness deteriorated by around 10% between 1999 and 2008 (based on average levels in the three pre-crisis quarters, see Chart 1, left panel). By contrast, the US, Japan and, to a lesser extent, the UK all recorded significant gains in price competitiveness over the same period - broadly in line with exchange rate trends (see Chart 1, right panel). The financial crisis came as a severe additional shock: Mainly reflecting the sharp decline in global demand, the fall in Eurozone exports was amplified by unfavourable developments in price competitiveness, amid a broad-based

appreciation of the euro until October 2009. As a result, the Eurozone continued to lose export market shares over this period.

While price competitiveness has been a critical factor shaping the relative export performance for the Eurozone as a whole, some countries experienced rather strong improvements in price competitiveness, yet saw steady losses in their export shares (see Chart 2).

To explain such divergences, traditional competitiveness analysis has considered non-price related factors, such as differences in the degree of cross-country openness and sectoral export specialisation.

There are remarkable differences between Eurozone economies in terms of their openness to other Member States and to the rest of the world (intra- vs. extra-trade openness, see Chart 3). This could have important implications for export performance at the country level, either by directly affecting developments in price and cost competitiveness or indirectly through the degree of competition. However, differences in intra- or extra-orientation of trade do not appear to be very important in determining the overall price competitiveness of individual countries. Historically, there has been a very high correlation between developments in individual countries' price competitiveness indicators computed vis-à-vis only the other Eurozone countries and those computed with respect to the rest of the world. This suggests that the price competitive position of individual Eurozone countries within the Eurozone, which is determined mainly by the evolution of domestic prices and costs, tends to be mirrored in extra- Eurozone competitiveness as well.

While price competitiveness improvements appear to be a necessary condition, they may however not be sufficient to improve export performance. Therefore it is also critical to look at a country's export composition, in order to assess whether it is consistent with (perceived) comparative advantage and whether it is concentrated in fast-growing global market segments. As measured by the Balassa Index (BI) – the Eurozone is strongly specialised in medium-high-tech exports – in line with the export structures of Germany, France, Italy and Spain (see Table 1). While this specialisation has benefited the Eurozone overall, since world demand was rather strong for those sectors (particularly for machinery and equipment and motor vehicles and transport equipment), it is striking and somewhat surprising that, overall, Eurozone countries have not shown an increasing specialisation in fast-growing high-tech sectors. While this might reflect structural rigidities that constrain the ability of Eurozone firms to adjust rapidly, it could also reflect the fact that Eurozone firms have so far not been under significant pressure to make substantial changes to their specialisation. By contrast, Greece, Portugal and, to a lesser extent, Italy appeared to specialise rather strongly in low-and medium-tech sectors (e.g. textiles), suggesting that these countries are more directly exposed to competition from low-cost countries, and in particular from China. Such observations are also consistent with the significant export market share losses of Greece, Portugal and Italy since 1999.

A more holistic approach to competitiveness: A micro-based framework

As mentioned above, there are strong arguments in favour of complementing the competitiveness analysis based on traditional measures with a more holistic approach. More specifically, we consider the results from a model-based framework that captures three broad sets of factors: (i) firm-level, such as the technological ability to utilise a given factor endowment; (ii) country-related, such as institutional efficiency barriers to entry in a sector and demand conditions; and (iii) geography and trade frictions – i.e. how accessible the country is to international competition and, at the same time, how accessible foreign markets are for domestic producers and exporters.

To this end, two types of competitiveness measures are computed. The first is an “overall” measure of competitiveness and corresponds to the observed productivity of the firms, which would depend on all sets of factors identified by the model. The second – “producer” competitiveness – measures the impact of technology and institutional factors after filtering out the effects of geographical location. This captures the ability of countries to generate highly productive firms, abstracting from their respective market size and level of accessibility.

The results of the calibrated model show that the most competitive (in accordance to the “overall competitiveness” indicator) countries are the ones that are centrally located (Belgium, The Netherlands) or that combine technological superiority with easy market access (e.g. Finland, see Table 2, columns 1 and 2). These findings are in line with a theoretical model predicting that countries that are large or easily accessible to firms from trading partners should exhibit a tougher competitive environment and a stronger ability to channel resources from low to high productivity uses. On the other hand, more peripheral countries such as the Mediterranean countries rank low because of a less central location with respect to their export markets and a possible technology disadvantage, which may be also a signal of high entry cost for foreign firms.

When abstracting from the geographical position and focussing on producer competitiveness (see Table 2, column 2), the Netherlands ranks first: it appears to have a strong technological advantage and a sound institutional environment thus being able to generate highly competitive firms. As particularly the case of the second-ranked country Sweden shows, being at the periphery does not per se represent a problem for a country, unless it is compounded by clear relative technological and institutional disadvantages that hamper firm productivity. In this context, it is worth noticing that the Mediterranean countries, namely Spain, Italy and Portugal, are consistently in the lower part of the competitiveness ranking, no matter how this is measured. This points to the presence of parallel negative impacts of all the determinants of competitiveness identified in the model, namely geographical location, market access, technological and institutional (dis)advantage. At the same time, some centrally located countries, such as Belgium, show a rather substantial worsening in terms of producer competitiveness compared to their ranking in terms of overall competitiveness,

signalling possible technology disadvantages and/or institutional bottlenecks that are partially offset by its central location.

Conclusion

Reducing global imbalances and re-establishing sustainable external accounts remains a key priority. Having underlined the difficulty to fully explain export performance in the context of increasingly integrated global product markets, our analysis generally calls for policy responses to be aligned with the complexity of the factors underlying country competitiveness. More particularly, to address the divergences within the Eurozone, it is important to stress that the policy responses should go beyond restoring solely price competitiveness.

As the prospects for improving the overall country competitiveness in the medium term more broadly depend on the outlook for aggregate productivity growth, Eurozone countries should foster innovation and continue to enhance the flexibility of national goods and labour markets, including a healthy process of selection of the most productive firms. At the same time, strengthening market integration within Europe will create larger local markets, attract foreign competitors, and foster firm productivity, also through smoother labour force adjustment across sectors.

Finally, all Eurozone economies would benefit from embracing openness to international trade, including imports, thus resisting protectionist pressures. Such a more wide-ranging approach will ultimately lead to aligning Eurozone exports to comparative advantage, thus contributing to readjustment of global imbalances.

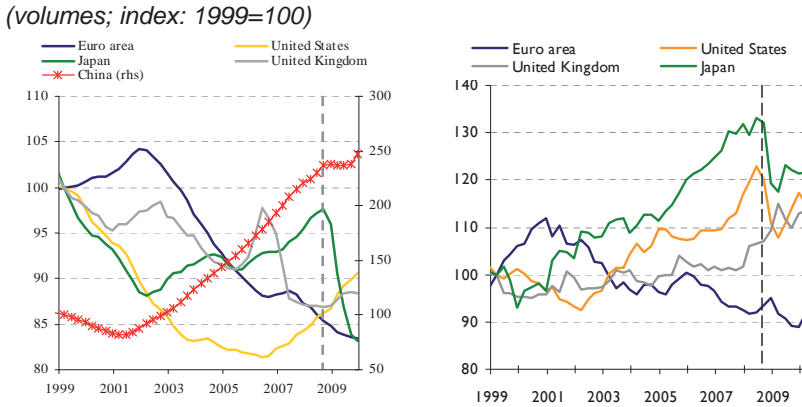
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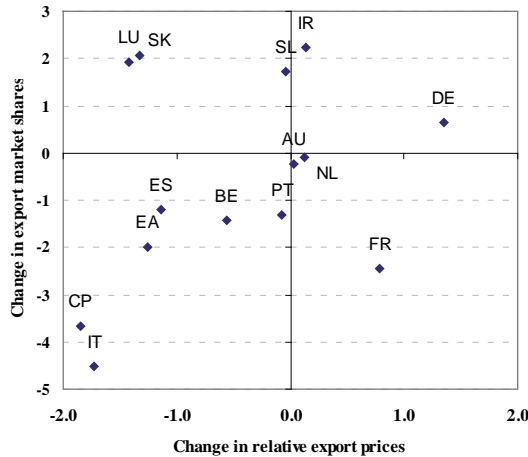
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Chart 1. Export market shares and relative export prices of major advanced economies (volumes; index: 1999=100)



Source: Authors' calculations based on IMF and Eurostat data. Note: Relative prices are defined as the ratio of a weighted sum of competitors' export prices to domestic export prices (both expressed in domestic currency). Lower values signal a loss in competitiveness. The latest observation refers to 2009Q4 (for export market shares) and 2010Q1 (for relative export prices). The vertical dotted lines correspond to September 2008 (i.e., the breakdown of Lehman Brothers).

Chart 2. Developments in export market shares and price competitiveness across Eurozone Member States (annual average changes over 1999Q1- 2009Q4; percent)

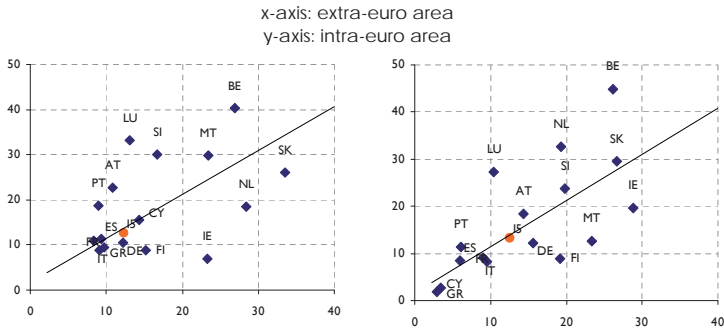


Source: Authors' calculations based on Eurostat data. Note: Price competitiveness is proxied by relative export prices (competitors' export prices divided by the country's export prices). A positive (negative) number implies a gain (loss) in price competitiveness

Chart 3. Extra and intra-Eurozone trade openness (percentage of GDP; average over 1999-2008)

Imports

Exports



Source: Eurostat.

Table 1. Export specialisation by country and sector (*Balassa Index, average 2005-2008, based on values in USD*)

| | EA | BE | DE | IE | GR | ES | FR | IT | NL | AT | PT | SI | SK | FI |
|---|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| High-technology industries (HT) | 0.8 | 0.7 | 0.8 | 2.1 | 0.5 | 0.4 | 1.0 | 0.4 | 0.5 | 1.2 | 0.5 | 0.6 | 0.6 | 1.0 |
| Medium-high-technology industries (MHT) | 1.2 | 1.0 | 1.4 | 0.9 | 0.5 | 1.3 | 1.1 | 1.3 | 1.2 | 0.8 | 0.9 | 1.5 | 1.4 | 0.9 |
| Medium-low-technology industries (MLT) | 0.9 | 1.4 | 0.8 | 0.2 | 1.6 | 1.1 | 0.8 | 1.0 | 1.0 | 0.9 | 1.0 | 0.7 | 1.0 | 1.2 |
| Low-technology industries (LT) | 1.0 | 1.0 | 0.8 | 0.7 | 1.7 | 1.1 | 0.9 | 1.1 | 1.0 | 1.2 | 1.5 | 1.1 | 0.8 | 1.0 |

Source: Authors' calculations based on CHELEM data.

Note: High-tech (HT), medium-high-tech (MHT), medium-low-tech (MLT) and low-tech (LT), based on OECD classification. Eurozone refers to both intra and extra-Eurozone exports.

Table 2. Broad measures of competitiveness of the manufacturing sector (based on data for 2003-2005)

| Countries | Overall competitiveness | Producer competitiveness |
|----------------|-------------------------|--------------------------|
| Finland | 1 | 3 |
| Belgium | 2 | 6 |
| Netherlands | 3 | 1 |
| Sweden | 4 | 2 |
| Germany | 5 | 5 |
| France | 6 | 9 |
| Denmark | 7 | 4 |
| Austria | 8 | 8 |
| United Kingdom | 9 | 7 |
| Italy | 10 | 11 |
| Spain | 11 | 10 |
| Portugal | 12 | 12 |

Source: Authors' calculations, following Ottaviano, Taglioni and di Mauro (2009). Note: Two types of competitiveness measures are computed: "overall" competitiveness and "producer" competitiveness. The former measures the actual competitive position of countries as determined by, among other factors, relative size, location and the level of barriers to imports and exports. Producer competitiveness captures the ability of countries to generate highly productive firms, abstracting from its market size and accessibility.

About the Authors

Filippo di Mauro is Head of the External Developments Division of the European Central Bank (ECB), which he joined in 1998. His division is in charge of the international forecast, medium term FX analysis and the balance of payments of the Euro area. Filippo started his career in 1984 at the Research Department of the Central Bank of Italy, following a short period of consulting at the OECD. Prior to joining the ECB, he also held various economist positions at the International Monetary Fund (IMF 1986/87 and 1994/96) and the Asian Development Bank (1990/94). Publications include papers on Computable General Equilibrium models for Developing countries, International linkages, Global VAR Modelling, commodity prices indicators, external debt issues, fiscal policy indicators, external trade and competitiveness.

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19 A commercial policy package for rebalancing the global economy?

Przemyslaw Kowalski and Molly Leshner
OECD

This chapter suggests that while macroeconomic policies have undoubtedly played a key role in the build up of global imbalances, policymakers should understand the contribution of commercial policies. It argues that the right commercial policies can cut or even eliminate the current account imbalances – at the same time as supporting the global recovery.

While global imbalances are not always harmful from an economic perspective, world leaders recently committed to reducing large current account imbalances and supporting open trade and investment regimes.¹ But if imbalances are not necessarily detrimental, why did world leaders make this pledge? For one, global imbalances do not always build up in a way that is consistent with the intertemporal trade hypothesis,² possibly because of underlying economic distortions. Second, excessive imbalances can have pernicious effects on economies, particularly if they are financed in unsustainable ways. Given that the global economy is increasingly interconnected, a balance of payments crisis in one country can ripple across the globe. And third, from a political perspective, large bilateral imbalances can breed political pressures to raise tariffs and impose other forms of protection on the trading partners with which large imbalances have accumulated.

It is perhaps because of the polarising nature of the debate on bilateral trade imbalances (particularly in the US-China context) and fears of protectionism that much of the attention in the rebalancing debate has centred on how shifts in monetary and fiscal policies may affect national saving-investment imbalances (i.e. on one side of the national net savings-current account identity).³ This may have created the impression that rebalancing is solely an internal macroeconomic policy issue in countries with particularly large surpluses or deficits. While macroeconomic policies have undoubtedly been a key contributor to the build-

1 See the leadership statement from the G-20 Summit in Pittsburgh, 2009.

2 A country may be running a current account deficit today and in return will run a current account surplus in the future. For example, in a capital-poor developing country the investment potential may exceed national savings and this gap can be matched by foreign investment, which is reflected in a current account deficit and capital inflows, see e.g. Ghosh and Ramakrishnan (2006) or Deardorff (2010).

3 $(S-I)+(T-G)=X-M$, where (S) = the amount of disposable income consumers are willing to save, (I) = private investment, (T) = taxes, (G) = government consumption, (X) = exports and (M) = imports.

up of imbalances prior to the economic crisis, policymakers must understand the role that commercial policies can play in the global rebalancing process.

Current account imbalances can undoubtedly be reduced or even eliminated with commercial policies. And while significantly restricting international trade and investment represents an extreme response to the rebalancing question, it is not a purely theoretical option, as some prominent economists have called for the imposition of protectionism as a way to force rebalancing.⁴ But protectionism is not the only way commercial policies can play a role in rebalancing the global economy. We argue that if world leaders pursue an integrated strategy for commercial policy reform across goods and services sectors, this could help the rebalancing process and at the same time support the global economic recovery.

Trade policy solutions to the rebalancing problem

Global imbalances could in principle be reduced or even eliminated by restricting trade and investment flows. However, moving toward protectionism or putting off further liberalisation efforts are most likely not the best strategies to pursue. This is simply because such strategies imply a risky and highly uncertain trade-off. First, since some current account imbalances can be desirable, it is hard to know how much imbalances should be reduced in general. Desirability and sustainability might even be hard to assess on a country-by-country basis. In this context, the uncertainty surrounding the benefits of reducing imbalances must be weighed against the benefits of trade and investment, including efficiency gains related to specialisation according to comparative advantage, economies of scale, access to a wide variety of intermediate and final products, and technology transfer associated with international commerce.

But protectionism is not the only way in which commercial policies can play a role in the rebalancing process. Deardorff (2010), for example, demonstrates how comparative advantage theory can be useful in assessing the commercial policy implications of global imbalances. His work points out that implicit or explicit subsidisation can lead to the accumulation of trade surpluses and deficits that work against a country's natural comparative advantage. Removing such subsidies would both enhance welfare and reduce imbalances.

The comparative advantage principle can also be a useful guide in thinking about global imbalances in a more traditional, static sense. For example, in a two-country two-product model, a welfare-reducing trade imbalance could arise between two countries if the levels of trade protection are asymmetric. If one country (say China) has a comparative advantage in the production of labour-intensive products (goods), and the other country (say US) has a comparative advantage in the production of human capital - or technology-intensive products (services) - then any asymmetries in the structure of trade barriers could result in

⁴ Krugman (2010), for example, called for import tariffs to be imposed on Chinese imports to solve the problem of the US's bilateral trade deficit with China. In addition, the temporary 1971 US import surcharge has been considered as a viable precedent in the current US-China currency dispute. Others judge a potential protectionist approach as self-defeating and highly destructive. See Evenett (2010a) for a summary of this debate and Evenett (2010b) for an analysis of the 1971 import surcharge.

the build-up of unsustainable (and welfare-reducing) imbalances. This would be the case if import barriers are persistently higher in services than in goods in both countries, or if one of the countries has higher import barriers on both products. A liberalisation scenario that alleviates this asymmetry would result in both the reduction of imbalances as well as welfare gains.

Insights from the Balance of Payments and the structure of trade protection

How does theory fit with reality? First, we look at whether the evolution and structure of global imbalances in the run-up to the economic crisis point to welfare-reducing and imbalances-enhancing distortions. Strikingly, the build-up of global current account balances – measured as the sum of the absolute value of world current account balances divided by world GDP – that began in the mid-1990s was driven by the goods side of the trade account (that is, imbalances related to trade in goods have contributed the most to global imbalances since the mid-1990s) (Figure 1). In fact, the contribution of the goods sector to imbalances doubled from below 3% of world GDP in mid-1990s to above 6% in the late 2000s.

In contrast, the contribution of services trade to global imbalances has remained relatively constant at around 1.5% of world GDP over the period, albeit with a slight upturn in 2007-2008. Of course, the current account does not capture all of the channels through which services are traded,⁵ but this potential bias would not be expected to increase over time. It is also hard to resist comparing the timing of the emergence of this disparity (the mid-1990s) and the conclusion of the Uruguay Round of trade negotiations (1994), especially since the commitments in goods have been reported to deliver more actual trade liberalisation than those in services.⁶ Thus, these trends may be suggestive of a growing divergence in the structure of trade protection for goods and services, especially given the fact that the countries that account for the bulk of the large deficits in goods are specialised in the services sector.

This trend is also evident when analysing the current account balances of the 10 countries with the largest current account surpluses and deficits in 2007 – the year preceding the economic crisis (Figure 2).⁷ Only two of the economies with a current account surplus in 2007 are not high-income – China and Malaysia. But half of the surplus countries are Asian – China, Japan, Singapore, Chinese Taipei and Malaysia. This is a marked contrast from 1996 – the year when current account imbalances began to increase significantly – when only China (no. 9) and Chinese Taipei (no. 8) made it into the top 10. This pattern reveals both the

5 The services category in the current account does not cover two important modes of services delivery (mode 3 services trade (commercial presence) and mode 4 services trade (temporary migration of labour)). These components are captured in the capital (mode 4) and financial (mode 3) accounts of the Balance of Payments.

6 Hoekman (1995), for example, provides an assessment of the Uruguay Round Agreement commitments on services and their failure in terms of generating liberalisation.

7 This ranking excludes large net oil exporters.

shift of economic clout from West to East as well as some of the aftershocks of the East Asian Financial Crisis of 1997-1998, when balance of payments problems induced countries to pursue economic policies aimed at achieving current account surpluses.

On the deficit side, all of the countries are high-income countries (and all OECD members except Romania). The opposite trend appears here, as developing and largely Asian countries⁸ moved out of the top 10 deficit countries in the 11-year period (1996-2007) and more high-income, largely European countries⁹ moved in. Remarkably, in 2007 nine out of the ten countries with the largest current account deficits recorded negative balances on goods trade and, at the same time, positive balances on services trade. All surplus countries recorded a positive balance on goods trade and the three countries with the largest surpluses (China, Germany, Japan) as well as Chinese Taipei and Canada had at the same time a negative services trade balance.

Can these differences in the structure of the balance of payments between surplus and deficit countries be related to the prevailing structure of comparative advantage and trade barriers? Possibly yes. Figure 3, Panel A demonstrates that while the levels of protection on imports of goods are comparable across the surplus and deficit countries (Singapore and Malaysia are exceptions with relatively high barriers), barriers on imports of services tend to be higher¹⁰ in surplus countries (Panel B). Deficit countries tend to be more (less) specialised in exports of services (goods) than surplus countries (Panel C), which suggests that their exports could be hampered disproportionately by relatively higher services trade barriers. Interestingly, this line of thinking possibly generalises beyond the top 10 surplus and deficit countries, as a strong tendency can be observed for barriers to services trade to decrease as income levels rise (Panel B, Income Groups), while the share of services in value added and specialisation in exports of services tend to increase with income (Panel C, Income Groups).

In the deficit economies (apart from Turkey), the portfolio and other investments elements – not FDI – contribute the most to the overall financial account balance (Figure 4). This pattern has not changed much over the 11-year period. Given that current account imbalances are more sustainable in the medium-term if they are financed by FDI, which is less subject to sudden reversals, it appears that the largest deficit countries may have difficulties continuing to run deficits with the current structure of their balance of payments. As a result, encouraging FDI (or mode 3 trade in services) is an important element of any policy package designed to help reduce unsustainable imbalances.

If it is essential to encourage FDI, then policymakers must understand how restrictive services policies are in the countries that contribute the most to

8 Brazil (no 2), Korea (no 3), Thailand (no 5), Indonesia (no 8), Argentina (no 9), and India (no 10).

9 Spain, Italy, Greece, Turkey, France, Romania, and Portugal all moved into the top 10 during this time.

10 This is based on the World Bank index of GATS commitments reported in the World Trade Indicators database. This is an imperfect measure of services trade restrictiveness but so far this is the only index that offers a broad sectoral coverage and comparability across countries. Other sources of information on services trade barriers such as Dihel and Shepherd (2007) and Wölfl et al. (2009) confirm the general finding that barriers to services trade tend to be higher in developing and emerging economies, as compared to the OECD area. The OECD is currently developing services restrictiveness indexes at the sector level: <http://www.oecd.org/trade/stri>.

global imbalances. Based on the currently available data, it does not appear that the countries that are on the deficit side have particularly restrictive policies toward trade in services. Using either the FDI component of the OECD's measure of product market regulation or the World Bank's GATS Commitments Restrictiveness Index, it does not appear that the deficit countries (apart from Turkey) have overly restrictive services regimes (Figure 3, Panel B). However, these measures are imperfect and more robust measures covering a wide variety of developed and developing economies are needed.¹¹

These data suggest that surplus countries are not choosing to invest via portfolio and other means in deficit countries because they face overly burdensome restrictions to direct investment. Indeed, their World Bank Doing Business scores all rank quite well (apart from Greece and to some extent Turkey). What we can say is that Asian countries, particularly developing Asian countries, are playing a larger role in financing other countries' deficits, and that this has come in the form of portfolio and other investments, as well as reserve assets in the case of China, which is less sustainable than FDI. These developing countries generally have more restrictive services policies than the high-income countries on the deficit side.

Conclusion

Differences in the structure of current and financial accounts, the pattern of post-Uruguay Round barriers to trade in goods and services, together with broad patterns of trade specialisation, all suggest that a policy package designed to rebalance the global economy can usefully include services trade liberalisation as one important element. Since many of the deficit countries specialise in services, they are at a disadvantage when trying to rebalance their economies because they face higher barriers to exporting in the sectors in which they have a comparative advantage. Similar reasoning may also apply to remaining protection within goods sectors.

It also makes sense to liberalise services from the perspective of the surplus economies, particularly those in developing Asia where barriers are highest. Crucially, services liberalisation would help the surplus countries by providing access to a greater variety and quality of services. The associated services productivity boost would encourage domestic consumption, thus putting these countries on a more sustainable growth trajectory. Moreover, there can be important feedback mechanisms between services liberalisation and productivity in manufacturing, the sector in which many of the surplus economies have a comparative advantage, with positive welfare implications (Leshner and Nordås, 2006).

Some existing commentary suggests that this policy prescription could indeed be a viable option for the two countries with the largest current account

¹¹ The OECD is currently developing a comparable services trade restrictiveness index, though the first stages of this work have concentrated on current OECD members and a limited number of sectors (see: <http://www.oecd.org/trade/stri>)

imbalances – China and the US. Greene et al. (2006), for example, describe the duality in China's economy where the opening up of trade and FDI in goods coexists with a high level of public ownership and important regulatory barriers in the services sectors.¹² Indeed, this is independently acknowledged in internal discussions on China's 11th Five-Year Plan (2006-2010) which for the first time emphasises development of services as a means of improving the overall structure of industry, job opportunities and comprehensive competitiveness.¹³ More recently, Godement (2010) argues that greater access to China's capital market and services sector and public procurement ("second opening") would be a better solution to the US-China currency dispute than currency revaluation.

Evidence presented in this note provides support for these arguments but, by showing potentially harmful asymmetries in the levels of protection across the goods and services sectors and countries at different levels of economic development, it also advocates for a wider and a more transparent services liberalisation agenda (e.g. in the context of the DDA negotiations in the WTO or through free trade agreements). Commercial policies can usefully contribute to global rebalancing and support the global economic recovery, and policymakers would be well-served to incorporate them in their policy agenda.

The views presented are strictly those of the authors and do not represent the views of the OECD Secretariat or its member countries. Useful discussions with Michael Plummer and statistical assistance from Clarisse Legendre are gratefully acknowledged.

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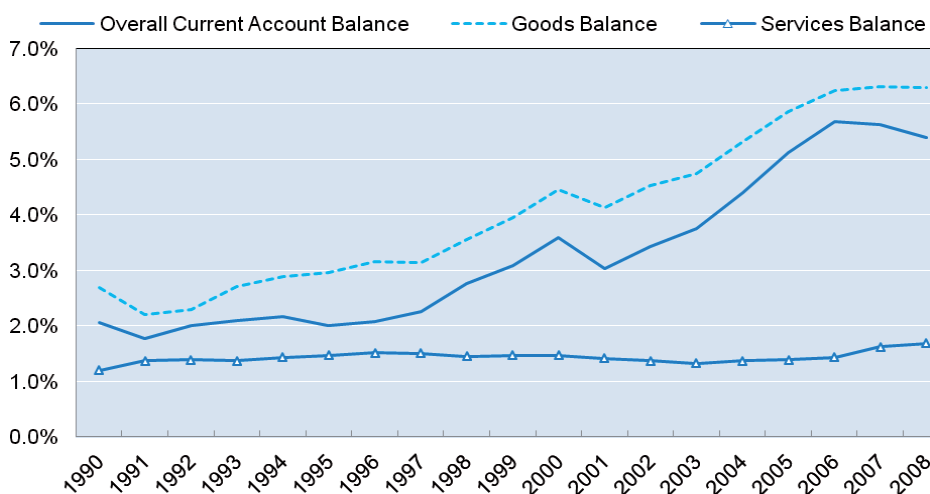
¹² High entry barriers, excessive state involvement, opaque regulatory process and overly burdensome licensing and operating requirements.

¹³ See e.g. <http://www.china.org.cn/english/2006/Mar/160397.htm>.

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Figure 1. Composition of Current Account Balances, 1990-2008

Absolute values of respective imbalances divided by world GDP



Source: Authors' calculations based on IMF Balance of Payments data. For presentational purposes, net income and transfers, the other two components of the Current Account, are omitted.

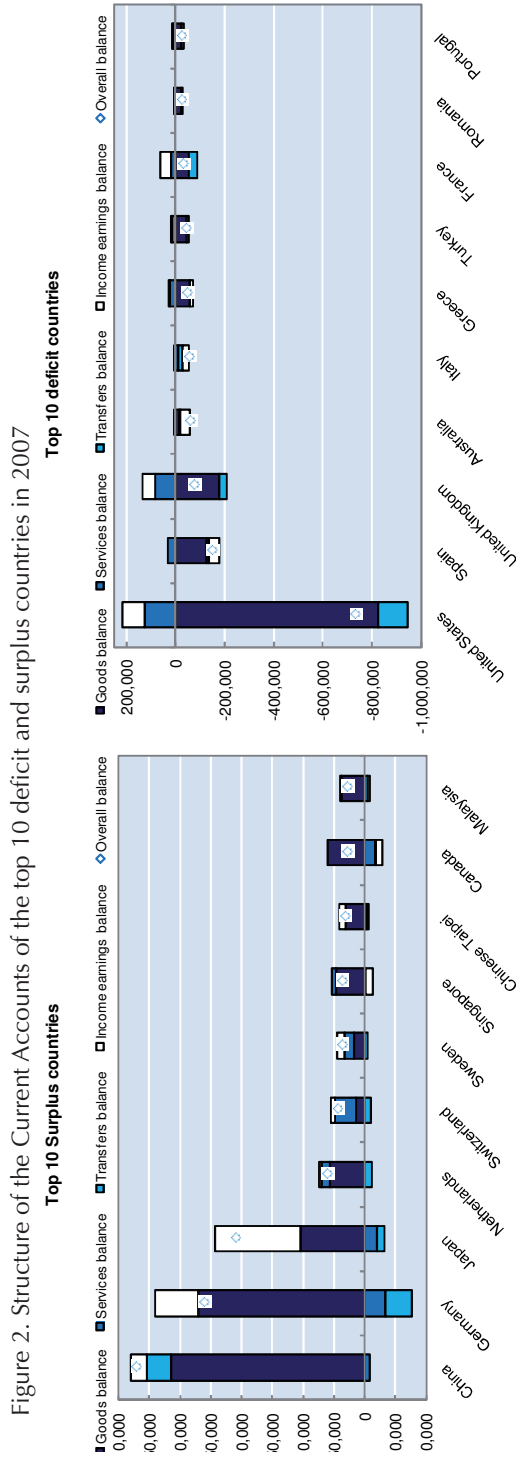
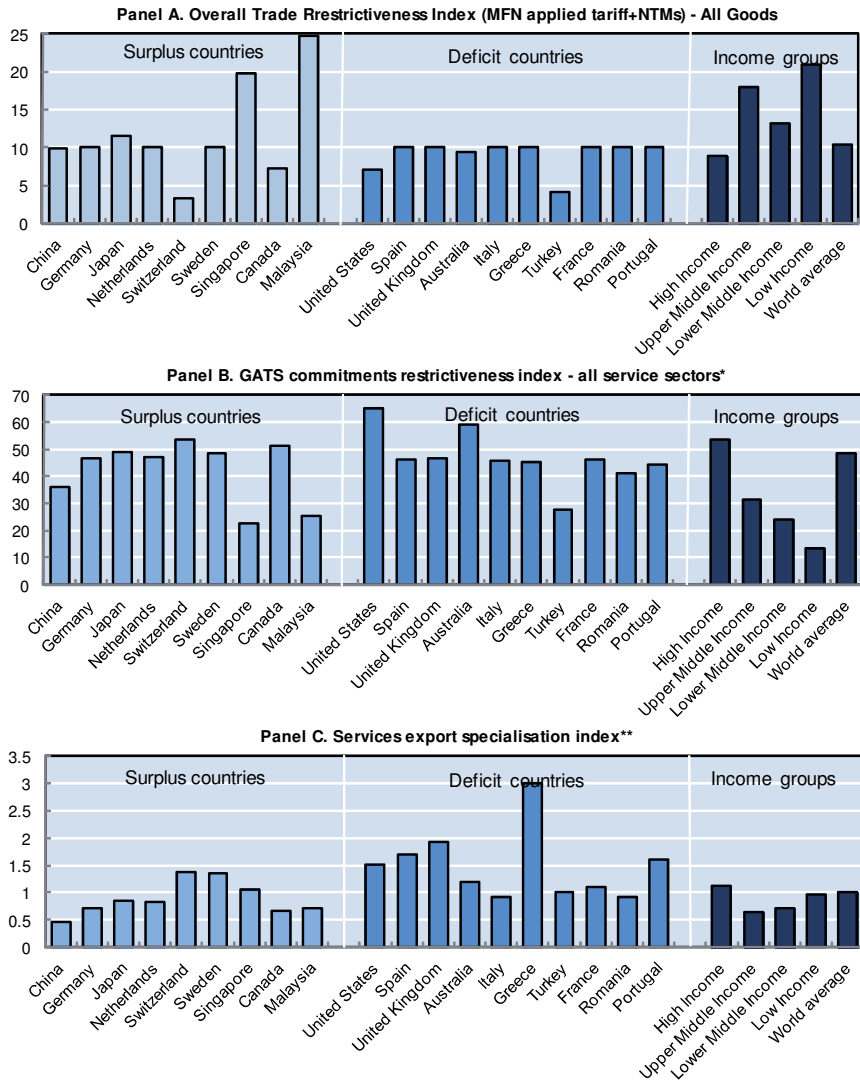


Figure 2. Structure of the Current Accounts of the top 10 deficit and surplus countries in 2007

Source: Authors' calculations based on IMF Balance of Payments data.

Figure 3. Structure of protection in goods and services markets and services export specialisation



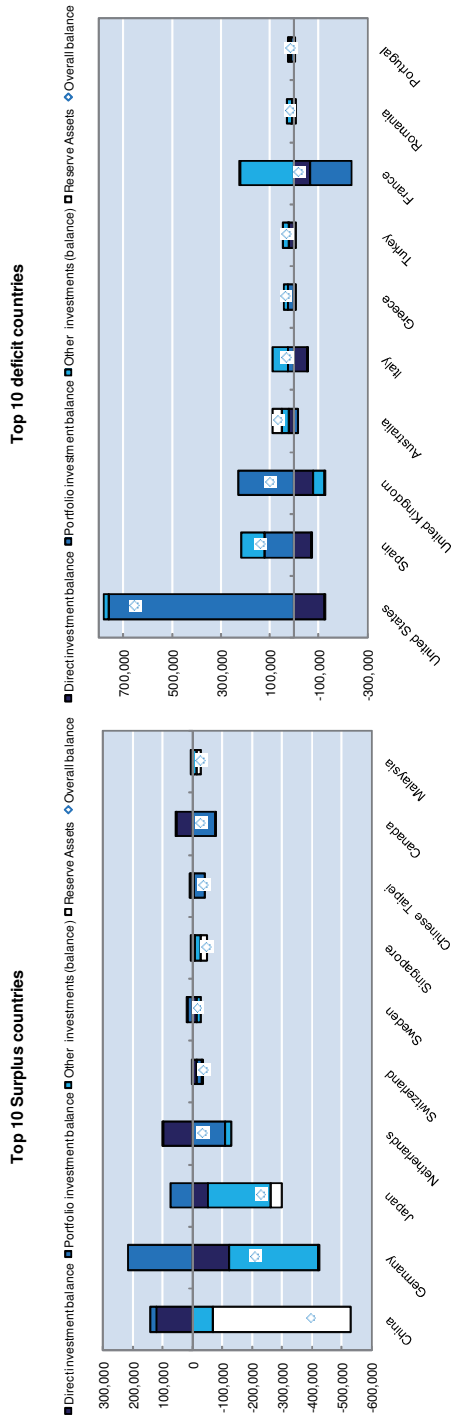
Notes:

* The GATS Index score for these countries is on a scale of 0-100, with 100 meaning fully liberal.

**This is ratio of a share of a country in world service exports (current US\$) and a share of a country in world exports of goods and services (current US\$).

Source: Authors' calculations based on World Trade Indicators and World Development Indicators data.

Figure 4. Structure of the Financial Accounts of the top 10 deficit and surplus countries in 2007



Source: Authors' calculations based on IMF Balance of Payments data.

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20 Rebalancing will require supply side policy changes, but pitfalls abound

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Much of the debate over global imbalances has focussed on the demand side. This chapter argues that rebalancing national economies should not overlook the contribution that supply side factors can make. Nevertheless, it warns that any rebalancing imperative may well be hijacked by governments to advocate policies that promote certain sectors over others, which will inevitably foster international trade conflicts.

All too often, the rebalancing of national economies is treated foremost as a demand side challenge. Appealing to national income accounting, every economics student knows that narrowing the current account requires steps to reduce the gap between total national savings and national investment. One component of the former is the government's budget deficit which, depending on your view of macroeconomics, may be determined by aggregate demand management policies. Investment expenditure is said to be an expectations-driven factor, influenced by optimism about future economic performance. Deficit countries need to cut government spending, raise taxes, fund more private sector investment themselves (or forgo that investment) if current account imbalances are to be fall. Is there no role, then, for supply side policies to contribute to rebalancing?

We argue that rebalancing national economies should not overlook the contribution that supply side factors – many of which, for better or for worse, are amenable to government policies – can make. In one respect certain policymakers are already ahead of the analysts. For instance, senior members of the outgoing UK Labour Government had made the link between that country's trade deficit and the need (in their view) for reindustrialisation and, ultimately, for a new batch of industrial policies.¹ Coming on top of the slew of state measures that discriminate in favour of industrial firms taken by many governments during the

¹ Such was the apparent openness to new ideas that Lord Mandelson, a leading figure in the UK administration of Gordon Brown, argued that there were lessons the UK could take from French experience with industrial policy. While the new UK government has yet to express itself fully on the matter of industrial policy Lord Mandelson's successor, Dr. Vincent Cable, was careful not to rule out such initiatives in his first major speech.

recent global economic downturn, rebalancing may well give industrial policy a new lease of life – hence the reference to pitfalls in the title of this chapter.

There are clear links and some differences between the arguments made in this chapter and elsewhere in this volume. Both Lim and di Mauro and Forster argue that supply side considerations influence current account imbalances. Lim argues that government ownership of leading firms in East Asia affected the level of corporate savings and, effectively, influenced national savings behaviour and hence accounted, in part, for the growing imbalances of recent years. By contrast, di Mauro and Forster argue that improving competitiveness in the Eurozone would go a long way to redressing Eurozone imbalances. Policies that promote innovation and competition between firms, they argue, are part of the rebalancing package. For their part, Kowalski and Leshner argue that commercial policy changes can facilitate rebalancing. If these arguments are right, then they too question the wisdom of viewing rebalancing purely through a demand management lens.

Beyond expenditure switching and expenditure reducing measures

Reducing imbalances is often regarded as a matter of switching and, in some cases, reducing different components of national expenditure, implicitly keeping the focus on the demand side. But most of the relevant decisions taken by the private sector or the public sector are likely to be affected by supply side factors in the markets in question. Moreover, the impact of government measures to reduce imbalances may well be a function of those supply side factors.

For example, it may seem “obvious” that increased tax breaks for individual savings are needed in countries with large current account deficits. But private individuals are less likely to respond to such tax breaks if – based on previous experience – they believe that any tax advantages will be principally absorbed by an oligopolistic personal finance sector in terms of higher charges. Furthermore, given the legacy effects of prior malfeasance by firms in the personal finance sector (e.g. the UK pension “mis-selling” scandal) on the willingness of individuals to save, it should be little surprise that the personal savings rate is only marginally affected by tax changes.

There are at least two responses to the last example. The first response might be to argue that the state employ a measure that doesn’t run into the same supply side constraints – assuming one exists. In the case of promoting private sector savings this might involve the adoption of draconian measures, such as mandatory personal savings regimes. The second, and perhaps more palatable, alternative is to argue that a longer-term fix for rebalancing requires state measures that eliminate pertinent supply side deficiencies as well as expenditure-influencing measures. This is because those very deficiencies may well have contributed substantially to the “under-saving” and, therefore, to the current account deficit, in the first place.

Pursing this logic further requires a government to identify to what extent private sector savings and investment decisions (and in principle, the government budget deficit) are influenced by the organisational-, entry-, competition-, and possible ownership-related bottlenecks of relevant markets. Without successful identification and remedy of the latter supply side constraints, surely questions will arise as to the likely success of any package of rebalancing measures.²

Rebalancing and reindustrialisation: The slippery slope.

As a share of national spending, the shifts in expenditure needed for some countries to bring their current accounts into balance are significant. For deficit countries, some have argued that rebalancing should not require curtailing consumption, but rather the expansion of national output. What's more, many making such claims make the case for reinvigorating manufacturing industry. All too soon, such "logic" links rebalancing to reindustrialisation and to policies to promote certain sectors over others.

Concerns about deindustrialisation and appeals for national industrial policies are not new. What is of interest here is that they may be given a new lease of life by the attention given to rebalancing national economies. As acute readers have already noted, rebalancing in a country with a deficit country requires an expansion of national output (that other things being equal increases national savings) and that increase in national output could take any form, not just manufacturing. Rebalancing does not provide a justification for favouring manufacturing per se.

Still, governments may face significant political and corporate pressure to follow activist policies to shift resources into certain sectors, including manufacturing. In such a case, we may see rebalancing used to justify the mother of all sectoral policies. Worse, given the state measures adopted during the recent global economic downturn, governments may well be stumbling into policies of widespread cross-sectoral discrimination. What does the record say?

The precedent of adjustment efforts during the Great Recession does not augur well for the new discussion of rebalancing. Despite a relatively benign trade environment (albeit by contrast with the admittedly low standard of the dramatic growth in protectionism in the 1930s), Baldwin and Evenett (2009) have argued that in the recent global economic downturn there has been a rise in "murky protectionism." As they note, in addition to the usual raising of tariffs, quotas, and subsidies that often accompany economic downturns, governments have been using health and safety standards, "buy national" provisions, and "green policies" to boost their domestic economies – but often in a hidden discriminatory manner that on the surface are consistent with their formal WTO obligations, but hardly with its intent.

² Lim's analysis in this volume is a case in point. If government ownership of many firms in East Asia accounts in large part for those firms saving more than they would have done had they been privately owned, one must wonder how effective any East Asian government policies' towards rebalancing must be if they solely focus on altering the behaviour of individual private savers (assuming measures for corporate savers are off limits).

In previous work, we have systematically analysed if countries are indeed using the financial crisis as an excuse to promote some type of “new industrial policy” that will give their firms an advantage (Aggarwal and Evenett 2010). Our findings are a cause for concern. The analysis we have conducted is based on the Global Trade Alert (GTA) database, which at the time consisted nearly 800 investigations of state measures that have been announced or implemented after the first crisis-related G20 summit in November 2008.³ Based on our statistical analysis using proxies for pre-crisis intervention and comparing them to current intervention efforts in manufacturing, we found that pre-crisis measures of trade policy stance can account for only a sixth of the crisis-era discrimination in the Asia-Pacific region and just over a quarter of such variation in the non-Asia Pacific region.

Put differently, these findings suggest that “business as usual” – at least as seen as state favouritism along the lines of defensive trade policy considerations – cannot satisfactorily account for all of the crisis-era protectionism. Instead, the current crisis appears to have been motivated by other considerations. These motivations include the desire to promote new growth poles as well as environmentally-friendly technologies (so-called green industries) in addition to traditional protectionist responses.

In reality, we can envisage four forms of government bias towards sectors (see Figure 1). As will become clear, once rebalancing is introduced as an argument, in most cases it reinforces the case for sectoral discrimination. On the X-axis, we consider the sectoral objective being promoted by the policy. On the Y-axis or vertical dimension, we identify the force lobbying for sectoral discrimination: governments or firms.

In some countries, relatively inefficient firms have been actively lobbying for government action, with good examples being the General Motors and Chrysler in the US. These measures have protectionist elements, as helping failing industries through financial aid obviously distorts competition. Such lobbying has also been taking place among European firms as well. Also, in typical US fashion of defending old industries, firms receiving protection in the US include restraints against Chinese chicken imports and switchblades. In all of these cases, as output expansions can be argued (*ceteris paribus*) to increase national income and savings, then this form of discrimination is not on the face of it inconsistent with rebalancing.

³ Each investigation report identified the trading jurisdiction responsible for the announcement or implementation of the measure, a description of the measure (plus sources), and an evaluation as to whether the measure introduces, eliminates, increases, narrows, or otherwise changes any asymmetric treatment between domestic and foreign commercial interests. A traffic light system was used to distinguish between measures that do not change or improve the relative treatment of foreign commercial interests, that might disadvantage foreign commercial interests, and that almost certainly discriminate against foreign commercial interests.

In addition, each investigation of a state measure in Global Trade Alert identifies those economic sectors that are likely to be affected by a state measure. Details about a state initiative that are in the public domain are sought to identify the sectors affected. This assessment is conducted in a conservative manner. Indeed, if anything, there may be a tendency to under-report the number of affected sectors. The United Nations’ CPC scheme for classifying economic activities (both goods and services) into sectors is employed.

Figure 1: Categorising the Motivation for Discriminatory Sectoral Policies⁴

| Sectoral Objective | | |
|--------------------------------|--|--|
| <i>Driving force</i> | Defense of declining or impaired sectors | Promotion of new products and services |
| Firm-led measures | US and European auto sector, agriculture, insurance, banking | Educational services, carbon tax |
| Government-led measures | Banking | Fuel efficient autos (US), IT, wind turbines (PRC) |

A second type of pressure for sectoral discrimination is from firms that are innovating new products to restrict competition as they attempt to develop their goods and services. One significant example of this is the heavy lobbying by American and European firms to institute unilateral tariffs on countries that have not agreed to cap-and-trade controls in connection with the effort to limit greenhouse gases. Worse, to the extent that promoting new products is seen as contributing to national innovation and output expansion, it could be sold as a contribution to rebalancing too.

Governments have also taken their own initiatives, as in the extensive US and European aid to the financial sector. Although clearly lobbied for by banks and other financial enterprises, many of the measures undertaken by governments have been developed and promoted by government officials themselves with an eye to mitigating the effects of banks failures on the real economy. In this instance sectoral discrimination may not sit well with rebalancing national economies, in particular if banking and financial sector innovations have induced lower national savings rates.

Finally, there may be state-led efforts to develop nascent industries through restrictive measures. Although many analysts are rightly sceptical of the efficacy of industrial policy efforts, companies that actually have to deal with state-supported competition are often concerned with unfair competition – and may tie arguments for discrimination with those for rebalancing. In the recent global economic downturn, for example, the “green” measures being pursued by the Chinese government have little to do with coping with the financial crisis and much to do with state-led capitalism.⁵ Any rebalancing imperative must not give such measures a new lease of respectability among policymakers.

⁴ See Aggarwal (2009) for a more detailed discussion.

⁵ The Chinese have been shielding their clean energy sector from competition to develop their own domestic firms, using government procurement to favour their own firms, and banning wind turbines with a capacity less than 1,000 kilowatts as a means to undermine the competitive position of European exporters of the most popular 850 kilowatt design. Chinese complaints about carbon tariffs in view of their own industrial policy efforts are less convincing in this light.

Implications for policymaking

It is because circumstances differ so markedly across national economies – and so the proper mix of policies to support rebalancing are likely to vary too – that the purpose of this volume is as much as to highlight the relevant factors that policymakers must consider when formulating national, regional, and multilateral responses, as it is to hone in on the best policy for any one specific case.

In this chapter we have emphasised that it would be a mistake to think of rebalancing solely in terms of altering the level and composition of aggregate demand within an economy. For various reasons given here, supply side considerations are important as well, not least in conditioning how measures to affect demand actually alter market outcomes and national economic performance.

Macroeconomic fixes, then, may not be enough to deal with the longer-term causes of global imbalances. This is not to imply that the relevant “fixes” are easy to pull off, as there may well be substantial domestic opposition to the associated policy changes by vested interests. Rather, it is to suggest that the very interests that account for some supply side distortions (e.g limited competition among firms in the personal finance sector) in national economies may well be contributing to the growth and persistence of current account imbalances. Thus, a comprehensive approach to tackling those imbalances will require fixing those supply side distortions and ultimately taking on the vested interests concerned. This challenge may not be as daunting as it appears at first because governments can sequence their initiatives to reduce current account imbalances, confronting different interested parties at different times.

Finally, there is a risk that any rebalancing imperative will be inappropriately hijacked to advocate policies that promote certain sectors over others. Worse, such hijacking could extend the operational life of industrial policy measures put in place during the recent global economic downturn for which there was only a narrow interest group rationale. It is important for policymakers to remember that expanding one sector often comes at the expense of the contraction of another, providing little up front confidence as to how the gap between national savings and investment will change (the latter being the key determinant of imbalances.) Even when the expansion of a sector does not draw resources out of another sector, policymakers should satisfy themselves that there are no other knock-on effects of promoting the sector in question and that there is every reason to believe that the economy will move closer to current account balance. The evidential bar for sectoral policy advocates should, therefore, be set correspondingly high. Without such care, the rebalancing imperative will likely lead down the slippery slope to further state favouritism that will inevitably foster international trade conflicts.

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PART 5: The political viability of rebalancing

21 The political economy of rebalancing

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The global imbalances of the past decade were an underlying cause of the global crisis. This chapter argues that these imbalances are no longer sustainable and there is little doubt that the world economy will have to adjust to a new reality. The challenges of the next decade are two-fold: to manage political conflicts within countries, and to manage political conflicts among countries.

For fifteen years, macroeconomic imbalances, and concomitant international financial flows, have been a central feature of the world economy. One group of countries has borrowed heavily from the rest of the world, largely to finance increased consumption. Another set of countries has provided the goods, and the financing. The result was a decade and more in which borrowing countries ran huge deficits, while lending countries ran huge surpluses.

These imbalances are not sustainable over the medium and long run. As the world struggles through the crisis and its aftermath, the principal long-term question will be how these imbalances can be reduced. All conceivable outcomes involve political difficulties. Within countries, there will be conflict over who will make the sacrifices necessary to rebalance the national economy. Among countries, there will be conflict over the distribution of the adjustment burden between surplus and deficit nations. The future path of world economic activity depends on whether, and how, these conflicts play themselves out.

The need for rebalancing

Since the late 1990s, the pattern of international financial flows has been a peculiar one. The US, the UK, Spain, Ireland, and a phalanx of other countries ran large current account deficits, sucking in foreign goods and foreign capital to pay for them. These deficit countries relied on debt-financed consumption as the engine of their economic growth.

The principal lenders were Japan, Germany, China, and the Persian Gulf states. These countries, in one way or another, based their economies on exports to the deficit nations, using their export earnings to finance the deficits. In some cases the surpluses were the result of private saving and investment behavior, driven by a combination of demography and government policy. In other cases – in particular, China – the surpluses were the result of deliberate government

attempts to accumulate reserves rather than permit a currency appreciation. But whatever the reason, what tied this group of surplus countries together was that they relied on exports as the engine of their economic growth.

This model of international economic interaction will almost certainly prove unsustainable in the future. The major debtor nations have exhausted their willingness, and perhaps their ability, to incur further debts, while the major lenders show increasing signs of uneasiness about further lending.¹ Once emergency short-term measures to address the crisis are behind us, deficit and surplus countries alike will have to rework their relationship with the rest of the world economy. This “rebalancing,” to reduce the previous imbalances, is not primarily a technical, or purely economic problem, but rather a political one.

Upon whose backs will these national economies, and the world economy, be rebalanced? This question is central to the aftermath of every international debt crisis, such as the one we are currently living through. There is little doubt that national economies, and the world economy, will have to adjust to a new reality. But who will bear the burden of adjustment? How will the cost of these adjustments be distributed, both among countries, and within countries?

Rebalancing within countries

1. Rebalancing in the deficit countries

Part of the burden of adjusting to a major rebalancing of international financial flows will certainly fall on the major debtor nations and their people. The principal borrowers will no longer be able to rely on running massive current account deficits. This will especially be the case given the very large additional debt burdens their governments have taken on during the crisis. Every major debtor country will, like the US, come out of the crisis with government debts roughly equal to (or larger than) the size of the national economy – a level which, if the historical record can be trusted, means they face a long period of slow growth and retrenchment (see Reinhart and Rogoff 2009).

The problems and prospects of rebalancing in deficit countries can be seen in the US. The country’s foreign borrowing binge followed a well-known path. As capital flowed into the country, Americans were able to consume more than they produced, invest more than they saved, and the US government was able to spend more than it took in. The consumption boom had familiar sectoral effects. Some of the borrowed funds were spent on hard goods that enter easily into world trade, leading to an import surge and a ballooning trade deficit. The rest of the borrowing went to the consumption of non-tradable goods and services: education, health

¹ This is not to say that deficits and surpluses are in themselves technically unsustainable. So long as lenders are willing to lend, and borrowers to borrow, capital flows of this sort could go on forever. The point, however, is that effects of further massive increases in debt levels are unlikely, in my view, to be politically sustainable, as neither borrowing nor lending societies appear willing to resume pre-2008 levels of capital flows. A related point is that the capital flows of the past decade are almost entirely from poor to rich countries, or among rich countries; while the latter can be defended on some grounds, the former is hard to justify economically.

care, financial services, and housing. The result was flush times for non-tradables sectors, especially finance, insurance, and real estate, while conditions were less favorable for tradables sectors (manufacturing and agriculture). These economic trends had attendant political effects. The political influence of the booming sectors, especially finance and housing, grew continually, while the influence of the lagging sectors (manufacturing and agriculture) faded.²

As the scale of capital inflows is reduced – eventually, in my view, dramatically – those relationships will turn around. The country will have to produce more than it consumes, save more than it invests, and the US government will have to take in more than it spends in current costs. This implies serious austerity measures to restrict consumption, encourage savings, and reduce the government budget deficit. Americans – like the British, Irish, Spaniards and others – face a decade of reduced consumption, flat or declining real wages, and a stagnant standard of living. The sectoral effects will be a mirror image of the upswing. Rebalancing implies not only reducing spending, but switching it: increasing exports, stimulating tradable goods industries and reducing the importance of non-tradables. Hard as it may be to imagine now, the prospects are for a reduced economic role for the financial, insurance, and real estate complex that has been so central to the American political economy.

None of these adjustments will be politically easy. The austerity measures and compression of consumption ask Americans to put up with a long period of hardship. This is particularly difficult politically because even during the boom there was a widespread feeling that the benefits of economic growth were not evenly distributed; and in fact this feeling was accurate, as two-thirds of the country's income growth between 2002 and 2007 was captured by the wealthiest one percent of American households (see Saez 2007). There is already a widespread sentiment – reflected in the dramatic upsurge of populist rhetoric – that those who benefited from the boom are not paying their fair share of the retrenchment, while those being asked to sacrifice did not gain much from the previous expansion.

Both the broad public anger about the distributional effects of the crisis and its aftermath, and the political impact of the inevitable sectoral shifts in the economy, will make for hard times. The US, like other countries in similar positions, faces a very difficult next ten years. It will not be easy simultaneously to restore macroeconomic balance, create the conditions for future growth, and maintain a reasonable social consensus. Most of the government's, and the society's, efforts are likely to be expended in this effort.

2 Some might argue that political influence caused the sectoral pattern, rather than being caused by it, especially given the general tilt of the ruling Republicans toward the housing and financial services industries. However, the sectoral effects are very similar to dozens of previous capital inflow experiences, and very similar to those experienced by other deficit countries of many different partisan stripes. Partisan and other political factors may have heightened the impact of the underlying macroeconomic trends, but they did not create them.

2. Rebalancing in the surplus countries.

It is not just the major debtors that will have to undertake substantial, politically complicated, changes; the major creditor countries also face significant adjustments. Even if Germany, Japan, China, and others wanted to continue to run the kinds of surpluses they have gotten used to, their previous markets will be limiting their demand for imports. They have to reduce their dependence on exports, which implies that they have to increase domestic production for domestic consumption. Exporters will be less favored than they were in the upswing, as their economies turn away from relying on the export sector and toward the promotion of domestic consumption and the domestic service sectors. The surplus countries will of necessity turn inward.

Turning these export-oriented economies toward domestic markets will be politically difficult. In China, for example, the manufactured export sector has been at the center of the country's economic, social, and political order for decades, and it is almost certain that it will not be easy to reduce its economic importance. The country's political system has been heavily biased toward export manufacturing, and toward the coastal provinces where it is based. Chinese politics and policies have also strongly privileged investment over consumption – and investors over consumers. Changing this emphasis is not primarily a technical matter; it involves shifting decades-long patterns of social, political, and economic influence. In China and the other surplus countries, as in the deficit countries, rebalancing implies a fundamental change in the center of gravity of the economic, and therefore political, life of the societies in question.

Rebalancing, then, raises again the problem of winners and losers. This was true in the 1930s. It was true after the debt crisis of the 1980s in Latin America, or that of 1997-1998 in East Asia. It will be true again in the decade to come. Now, as in the past, economic changes brought on by the crises may also lead to fundamental political change, as winners became losers, losers became winners, and political conflicts ensue. These domestic political conflicts are certain to spill over into conflicts among nations.

Rebalancing among countries

Given the inevitable domestic conflicts between the winners and losers from rebalancing within countries, there are powerful incentives for governments to push some of the adjustment burden onto other nations. Debtors will attempt to force their creditors to pay some part of the price of debts gone bad. After all, debt crises create as many problems for creditors as for debtors – as Keynes put it: “If you owe your bank manager a hundred pounds, you have a problem. If you owe a million, it has.” Debtors can inflate or depreciate away some of their debts. If, as in the case of members of the Eurozone, this option is not available, they can insist that their debts be renegotiated or that their governments be bailed out – at the expense of creditors, and the governments of their Eurozone partners. Creditors also have tools in their arsenals – including undertaking little

or no new lending – and experience indicates that cross-border debt problems are rarely resolved without conflict.

There will also be international conflicts about the measures countries take to attempt to rebalance. The most obvious will be over trade, as deficit countries struggle to increase exports and restrain imports while surplus countries are in most cases still heavily oriented toward exports. Attempts by countries like the US to trim the trade deficit will almost certainly include aggressive measures against imports, as American industries increase their demands for import protection. There may also be insistent attempts to stimulate exports, including by trying to force open foreign markets with unilateral threats of retaliation. And while the US will not find it easy to weaken the dollar so long as the currency's safe-haven role persists, it can certainly pressure trading partners to appreciate their currencies.

While heavily indebted members of the Eurozone do not have the option of engineering country-specific inflation or depreciation to reduce their real debt burden and facilitate adjustment, they can attempt to influence ECB policy in this direction. The most powerful bargaining chip the Eurozone debtors have is the havoc a Eurozone sovereign default would wreak on financial markets throughout the EU; faced with a choice between this and looser policy than it might like, the ECB is likely to choose the latter. All in all, national attempts to get other countries to share in paying the price of adjustment are almost certain to heighten international conflicts over commercial, financial, and currency policy.

The case of the renminbi

International conflicts over currency policy are likely to intensify as the world economy rebalances, with China and the US the principal actors – a trend that revives the specter of “competitive devaluations,” so central to the trade and currency wars of the 1930s. Since it opened to the world economy in 1979, China has kept the renminbi depreciated. The value of this policy for China can be debated – certainly it punishes Chinese consumers in favor of export sectors, although plenty of analysts are sympathetic to a weak-currency policy for a developing country (see Rodrik 2008) – but there is little doubt that a weak renminbi increases competitive pressures on manufacturers who compete with the Chinese. Indeed, the growing chorus of protests by American industry led 130 Congressmen and Senators to condemn China in March 2010, writing in a joint statement: “Maintaining its currency at a devalued exchange rate provides a subsidy to Chinese companies and unfairly disadvantages foreign competitors.” (Palmer 2010).

A weak renminbi encourages US imports from China and discourages US exports to China, at a time when the US needs to reduce its imports and increase its exports. Some might welcome the implicit subsidy to US consumers reflected by cheap Chinese imports. But at this point America's economic policy agenda is dominated by the need to reduce consumption, increase savings, reduce imports, and increase exports – all of which are hampered by a weak renminbi.

However, the Chinese will resist what one Foreign Ministry spokesman called “wrongful accusations and pressure.” (Wong and Landler 2010) In language reminiscent of the currency wars of the 1930s, Premier Wen has insisted: “A country’s exchange rate policy and its exchange rates should depend on its national economy and economic situation.” Chung, Olivia (2010), “Wen hints at yuan move,” *Asia Times*, 16 March. In the face of increasingly heated American rhetoric, one Chinese editorialist wrote, “A trade war would be regrettable, but creating a long-term deterrent to US protectionism may require retaliation.” (Schuman 2009).

The US-China currency conflict is emblematic of the domestic and international conflicts the crisis will spark and deepen. It demonstrates how the aftermath of the crisis is likely to reduce the interests of major governments in international economic cooperation. It is not that the global economy will become irrelevant, for the depth and breadth of international commercial and financial ties is extraordinary. It is, however, that the goals of major governments are likely to be more inward-looking than they have been. Their constituents will be more concerned about domestic matters, and less concerned about international ones, than they have in the recent past.

Prospects

The global macroeconomic imbalances of the past decade were the underlying cause of the crisis that erupted late in 2007. Even if we wanted to restore these imbalances, it is almost certain that they are no longer sustainable. The principal item on the international economic agenda is how to rebalance the world economy, and national economies within it. These interrelated tasks are extraordinarily challenging, and not primarily for technical reasons. They are challenging because they call into question established patterns of political power and economic influence, both within countries and among countries. The principal challenges of the next decade are two-fold, and closely related: to manage political conflicts within countries, and to manage political conflicts among countries.

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22 China-US imbalances and Europe's fiscal crisis: Plus ça change?

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As the global crisis subsides, focus is shifting to the global imbalances. This chapter argues that China-US economic imbalances, and the challenge of managing them down politically as well as economically, are likely to become even more critical. It adds that the world can only hope that both sides will be up to the challenge.

Judging by the China-US two-step, in which the US first backed off criticizing China for its undervalued currency and now China has agreed to allow the renminbi to start rising against the dollar, one might think that the longstanding tensions between the world's largest surplus nation, China, and the world's largest deficit country, the US, have abated to the point where they will not be an issue at the upcoming Toronto G20 summit and beyond.

But this apparent thaw in China-US relations belies the fact that what was already the most imbalanced economic relationship in history has become even more imbalanced during the current global economic crisis. While China's global surplus and the US's global deficit shrank substantially in 2009, China-US imbalances remained stubbornly high. With high unemployment in the US and rising social unrest in China, the political temptations to blame the other country for big problems at home are increasing. An appreciating renminbi will certainly help in the short run, but the longer term structural imbalances and the frictions they generate are not going away anytime soon.

The recent exchange rate politics are just the latest example of the general political trend in recent years in Sino-American relations. Through frequent high level behind-closed-doors diplomacy, China and the US have managed down frictions over imbalances that are exacerbated by their fundamental differences in world views and their nascent geopolitical rivalry.

After the ravages of the global economic crisis, China-US economic imbalances and the challenge of managing them down politically as well as economically are likely to become even more important. Meanwhile, Europe's deep malaise—a weaker euro and stagnant European demand amid a sweeping fiscal crisis—provides a new set of challenges. The euro's swoon has decreased the competitiveness of Chinese exports in Europe.. Depressed European demand puts more pressure on the American consumer to become again the world's growth engine.

As a result, China and the US may pursue different objectives at the Toronto summit—even though they will no doubt be celebrating their bilateral currency

win-win. The US wants Europe to keep stimulating demand in the short term, putting off fiscal consolidation. China's principal short term interest is in a stronger euro, which could be accomplished by tighter monetary policy by the European Central Bank.

Squaring the circle between these quite different American and Chinese approaches to the Eurozone crisis, which reinforce the divisions between Germany and other European nations led by France and Italy, will likely be a major focus of the Toronto G20.

2009 was a diabolical year for the world economy. But there was supposed to be a silver lining—the global recession was supposed to reduce the massive imbalances between China and the US. Stagnant US consumer demand would slow the flood of Chinese imports. China's large scale fiscal stimulus plus bank lending boom would increase Chinese consumer demand for American exports. Given the uncertainties of the global economy, no one was surprised that China re-pegged the renminbi to the dollar. But American contraction and Chinese stimulus were nonetheless expected to cut into Sino- American imbalances.

China's global surpluses and America's global deficits did indeed shrink dramatically in 2009. China-US imbalances, however, were much more resilient. The result is that for both China's surpluses and the US's deficits, the role played by the other country was a much bigger part of the story in 2009 than even in 2008 (see Table 1).

Table 1. China-US Trade Imbalances

| A. US Trade Deficits (billions \$US) | | | |
|---|--------------|--------------|--------------------|
| With: | China | World | China/World |
| 2008 | 268 | 816 | 33% |
| 2009 | 227 | 501 | 45% |
| Change | -15% | -39% | |
| http://www.census.gov/foreign-trade/balance/ | | | |
| B. China Trade Surpluses (billions \$US) | | | |
| With: | US | World | US/World |
| 2008 | 268 | 298 | 89% |
| 2009 | 227 | 196 | 116% |
| Change | -15% | -34% | |
| http://www.uschina.org/statistics/tradetable.html | | | |

In 2008, America's trade deficit with China was \$US 268 billion, one-third of its global trade deficit. The overall US trade deficit was cut by 40% in 2009. But its deficit with China only decreased by 15%. As a result the US's trade deficit with China was 45% of its trade deficit with the whole world in 2009.

This trend of more concentrated imbalances was even more striking from China's perspective. In 2008, 89% of China's trade surplus was with the US. In 2009, China's surplus with the whole world dropped by one third. But its surplus with the US only declined by 15%. China's surplus with the US in 2009 was bigger than its surplus with the whole world. Put differently, while China continued to run an enormous trade surplus with the US in 2009, its trade with the rest of the world was actually in deficit in 2009.

The bottom line from Table 1 is that American consumers were the port in the storm for Chinese exporters during the global trade cyclone of 2009. Turning to 2010, there is ample evidence that global trade is recovering. But there is no reason to think that this will decrease China-US imbalances.

The effects of the Eurozone crisis obviously extend far beyond Greece and the costs of bailing out its sovereign debt. As Figure 1 shows, the euro has depreciated more than 20% against the dollar in the past six months. Because China maintained its peg against the dollar until this week, the renminbi has also appreciated dramatically against the euro. Chinese exports have lost competitiveness in Europe, making American markets even more important to Chinese prosperity.

Figure 1. Euro and RMB exchange rates against the dollar



Source: <http://research.stlouisfed.org/fred2/categories/94>

In this new environment, there is no reason to think that China-US imbalances will decrease any time soon. In fact, America's trade deficit in China over the first four months of 2010 was \$US 71 billion, 11% higher than for the comparable period in 2009. Over the same period, Chinese holdings of American Treasury bills, the capital account flip side of the US trade deficit, increased by 17% to \$US 895 billion. First on the downside of the global recession and now as China

and the US recover while Europe flounders, Sino-American imbalances seem an enduring part of the global economic landscape

While the reality of China-US imbalances has not changed during the global economic crisis, the tone of China-US relations certainly has. Before the crisis, the US was wont to lecture and hector China over what Americans viewed as China's undervalued currency and unfair trade surpluses. The crisis could have intensified this dynamic. China went into the crisis worried that its thirty year growth miracle could be choked off by the collapse in global trade. The US entered into the crisis confident that it would bounce back quickly to remain the world's growth engine.

But China came out of the crisis arguably stronger and certainly more confident, while the US became less aggressive less convinced about the durability of its primacy. The result has been the kind of diplomacy evident at last month's Strategic and Economic Dialogue—American praise for Chinese stimulus and backing off regarding currency manipulation coupled Chinese assertiveness that it will manage its economy based on domestic considerations rather than American pressure.

It is against this background of enduring economic imbalance and new political balance that the future of China-US economic relations should be assessed. What needs to be done to bring balance to the economic relationship was made clear by Geithner and US Secretary of State Hillary Clinton before the July 2009 Strategic and Economic Dialogue:

We must take additional steps to lay the foundation for balanced and sustainable growth in the years to come. That will involve Americans rebuilding our savings, strengthening our financial system and investing in energy, education and health care to make our nation more productive and prosperous. For China it involves continuing financial sector reform and development. It also involves spurring domestic demand growth and making the Chinese economy less reliant on exports. (Wall Street Journal, 27 July 2009).

But this rebalancing requires changing the economic DNA of both countries, a task that is more likely to take decades than months. China must become more American by saving less and consuming more. America must become more Chinese by saving more and consuming less.

Just stabilising US public debt after the full effects of the Obama administration's crisis fighting measures are felt is estimated to require tax cuts or spending increases of nearly one-third of central government spending. Americans have repeatedly shown that they will punish politicians for much less belt tightening than the US clearly needs.

What about tax increases, focusing on measures that would reduce future asset bubbles? Every dollar spent on servicing American mortgage debt is fully tax deductible. No US politician would commit the political suicide of suggesting America should wean itself off the motherhood and apple pie of government subsidised mortgages to realise the American dream of home ownership.

China's challenge is the mirror image of that facing the US. Whereas Americans borrow because they are confident about the future, Chinese citizens save for

a rainy day. The Chinese government probably has the capacity to build an effective social safety net and to change the regulatory environment to favour the growth of retail banks, credit cards and insurance targeted at consumers. Indeed, it has taken important steps in this direction in recent years. But the overriding instinct of the government remains to use state-controlled banks to invest in infrastructure and state controlled companies rather than to empower the consuming middle class that might one day form the base for political liberalisation in China.

The mismatch between the big changes needed to rebalance the American and Chinese economies and the immutable political constraints against doing so mean that it will always be tempting for both sides to blame each other for their economic problems. Up until now, China and the US have both largely resisted these temptations and managed down tensions in their relationship when they have flared up. The renminbi-dollar modus Vivendi is but the latest example.

But the more China rises towards becoming a genuine rival of the US, the longer America's current economic woes drag on, and the greater domestic unrest in China, the greater will be the diplomatic obstacles facing Beijing and Washington as they strive to keep driving forward their two decades of win-win economic engagement.

China and the US will come to the Toronto G20 meeting on the back of what amounts to a political love over the past month. However, the two countries have different interests regarding European economic policy. China wants the euro to appreciate to lighten the cost pressures on its exporters. The US wants Europe to put off fiscal consolidation to lighten the load on American demand as the engine of global growth.

These different positions are the direct result of the enduring imbalances between the American and Chinese economies. Toronto will prove yet another test for the management of Sino-American economic relations that will have global ramifications. The world can only hope that both sides will be up to the challenge and, based on recent history, there is reason to believe they will be.

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PART 6: Are new system-wide accords needed to promote rebalancing or to discourage persistent imbalances?

23 Global governance: Pre and post crisis

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The global economy is operating with little room for error. This chapter warns that, while it may be natural for countries to look inwardly in these circumstances, this would be a big mistake. The global economy is too inter-connected across borders to be subject to national solutions. Indeed, proper global coordination and governance must play a critical role.

The global economy is resetting after the traumatic 2008-09 financial crisis that shook the banking system, disrupted growth, raised unemployment, and increased tensions among and within countries. The crisis exposed big gaps at virtually every level of national societies – from individuals that bought homes that they could not afford using exotic mortgages that they did not understand; to firms that had inadequate risk management systems, poor incentives and partial disclosures; and to governments that failed in their regulatory responsibilities and prudential supervision.

These consequential breakdowns occurred in multiple national jurisdictions – most critically in the highly finance-dependent economies of the UK and US. Yet they do not constitute the whole story. They were also accompanied by amplifying failures at the global level. More than ever before, the crisis exposed the damaging inadequacies in the governance of a global system that has become highly interdependent and lacking in prudential redundancies and circuit breakers.

In contrast to the national level where large parts of society were caught unaware by the extent of the underlying vulnerabilities, recognition was less of an issue at the global level. After all, there were many analyses of the persistent and well publicised payments imbalances, unfair country representation at the international financial institutions, and the general legitimacy deficit in global governance. There were, and continue to be concerns about an international exchange rate regime with a mixture of floating and managed exchange rates with little effective oversight of the collective interests.

High recognition did not give way to meaningful action until the global financial crisis imposed a “sudden stop” on trade, contaminated economic activity and fuelled a surge in joblessness. The global reaction that followed was instrumental in avoiding a global depression. And rather than be coordinated through the long-standing mechanisms of the G7 and the IMF, this crisis management brought to the fore a relatively new grouping – that of the G20 –

which involves a more sensible representation of both industrial and emerging economies.

Notwithstanding this critical success of the global crisis *management* response – and despite the even more evident prior failures in global crisis *prevention* – the focus on better global governance is already dissipating. National and, in the case of Europe, regional issues are again becoming much more dominant; and not only in absolute terms but also in a fashion that is undermining recent gains at the global level.

If this phenomenon continues – and it will continue if left to its own devices – it will reverse some of the achievements and make the resetting of the global economy an even bumpier, lengthier and more partial process. The result will be a global economy that retains an important element of instability that, regrettably, will again prove problematic over the medium-term.

The purpose of our chapter is threefold. First, to summarise the manner in which failures at the global level contributed to the financial crisis; second, to show how the subsequent enthusiasm for globally coordinated policy responses has already given way to conflicting national and regional initiatives; and third, to explain why, in the absence of corrective steps, weak global governance will remain a hindrance to medium-term growth and financial stability.

Global governance in the run-up to the global financial crisis

It is widely recognised today that many factors contributed to the global financial crisis. One of these multiple factors was the persistence of global imbalances – the seemingly endless willingness and ability of surplus countries to run persistent surpluses, and of deficit countries to run persistent deficits.

This “willingness” was a reflection of national beliefs that the status quo was in the interest of individual countries, be they in surplus or in deficit.

Among the surplus countries, led by China, the initial driver was a desire to accumulate large stocks of international reserves for prudential (self insurance) reasons. This was soon overtaken by the reality of how a dynamic net export orientation facilitates massive job creation, income generation and poverty alleviation.

In the deficit countries, led by the US, it was hard to resist the temptation to maintain consumption well above levels warranted by national income generation. This was particularly the case when appreciating asset prices appeared to be continuously increasing the wealth of households, businesses, non-profit institutions and even governments.

How about “ability”? Two elements were in play here which asymmetrically impacted surplus and deficit countries: first, the ability to control one’s destiny and, second, the ability to change course.

Surplus countries maintained much greater ability to maintain their chosen course. Unlike the deficit economies, they did not need to rely on others to fund consumption. And the longer the imbalances persisted, the greater the improvements in their international financial balance sheet.

By contrast, deficit countries relied on external borrowing to cover the inadequacy of their internal savings and, with time, incurred a growing cost of servicing that part of the debt. The extent of their reliance varied depending on whether they could borrow in their local currencies, how far they could extend maturities, and their overall stock of debt.

There were also variations across countries in the extent of net borrowing by households and governments. For example, in the USA, both rose rapidly in the run-up to the crisis. The same was true of the UK and Spain. Many other EU countries, however, did not experience a significant expansion of household debt.

The ability to change course was also material. It was not easy. At the very root of the analysis, the persistence of the imbalances reflected structural – and not just pricing/exchange rate – issues. As such, policy adaptations faced complex design and implementation challenges. The socio-political narrative required considerable attention which was mostly lacking or badly handled. Moreover, as tends to be the case with structural reforms, short-term political considerations often clashed with the required longer-term economic and financial re-orientations.

This combination of willingness and ability factors fuelled growingly unstable conditions at both the national and the global levels. Too large a range of activities was enabled by a system that lacked the needed national and international infrastructures. The system built to a critical state. It was like a mound of sand: incremental grains went from growing the mound into an imposing shape to suddenly demolishing it in a disorderly fashion.

By early 2007, the growing excesses were starting to give way to instability. Initially, the cracks were within specific sectors at the national level (e.g., the subprime segment of the US housing market). But the combination of deep-rooted excesses and poor circuit breakers fuelled a morphing crisis that first went national, then global. The world witnessed a cascading series of market and policy failures, resulting in the major global financial crisis that put large segments of populations at risk, and the world on the verge of a great economic and social depression.

At that stage, policy makers scrambled, adopting a “whatever it takes” mode. The policy response abandoned careful planning and conventional tools in its well-intentioned attempt to stabilise the situation at any cost. And policymakers had no choice but to risk a combination of collateral damage, unintended consequences, moral hazard, incentive mis-alignments and eroding the long-standing integrity of key institutions.

The global response – effectiveness

As policymakers gathered in Washington DC in early October 2008 for the Annual Meetings of the IMF and World Bank, they quickly recognised that their national narratives were echoing around them. It became evident that they were

all in the midst of a major global crisis. And it also became clear that this global crisis required a global response.

This global response essentially came in two steps. The first, which was led by the UK at the October Annual Meetings, involved a coordinated multi-country approach to stabilising the banking system and, within that, the functioning of a range of funding mechanisms. The second, which emerged from the April 2009 meeting of the G20 in London, involved a multi-country effort to arrest the collapse in economic activity using massive fiscal and monetary policy stimulus.

Both policy reactions were successful. The banking system slowly regained its footing, helped by massive injections of capital, guaranteed borrowing and steep yield curves. Funding markets started to normalise. However, the sheer size and distributional aspects of bailing out the banks left a large residue of anger that impacted political outcomes, with consequences for subsequent reform directions.

On balance, we suspect that this historical episode will be viewed as an impressive example of economic global coordination. A lot of it was designed on the fly. The catalyst was a sinister crisis that was morphing from bad to worse. And, particularly when it came to substance, the response essentially bypassed the long-standing institutions that had stood for years at the centre of the international monetary system (most notably the IMF and the G7) – illustrating once again that the global architecture was in need of urgent reform.

The question then turned to whether, having emerged in the crisis, global coordination could also prevail in the post-crisis phase. Could such coordination help clean up the collateral damage and the unintended consequences of the emergency measures; and could the coordination develop deep institutional roots that would ensure perseverance and long-term effectiveness?

The global policy response – dilution

Unfortunately, it did not take long for national and regional considerations to dominate once again. This was most evident in the US and in Europe.

Pushed by internal political pressures, the US and certain European authorities announced a series of policy measures that effectively pre-empted the discussions that were taking place at the multilateral level. Examples included US announcements on the taxation, the regulation of banks, and financial sector reform. They also included the country's bilateral dealing with the Chinese on exchange rate policy, and the low interest rate monetary policy that complicated the management of capital flows, asset prices and inflation in a range of countries.

Some European countries also moved independently. Witness the initiatives to regulate hedge funds and, in the case of Germany, the dramatic announcement on the banning of naked short selling.

For sure many of these items were on the agenda of the G20. Yet, when push came to shove, national authorities showed little interest in working through the collaborative mechanisms that had worked so effectively in the immediate aftermath of the global financial crisis.

All this led to more than just recriminations and heated multilateral discussions; it also sent confusing signals to the markets and to businesses, providing an additional headwind to investment activity and, more generally, the sustainable level of final private demand needed to make a meaningful dent in the high unemployment rates prevailing in many industrial economies.

Europe had an additional problem. The collateral damage from the 2008-09 “whatever it takes” policy responses manifested itself in the form of huge budgetary deficits that the weaker members of the Eurozone could no longer fund in an orderly fashion. Greece was the poster child, having run persistently high deficits even before the global financial crisis. Portugal also faced market pressures.

Spain did not enter the crisis with huge fiscal deficits. But it soon became evident that its fiscal situation was tentative, the product of a leveraged-fuelled real estate bubble whose collapse caused government revenues to fall and social insurance payments to rise. A difficult lesson relearned in many countries and subunits is that financial and economic imbalance cause fiscal imbalance; and fiscal issues can quickly translate into pressures on the banking system.

Facing a quickly-amplifying crisis of its own, Europe’s policy response was dramatic, albeit less than sufficiently effective. It involved agreement on large fiscal stabilisation funds, a complete turnaround in the ECB’s attitude towards asset purchases, and a series of national announcements on fiscal austerity.

Interestingly, this dramatic response was formulated at the regional level, with little global coordination. This was most vividly illustrated by the initial strong aversion expressed by European policymakers to having the IMF involved in regional issues – a stance that was reversed in a humiliatingly public fashion. Indeed, Europe went from insisting that it needed no IMF help to counting on the institution for over \$200 billion of the \$1 trillion “shock and awe” package aimed at safeguarding and stabilising the Eurozone and the Euro. Europe also looked to the IMF for technical expertise in managing the conditionality of the package.

It mattered little in Europe that the IMF was in no position to pre-commit such an amount to a region. It mattered little that the issue had not been properly discussed by the Board of the IMF which represents its 186 member countries. And it mattered little that the announcement went against the long-standing principle that the IMF treats its individual member countries on a case-by-case basis and adopts a uniformity of treatment when it comes to assessing financing needs and policy conditionality.

Europe’s initial exclusion of the IMF, followed by its co-option, sent a signal that goes beyond the subservience of global considerations to national and regional ones. It also highlighted the persistence of representation and legitimacy deficits in global governance.

Looking forward

The global financial crisis demonstrated that our globalised world has reached a level of international connectivity that far exceeds the reach of national policies and the effectiveness of the global architecture. It also demonstrated the extent to which the system as a whole lacked the redundancies and circuit breakers that underpin a degree of systemic resilience.

Initially, the crisis forced national governments to coordinate their policy responses and to abandon representation mechanisms that made sense 60 years ago but no longer do so today. Yet the post crisis period is already seeing a dilution in this trend toward greater cooperation.

Should we worry about this reversal and can something be done? Yes and yes.

The post-crisis world involves a multi-year resetting of the global economy. Elsewhere, we have likened it to journey, on an uneven road, through unfamiliar territory, and to a new destination. Importantly, this “bumpy journey to a new normal” is being undertaken with most of the spare tires having already been used up, resulting in a very limited capacity to accommodate any additional market accidents and policy mistakes. Political accommodation is also an issue given the trend towards greater polarisation and anti-incumbency.

Post-crisis we are looking at a world of more muted growth in industrial countries, re-regulation, partial financial de-globalisation (as a way to diminish the impact of disruptive financial transmission channels) and, more generally, a shift in the balance between unfettered markets and government involvement. It is also a world where systemically important emerging markets can probably maintain their development breakout phase provided they are properly accommodated within the international financial system.

The restoration of growth in major emerging markets to near pre-crisis levels has been extraordinary. Further, because of their size and expanding share of the global economy their growth can make the inevitable transitions and frictions, including those in the industrial countries, less costly.

This type of world urgently needs a steady hand at the helm of global governance. Yet, as argued above, the trend is going the other way.

What can be done to reduce this important weakness?

First, the G20 needs to succeed in addressing its two main challenges: (i) coordinated financial regulatory reform and (ii) restoring and rebalancing global demand. Its main supporting institutions in these efforts – namely, the BIS, the FSB, and the IMF – need to be more effective. They have to be, and must be seen to be governed in a way that is consistent with the evolving economic and financial standing of the participants – the global economy of today and tomorrow, rather than that of yesterday.

Second, politically, for the international agenda to get the attention it urgently deserves, a pattern of sustained growth needs to be restored and unemployment brought down in the industrialised countries. Some of this requires patience as

the de-leveraging process has further to run. Trying to accelerate that process by over-using the government wallet will negatively impact an already risky drift toward fiscal imbalance and sovereign debt risk in the industrial countries, and ultimately damage growth. Accordingly, governments must do a much better job at communicating to their citizens the reality, and the related multi-year programs to improve the outlook.

Third, major emerging economies need to become more comfortable with their increased global responsibilities, including accepting their roles in helping to manage the international economic and financial systems, and engaging more forcefully in the reform processes referred to above. Because this comes at stages of development where per capita incomes are still very low by historical standards, this will not be easy. A delicate and sophisticated balancing act will be required between purely domestic growth and development agendas, and international priorities.

Fourth, restoring balance to the global economy and maintaining it along with growth requires structural change in many economies, industrial and emerging. International policy coordination efforts need to reflect this reality and the timelines that are implied.

As part of that effort, exchange rate regimes need to be brought back into the sphere of international coordination. The present configuration dating back to the 1970's came from a shift away from managed exchange rate regimes toward floating rates and market determined outcomes in the industrial countries. That was never workable in the developing world where exchange rates have generally been managed for years. This latter group is now larger and the hybrid system is breaking down and adding to potential instability.

The present configuration is a diverse set of unilaterally determined approaches to the exchange rate interspersed with periodic bilateral negotiations and threats. The result is inevitably likely to be suboptimal uncoordinated equilibria. The system needs to be rebuilt with a view to accommodating the growth, development and structural adjustment goals of all countries.

Fifth, the EU governance structures are broadly acknowledged to require institutional reform. As one of the two largest economies in the world, its stability and that of the Euro have important global implications. While views on the right direction for reform vary, there is agreement that a stable common currency requires fiscal discipline. The shared and deep interest in fiscal discipline is simply inconsistent with complete fiscal decentralisation.

That was recognised in the original Maastricht rules. Whether these rules and oversight procedures can be modified so as to accommodate responses to shocks, structural adjustments and countercyclical policies while maintaining discipline is rightly subject to analysis and debate. The alternative is a greater degree of fiscal centralisation with questions about the political feasibility of moving in that direction.

Concluding Remarks

The global economy is at a critical juncture. It has emerged from the 2008-09 financial crisis weaker, and still subject to a lengthy process of resetting and rebalancing. It is operating with little room for error, at a time when unemployment in industrial countries is unusually high, the credibility of the banking system is very low. Moreover, public debt and deficits have exploded, and the credibility of central banks is being questioned.

It is natural for countries to look inwardly in these circumstances. Yet this would be a big mistake. The global economy is too inter-connected across borders to be subject to orderly national solutions. Proper global coordination and governance must also play a critical role.

The run-up to the global financial crisis and the subsequent crisis management process carry important lessons about global governance. Sadly, it appears that some of these lessons are already being forgotten, and others are being negated. Let us hope that this pattern is changed so that the global economy may reduce the probability of even more economic and financial volatility in the years ahead.

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24 Keynes, global imbalances, and international monetary reform, today

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This chapter argues that the Keynes Plan of 1941 for dealing with the trade imbalances of his time is highly relevant to the problem of East Asian-US imbalances today. Just as the first Bretton Woods system rested on a “grand bargain” between the US and Britain, a new Bretton Woods would test the statesmanship of the US and China.

The Problem of Global Imbalances

As the world tentatively scrambles out of the worst recession since World War II, the future of the world monetary system remains firmly off the agenda. The global downturn had many interacting causes, but a tenable view is that the accumulation of reserves by a handful of countries in East Asia and the Middle East played a key permissive role in the collapse. Between 2003 and 2009 (measurable) global reserves increased from \$2.6 trillion to \$6.8 trillion – an average annual rate of increase of about 15%, at a time when global GDP grew at an annual rate of 4.4%. This amounted to a big increase in deflationary pressure. However, the fact that the reserves were held mainly in dollars allowed the US to avoid deflation, and instead run a “Keynesian” domestic policy which set the stage for an unsustainable asset and consumption boom. In short, there was a nexus connecting reserve accumulation by China and expansionary monetary and fiscal policy in the US.

The purpose of this chapter is to show that the Keynes Plan of 1941 for dealing with the trade imbalances of his time is highly relevant to the problem of East Asian-US imbalances today. It proposes two mechanisms for alleviating the current problem of “symmetrical non-adjustment”. The first part of the essay will examine the historical context of the Keynes Plan and the breakdown of the Bretton Woods system; the second will analyse the present problem of non-adjustment and steps which can be taken to overcome it.

The Keynes Plan of 1941

In the 1920s Keynes had come to see deflation as the main cause of British unemployment; and the main source of deflationary pressure as the unbalanced creditor position of the US. In theory, the international gold standard, which was the currency regime of the time provided for automatic and symmetrical adjustment of current account imbalances. Prices would automatically rise in the gold gaining countries and would automatically fall in the gold-losing countries, thus restoring the equilibrium of exports and imports between the two. But Keynes had come to realise, as he put it in 1941, that adjustment was “*compulsory* for the debtor and *voluntary* for the creditor”. If the creditor does not choose to make, or allow, his share of the adjustment, he suffers no inconvenience: while a country’s reserve cannot fall below zero, there is no ceiling which sets an upper limit. The same is true if private capital flows are the means of adjustment. “The debtor must borrow; the creditor is under no...compulsion [to lend]”.

During the Great Depression itself, creditor “hoarding” had been aggravated by the flight of capital from deficit to surplus countries. Following the financial crisis of 1931, the gold standard collapsed, the international capital market seized up, and the major countries resorted to tariffs, competitive devaluations, and bilateral trade agreements to balance their accounts. The international payments system created in the 19th century ceased to function.

Keynes’ Clearing Union plan of 1941 was designed to avoid a repetition of this disaster. It would retain the advantages (as he saw them) of a fixed exchange rate system while avoiding the asymmetric costs of adjustment. The essential feature of his plan was that creditor countries would not be allowed to sterilise their surpluses, or charge punitive rates of interest for lending them out; rather these surpluses would be automatically available as cheap overdraft facilities to debtors through the mechanism of an international clearing bank whose depositors were the central banks of the union.

All residual international transactions – those giving rise to surpluses and deficits – were to be settled through “clearing accounts” held by member central banks in an International Clearing Bank (ICB). Member banks could buy foreign currencies and sell their own against debits and credits to their accounts at the ICB (denominated in bank money or “bancor”) up to an “index quota” equal to half the average value of their country’s international trade over the previous five years. Deposits of bank money (credits and debits) would be created by surpluses and deficits and extinguished by their liquidation. Each national currency would have a fixed but adjustable relation to a unit of bank money (bancor) which itself had a fixed relationship to gold. But though bancor could be obtained for gold, it was not convertible into gold. Keynes’ long term aim was to de-monetise gold and make bancor the ultimate reserve asset of the system. By increasing or reducing the total of quotas, the Bank’s managers would be able to vary the supply of bancor contra-cyclically.

Keynes sought to secure creditor adjustment without renouncing debtor discipline. To this end his scheme aimed to bring a simultaneous pressure on both surplus and deficit countries to “clear” their accounts. Persistent creditor

countries would be allowed or required to revalue their currencies, unblock any foreign-owned investments, and be charged rising rates of interest (up to 10 per cent) on credits running above a quarter of their quota. Any credit balances exceeding quotas at the end of a year would be confiscated and transferred to a Reserve Fund. Persistent deficit countries would be allowed or required to depreciate their currencies, to sell the ICB any free gold, and prohibit capital exports. They would also be charged interest on excessive debits. If all countries were in perfect balance at the year's end, the sum of bancor balances would be exactly zero.

The Keynes plan was vetoed by the US, which was not prepared to allow its "hard earned" surpluses to be automatically at the disposal of "profligate" debtor countries. Instead the Bretton Woods Agreement of 1944 set up an International Monetary Fund to provide short-term financial assistance for countries in temporary balance of payments difficulties. The IMF was a fund, not a bank, into which members would pay contributions or quotas made up of gold and domestic currencies. (The total resources of the Fund were set at \$8bn, as opposed to \$25bn. for Keynes' ICB). The Fund would supply foreign currencies to members up to the limit of their quotas, provided they corrected their domestic policies. Par values of currencies would be fixed in terms of gold, which could be altered only to correct a "fundamental disequilibrium". Both the Keynes Plan and the IMF system relied on capital controls to prevent the destabilising flows of "hot money".

The crucial point was that, while accepting the idea of fixed, but adjustable exchange rates, the Fund provided no mechanism to stop persistent reserve accumulation. It upheld, that is, the orthodox doctrine of debtor adjustment, and to that extent failed to solve the Keynes problem of persistent creditor hoarding. The contrast between the two plans was deliberate. For Keynes and the British, the problem which brought down the gold standard in 1931 had arisen from the refusal of the surplus countries to spend their surpluses; for the Americans it had arisen from the monetary indiscipline of the deficit countries.

The Bretton Woods system in practice

That the Bretton Woods fixed exchange rate system, which lasted from 1949 to 1971, did not reproduce the deflationary character of the inter-war system, was due to the general commitment of governments to full employment policies backed by the "dishoarding" policies of the US. America flooded the "free" world with dollars, to such an extent that by the late 1960s it was starting to run a balance of trade deficit itself. The boot was now on the other foot, but the need for the deficit country (now the USA) to deflate was circumvented by the role of the dollar as the world's main reserve asset. As its trade deficit widened, the USA printed an increasing quantity of dollars to cover its unrequited imports. The surplus countries accumulated American dollar liabilities which they invested in US Treasury bonds. The US did not have to restrict domestic credit by raising interest rates since the dollars it printed came back to it. In the absence of what

would have been a major deflationary force, the world economy boomed for twenty years.

The flaw in the system, as pointed out by Professor Triffin of Yale University, was that the increase in the liabilities of the key-currency country was bound to raise doubts about its ability to redeem these liabilities in gold. At the end of the 1960s, the French started converting their dollar reserves into gold. This brought about the predicted collapse of the gold-exchange standard in 1971. The dollar became inconvertible. A new supplementary international reserve currency, Special Drawing Rights (SDRs), had been set up, but since there was no mechanism for converting dollar balances into SDRs, the dollar continued to be the world's main reserve asset in a mixed world of floating, fixed, and managed exchange rates.

In theory, floating exchange rates remove the need for any reserves at all, since balance of payments deficits and surpluses would not arise. But the need for reserves unexpectedly survived, mainly to guard against speculative movements of hot money which could drive exchange rates away from their equilibrium values. This happened throughout the 1980s. Starting in the late 1990s, after the East Asian Crisis, East Asian governments unilaterally erected a "Bretton Woods II", linking their currencies to the dollar, and holding their reserves in dollars. This reproduced the expansionary benefits of Bretton Woods I, but at the cost of an increasingly unbalanced reserve position, as the dollar became progressively overvalued against the super-competitive renminbi.

Today's problem of current account imbalances reproduces the problems which brought down both the old gold standard and its successor Bretton Woods system. The gold standard failed to provide for the symmetric adjustment of surpluses and deficits. The Keynes Plan was designed to replace asymmetric adjustment which brought deflation to the deficit countries by deliberate provision for symmetric adjustment through the International Clearing Union. The Bretton Woods system did not solve the Keynes problem. It upheld the orthodox doctrine of debtor adjustment, but, through the IMF, gave debtor countries time to "put their houses in order". The deflationary pressure against which the Keynes plan was directed was solved not by the mechanisms he had envisaged, but by the voluntary "dishoarding" of its surpluses by the US. But this called into question the credibility of its promise to redeem dollars for gold. Today's system can be characterised as one of symmetric non-adjustment: as long as the surplus-earning countries are content to hold their accumulating reserves in dollars, neither side is under any pressure to adjust.

However, the main issue today is no longer the "sustainability of the deficit", but its effect on the economies of both surplus and deficit countries. A sequence of financial booms and busts is built into a system which brings no pressure for adjustment to bear on either creditors or the principal debtor (the U.S.). This is both irrational and costly. Unless steps are taken to re-balance global current accounts, we will be walking into the next crisis. To secure the automatic adjustment of current account surpluses and deficits was the object of the Keynes Plan of 1941. This should be the starting point of contemporary efforts to rebalance the world's money.

The present non-system

As we have suggested, global imbalances played a part in causing the severe credit crunch of 2008-9. But they are also dangerous per se. They can lead to disorderly reversals triggered by large capital movements; and they can also provoke trade restrictions. It is a fair bet that a continuation of the global imbalances of 2006 would have led to a dollar crisis or a protectionist frenzy if the credit bubble had not imploded first. The imbalances have now decreased but could open up again when the world economy recovers. They thus continue to be a serious potential problem.

Today's circumstances are different from Keynes' day. Capital mobility is now much greater. We do not have adjustably-pegged exchange rates. Indeed, there is now nothing that can be called an exchange rate "system". There is instead a wide diversity of exchange rate regimes. The reserve system is also different. It is centred on the dollar, not on gold. Today the dollar is the principal reserve currency, with the euro in second place but far behind. There also exists a fiduciary international central-bank money, the SDR, created in the late 1960s, but so far of minor quantitative importance. But despite the changed environment, Keynes' insights, encapsulated in his Clearing Union proposals, are still highly relevant to avoiding future imbalances.

A necessary requirement of smooth international adjustment is a well-functioning mechanism for changing real exchange rates. That does not currently exist. Many major countries are floating but some (notably China) are not. Non-floaters who run balance of payments surpluses are able to block real exchange rate changes by sterilising their reserves. International adjustment also ideally requires some international coordination of macroeconomic policies, at least sporadically. This requirement is conspicuous by its absence. (The cooperative demand stimulus in 2008/9 was an exception.) The absence of a satisfactory adjustment mechanism has resulted in the revival of the asymmetry strongly emphasised by Keynes. Adjustment pressures are concentrated on the deficit countries (unless the deficit country is a reserve-issuer like the US); the countries in surplus can get away without adjustment. A case in point is that of the emerging countries that have discovered the advantages of export-led growth. This strategy has yielded many benefits for these countries but it suffers from a fallacy of composition; the export surpluses must have counterpart deficits elsewhere. In other words, they can generate global imbalances.

The current reserve system is equally unsatisfactory. It is notable that greater capital mobility has increased, not reduced, the demand for owned reserves. Many countries have a rational fear of floating, as well as a rational fear of unstable capital flows; and reserves obtained by short-term borrowing can evaporate in a crisis. The sure-fire way of accumulating owned reserves is to run current account surpluses. East Asian countries were taught the value of owned reserves by the bitter experience of 1997 and the recent crisis has only confirmed this lesson. But substantial reserve accumulation, though rational for an individual country, is systemic nonsense if practised by many countries. Indeed it leads precisely to the global imbalances under discussion: reserve-hoarders run large surpluses

while America, the main reserve issuer, runs large deficits. The connection between reserve accumulation and global imbalances is not a logical necessity. It is possible in principle for current accounts to be balanced and reserves to be generated by purely capital-account transactions, say long-term foreign direct investment by the US matched by short-term deposits by the recipient countries in US Treasuries. But as a matter of fact, the recent growth of the reserve mountain did predominantly have US current account deficits as its counterpart. And the underlying behavioural connection has psychological and empirical plausibility: the “exorbitant privilege” conferred by the power to issue reserves weakens balance of payments discipline on the issuer country and sooner or later tempts it to overspend.

The argument that current account surpluses are deflationary for the world is only partially correct. Certainly they are deflationary in the first instance for the deficit countries. But the deficit countries are now very likely to be committed to full employment. So their probable and understandable reaction is expansion; large imbalances are the consequential by-product. This is certainly a plausible description of events in the middle of this decade: the “glut” of savings in parts of the world evoked a Keynesian expansionary response in the US, which widened global imbalances. Of course the day of reckoning has to come in the end and has the potential to be strongly deflationary for the world since the burden of adjustment would fall on the deficit countries.

Reforming the non-system

What can be done to prevent global imbalances? Complete overhaul of the system is not going to happen. But major improvements are possible that would ameliorate the imbalances problem and enable an evolutionary development of the world monetary system in a desirable long-term direction. Here Keynes’ Clearing Union proposals are very relevant.

We begin with the adjustment mechanism. This needs to be improved whatever reserve system is adopted. Ideally, as seen above, we need better macroeconomic coordination as well as a better exchange rate system. But these are subjects of great contention which are not going to be resolved easily or soon. A second-best but major step forward would be to adapt Keynes’ idea of penalties on *bancor* imbalances; the contemporary equivalent would be to tax persistent and excessive current account surpluses. The numerical specification of “excessive” and “persistent” would have to be agreed. So would the rate of tax to be paid to the IMF: it must obviously be big enough to affect behaviour. Taxing excessive reserve accumulation would be an inferior alternative because the connection between reserves and the current account is loose; moreover, reserves can be hidden in various ways.

We now turn to the reserve system. Keynes presciently wanted to abolish altogether the use of national currencies as international reserves and substitute “*bancor*” in their stead. Such a change would strike at the root of the self-insurance demand for dollars. And it would do so by enabling countries to

acquire fiduciary reserves which they own but do not have to earn since they would be supplied by an international central bank. This is a bridge too far to reach quickly. But it would be possible and desirable to take immediate steps to raise the SDR share of world reserves, within the context of a dollar-based reserve system. What is needed is an amendment of the IMF Articles to enable SDRs to be more flexibly created by substantial regular emissions, as well as by occasional issuance to meet world liquidity crises (to be followed by withdrawal when the crisis is over.) Moving decisively towards promoting the use of SDRs would reduce the need for countries to run current account surpluses to accumulate dollar reserves. Concomitantly, it would also help to reduce the “exorbitant privilege” of reserve-issuers and distribute the seignorage from reserve creation more equitably, promote a more symmetric adjustment mechanism, make the IMF a more genuine lender of last resort and reduce the risk of instability caused by switches between reserve currencies. Of course the appeal of the SDR would be materially enhanced if it were transformed into an asset that can be held by the private sector, not central banks alone. There are many ideas on the table for achieving that goal over the long haul. But promoting central-bank use of SDRs, as proposed above, need not wait on such schemes, and would bring about a marked improvement in the functioning of the world monetary system, even in their absence.

The reforms above should be accompanied by setting up a “substitution account”, lodged in the IMF, to enable countries to convert their reserve holdings into SDRs that are by their nature more stable in value than any single reserve currency. The main bone of contention would obviously be: who takes over the exchange risk that countries making use of the facility will want to shed? The advantages of this scheme would be two-fold. It would enable an increase in the volume of SDRs and a reduction in the quantity of foreign currency reserves. And it would open the road to a bargain with China. If the terms of the substitution account were such as to give China an incentive to convert its dollar reserves into SDRs, China may in return agree to penalties on excessive current account surpluses.

Just as the first Bretton Woods system rested on a “grand bargain” between the US and Britain, so a new Bretton Woods would require an agreement between the leading surplus and the leading deficit country. The challenge to the statesmanship of the US and China is to strike one.

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25 Rebalancing: A lesson from the 1940s

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Many commentators have compared the global imbalances with those that triggered a protectionist wave in the 1930s and prolonged the Great Depression. This chapter tells of the “positive approach” taken by Australia in arguing for an international commitment to maintain full employment as the prerequisite to the reduction of trade barriers and the elimination of tariff preferences.

During the 1930s, there was a widespread view that the US bore a large share of the blame for the disorder in the international economy. In the wake of World War I, the centre of economic power shifted from the UK to the US, and the US became the world's great creditor nation. Unprepared for this international responsibility, the US failed to act as a “responsible” creditor nation. The US insisted that its allies repay war loans, but at the same time, raised tariffs, which obstructed the ability of debtor nations to make these payments. The passage of the Hawley-Smoot tariff in 1930 raised duties to the highest levels in American history and triggered retaliatory action around the world. Efforts to stabilise international currencies at the Monetary and Economic Conference in 1933 came unstuck due to the Roosevelt administration's desire to stimulate its domestic economy by devaluing the dollar. Even the 1934 Reciprocal Trade Agreements Act, which was meant to drive trade liberalisation on a bilateral basis, was focused on opening markets for US exports, rather than on restoring two-way trade and reducing the US current account surplus. The resulting imbalance afflicted world production and trade and deepened the Great Depression.

The destruction of industrial and agricultural production in much of Europe and Asia during World War II exacerbated this structural imbalance. By the end of the war the US was the pre-eminent economic power, accounting for one-third of the world's total production and more than one-half of its manufactured goods. At the same time, it ran a massive surplus of trade in goods, services and foodstuffs, contributing to the “dollar shortage” which forced nations to tighten import restrictions in order to conserve scarce dollars and gold for essential purchases. It was in this context that the architects of the post-war reconstruction sought to establish a new liberal international economic order that would balance the twin objectives of full employment and liberal non-discriminatory trade.

One of the central questions in these debates pertained to the re-balancing of the international economy. Although there was wide agreement that much of the problem between the wars could be attributed to the US with its propensity

to over-export, under-import, and under-invest abroad, there was no consensus about how to address these problems, whether unilateral or coordinated international approaches were necessary, and who should bear the adjustment costs. The US Proposals for the Expansion of Trade and Employment were underpinned by the notion that non-discriminatory trade liberalisation would be the driver of economic growth and full employment, and that over time, this would restore equilibrium in the international economy. This implied equal responsibilities, obligations and commitments by all nations. By contrast, debtor countries advanced the argument that responsibility for correcting the balance of payments disequilibrium fell on the shoulders of the surplus countries alone, that is, on the US. Until this was achieved, debtor countries should be allowed to impose trade restrictions, on a discriminatory basis – that is, against the US -- in order to protect employment.

Australia emerged as the champion of this position, arguing that an international commitment to maintain full employment was the prerequisite to the reduction of trade barriers and the elimination of tariff preferences. This approach would impose particular responsibilities on the US, and other creditor countries, as they would need to minimise their credit balances through expanding their imports, invest abroad and lend to other debtor countries. The “positive approach” became the focus of Australia’s international economic diplomacy at every major international conference between 1943 and 1945, at the Bretton Woods conference in 1946, and at the meetings in London, Geneva, and Havana where the Charter for the International Trade Organization was developed between 1946 and 1948.

Australia’s full employment crusade gained considerable support from other commodity exporting countries in East Asia and Latin America, which were especially vulnerable to price fluctuations. Their argument was that when the US economy goes into recession, the prices for raw materials fall even more sharply than those of manufactured goods, and it was incumbent on the US to use Keynesian measures to maintain full employment. In the absence of US willingness to do so, a decline in demand for their exports would force primary producer countries to reduce imports, either through restrictions or currency devaluation, in order to protect foreign currency reserves.

These concerns were reflected in the Draft Charter for the International Trade Organization (ITO) which pledged members to maintain full employment and not to adopt measures that would create unemployment in other countries. At the London conference in 1946, Australia, with support from the UK, argued for much stronger commitments and, as a result, the employment provisions were beefed up through the inclusion of an undertaking that members would spend their trade surpluses on imports (rather than imposing deflation on members with severe or prolonged deficits). Australian negotiators also argued that quotas might have to be applied selectively against imports from specific countries – violation of the principle of non-discrimination which was at the heart of efforts to restore the multilateral trade system. The rationale for this discriminatory approach was the need to protect full employment in Australia against a persistent trade deficit with the US or the deflationary consequences of an American depression.

Australia's concern in this regard stemmed partly from its dissatisfaction with the rules of the International Monetary Fund which prevented members from using currency depreciation without agreement from the Fund, which was dominated by the US. Australia feared that once it joined the IMF, the only instrument left to prevent deflation passed on by other countries would be discriminatory import quotas.

The Australian proposal for discriminatory import restrictions to protect BOPs was vigorously opposed by the US (and India) which balked at the imputation that creditor countries were responsible for unemployment in other countries. In the end, compromise was reached through further drafting of the escape clauses in the draft Charter pertaining to balance of payments problems (which live on today in the General Agreement on Tariffs and Trade). Australia also secured an extension of the "nullification and impairment of benefits" provision that would allow a member to be released from its Charter obligations if it was found to be adversely affected by another member failing to live up to its undertakings on employment.

These provisions were further elaborated at the Havana conference to conclude the negotiations of the charter for the ITO. The final wording of the charter would effectively require the US to correct currency imbalances and allow countries like Australia to take defensive actions, including exchange controls and import restrictions, when confronted with balance of payments problems. The ITO would have a role in determining when this could occur and it would not be left solely to the IMF to decide when these measures were justified.

However, by the time of the Havana Conference, the US had lost interest in the ITO and it was never submitted to Congress for ratification. Re-balancing did occur but it was not through institutionalised cooperation as imagined by the architects of the post-war reconstruction, but rather through US unilateral action in the form of unreciprocated trade liberalisation and the Marshall Plan, which pumped millions of US dollars directly into the recovery of war-ravaged Europe.

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26 Persistent global imbalances

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This chapter argues that, in one way or another, the world will have to reach agreement on a mechanism to avoid these imbalances. Whether that happens because of lessons learned in the current crisis, or whether it takes another crisis before the policy community is motivated to action, is still a question.

Despite the global recession and the near-miss of a catastrophic financial meltdown, policy actions so far have not addressed a major underlying factor that made the situation so bad: global imbalances. While many phenomena intensified the crisis, at its root was the very low real interest rate that the global economy sustained in the 2003-2007 period. That low (and sometimes negative) real interest rate had several repercussions: it made borrowing to finance construction more attractive, increased the demand for housing (and for upgraded quality of housing) much more than would have happened at higher real interest rates, made borrowing costs low for governments, reduced incentives to save in countries with current account deficits, and led financial institutions to a search for yield far beyond what would have taken place at a higher interest rate. While there would have been housing booms, development of new financial products, and other factors which have been blamed for the crisis in any event, their magnitude, and hence the costs of the downturn, was greatly amplified because of low real interest rates.

Causes of global imbalances

Global imbalances came about because of the coincidence of overly lax policies on the part of some countries, but (because of its size) largely the US, and overly austere policies on the part of some other countries, particularly China (again, because of size), and also the oil exporting countries in 2005-7. Overly lax policies led to large current account deficits because expenditures exceeded income with resulting dissaving, while overly austere policies led to very low consumption rates and very high savings relative to income. By definition, the current account balance is the difference between domestic public and private saving and domestic public and private expenditure (including consumption and investment).

In normal circumstances, when a country continues to run large current account surpluses or deficits, there is quick feedback to policy makers that the policies are harmful. Flexible exchange rates can insure that import and export prices and quantities adjust somewhat, although without adjustment in the underlying savings/expenditure behaviour the offset will at best be very partial.

But even when exchange rates are fixed, there are normally strong pressures to adjust. In the case of surpluses, inflation rises as it becomes increasingly difficult to sterilise foreign exchange inflows. In the case of deficits, foreign borrowing increases and debt servicing payments rise. This is both because of larger debts and because of interest rate increases as debt rises relative to GDP and to other variables indicative of ability to pay. If monetary and fiscal policy remain lax enough to sustain continued imbalances, inflationary pressures also intensify in deficit countries, especially for goods (such as housing) that cannot be readily imported. In either case, pressures to alter policies to reduce the magnitude of the current account deficit or surplus mount, and policy makers usually respond.

But in the past decade, the two large blocs, one saving “too much”, and the other “saving too little”, offset each other. The combination of the high savings syndrome in China (and a few other countries) and high expenditures in the US meant that each country was an “enabler” of the other. The US became the “spender of last resort” while China was the “saver”.

Thus, the normal pressures that accompany large unsustainable balances, positive or negative, were greatly weakened. There was little or no pressure on prices in the US, and interest rates did not rise. Likewise, China was able to sterilise capital inflows and accumulate reserves with little effect on the domestic price level. The housing boom in the US and some other countries might have happened anyway; and new financial instruments would in any event have developed. But the boom would have been less pronounced then. Hence, signals that would have led the Federal Reserve to tighten monetary policy were not there, and the absence of price pressures in China did not signal the need for tightened policies there, nor did price increases lead to real appreciation of the Chinese yuan that would otherwise have happened. Without the global imbalances, the downturn, if and when it came, would surely have been much less severe.

Turning that proposition around, however, had the housing boom, the carry trade, and development of new financial instruments been dampened through other policy instruments while real interest rates remained low, global imbalances might have lasted longer, but the downturn would surely have come even if would not have been quite as severe.

Policy responses to date

Nothing has been done to address the factors underlying global imbalances. The US still runs an estimated structural deficit (i.e., the fiscal deficit that would result when economic activity was at normal levels) of about seven and a half percent of GDP, while China is clearly still saving a very high fraction – more than 50% – of income. Most economists believe that an appropriate fiscal policy is one that

is balanced over the cycle, and hence is approximately zero when there is full employment. In the Chinese case, an appreciated real exchange rate would help to increase domestic consumption, but so, too, would measures that reduced incentives for saving (by enterprises as well as individuals) in the economy.

Measures taken to reduce the attractiveness of risk-taking by financial institutions (through increased capital requirements for financial institutions, through improved incentives for their managers, and through appropriate regulation) may mean that it will take longer for global imbalances again to build up, or that they are somewhat less extreme and lead to a milder crisis, than was the case in the build-up to the last one. But as long as the underlying expenditure-savings patterns of the two sides remain relatively unaltered, it is only a matter of time before the unbalanced world economy tips into crisis again.

The G20 have recognised the problem, and asked that countries submit their macroeconomic programs to the IMF, with the stated intent of using “peer pressure” to resolve imbalances. But, as Keynes long ago recognised, and as the management of the IMF experienced in the 2005-6 period, peer pressure is a very weak reed.

IMF efforts at coordinating responses to imbalances

The IMF had been pinpointing global imbalances, and pointing to their unsustainability, since the middle of the decade. In 2005, the then Managing Director of the IMF, Rodrigo de Rato, called for consultations among the major global players, including China, Japan, Saudi Arabia (representing oil exporters), and the US. IMF staff met individually with the policy makers in each of the key countries, including especially China and the US, to focus on imbalances.

All participants agreed that there were imbalances, and that their continued existence posed a threat to the stability of the world economy. There was little disagreement as to the magnitude of the required adjustments between representatives of the countries and the IMF staff.

When it came to discussions of how global imbalances should be resolved, however, each deficit participant insisted on the need for the surplus countries to adjust, while each surplus participant viewed the problem as the responsibility of the deficit countries.

One can, of course, hope that future “consultations” and peer pressure, as proposed by the G20, will induce the needed adjustments. To date, however, there is no evidence of that happening. Even within the European Union, where there were potential (albeit not large and not exercised) penalties for violation of the Union’s fiscal rules, the rules were violated. And to date, the American Congress continues to focus on “penalties” for the Chinese in the event they do not adjust, while the Chinese continue to insist that America’s current account deficit is the Americans’ problem.

Need for coordinated adjustment

What is clearly needed is adjustment on both sides. Should one side, say the US, unilaterally attempt to reduce its fiscal deficit and provide incentives for greater private savings as well, the rest of the world would find itself under deflationary pressure unless offsetting measures to increase spending were taken elsewhere. The obviously place to take them would be China (and, to a lesser extent, a few other countries).

Similarly, should China reduce her savings rate significantly, the US and other countries incurring large current account deficits would face pressures of rising real interest rates and domestic inflation.

Coordinating the world's adjustment is therefore highly desirable, and the IMF is the logical place to do it. The problem, however, is that, beyond exhortation and the sorts of pressures tried by the IMF in 2005-6, there is little that the IMF, or the G20, or any other organisation can do without an enforceable international agreement as to how prospective imbalances might be measured, what adjustments would be needed over what period of time, and what sanctions might be applied in the event that the policy measures leading to these adjustments were not taken.

Issues to be addressed in devising an enforceable coordination procedure

But attaining that agreement is daunting. A first problem is that there is no agreed-upon metric for estimating what a "desirable" or "sustainable" current account balance is. Some countries with good policies may have excellent investment opportunities and be able to utilise large capital inflows for a period of years (South Korea had capital inflows of more than 10% of GDP for the better part of two decades and yet the rate of return on investment was sufficiently high that the debt-service ratio did not rise); other countries may be capital-abundant with low real rates of return to capital and benefit by investing abroad.

Even if agreement could be reached on estimates of desirable current account balances (presumably over the medium term), a next challenge would be to delineate the combination of policies that might bring about the adjustment, and to be able to allow for deviations based on cyclical factors, external shocks, and other unanticipated disturbances. The choice of which combination would be appropriate could be made by each country, although, of course, there would need to be agreement that the chosen combination would, barring unforeseen events, achieve the desired outcome.

Even if that were accomplished, there remains the difficult issue of sanctions for failure to comply. A number of possibilities come to mind, although the political feasibility is greatly in doubt. One possibility is that all countries might impose taxes on the new debt or on all new financial instruments issued by debtor countries in the event that deficit countries did not undertake the agreed upon measures. Similarly, countries might impose taxes on all imports from, and

subsidies on all exports to, a surplus country that did not apply the agreed upon measures. Such taxes and subsidies would have to be at a uniform rate, applied by all other countries, and the rate could be ratcheted upon or downward as compliance increased or diminished, and/or as time passed with inaction.

A second possibility might be financial penalties along the lines of those envisaged in the European Union for surplus and deficit countries. But such an approach would require a rule, or formula, the devising of which would pose a formidable challenge.

The outlook

In one way or another, the world will have to reach agreement on a mechanism to avoid extreme global imbalances. Whether that happens because of lessons learned in the current crisis, or whether it takes another crisis before the policy community is motivated to action is still a question.

Of course, while it is doubtful, there is a possibility that peer pressure will work – at least for a period of time. There is also a possibility that China, the US, and other countries will magically adjust as if coordinated, and that the coincidence of large “enablers” of both deficits and surpluses will not simultaneously arise again, at least in the next decade or so.

But in light of the serious consequences of imbalances, it is foolhardy to rely on the chance coincidence of domestic political needs inducing offsetting reductions and increases in expenditure. Equally, past experience with peer pressure does not give sufficient confidence that it can carry the day.

It may require another crisis, in order to convince all that the costs of accepting a global coordination mechanism would be substantially outweighed by the benefits of avoidance. But it is to be hoped that, despite the difficulties of establishing a global mechanism, enlightened leadership might rise to the challenge and develop coordination procedures in the aftermath of the current crisis. Given the costs of the past crisis, it is difficult to understand why such work has not yet begun, while memories are still fresh. Indeed, given the magnitude of the challenges in devising and agreeing upon an appropriate set of procedures and mechanisms, it will require many months of work to adopt an appropriate scheme, and even further time for its ratification by countries and its implementation.

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27 International financial safety nets and global imbalances

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One reason put forward to explain the global imbalances is that emerging countries have built up foreign currency reserves to guard against currency crises. This chapter evaluates the impact of international safety nets designed to substitute for this reserve hoarding. It argues they are unlikely to offer the same predictability and selectivity, and are therefore unlikely to have a significant impact.

Reforming international financial safety nets and liquidity arrangements is an important item on the agenda of the G20. In addition to mitigating economic disruption in crisis countries, one benefit that is expected from such reforms is that they will reduce global financial imbalances by making safety nets a better substitute to emerging market countries' international reserves. In other words, better international insurance will reduce the demand for, and accumulation of, precautionary reserves in emerging market countries. This benefit is hard to assess but – as I will argue in this chapter – there are reasons to think that it is small.

In order to make predictions about the impact of international safety nets on international reserves, we would like to know two things: the determinants of emerging market countries' demand for reserves, and the substitutability between countries' own reserves and international safety nets. In other words, by how much a given increase in the resources of the IMF or of regional liquidity arrangements might reduce the countries' own reserves. Unfortunately, we know relatively little about either thing.

Let us start with the demand for reserves. Clearly, not all reserves are accumulated for precautionary reasons. The accumulation of reserves may also be the by-product of high saving rates, or of foreign exchange interventions to keep the currency competitive. Improving international safety nets can reduce reserves accumulation only for the fraction of those reserves that are accumulated for precautionary reasons.

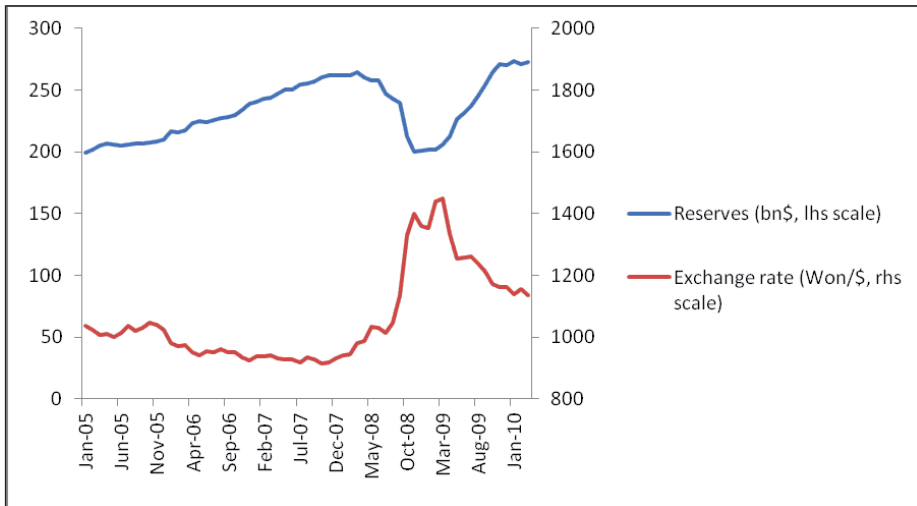
Unfortunately, the rather rich experience with balance-of-payments crises has not led to a consensus on what constitutes an adequate level of reserves. In principle, a roll-over crisis in a country's external debt does not require more reserves than the amount of short-term debt whose repayment is demanded by foreign creditors. By this logic, the adequate level of reserves should be measured

by reference to short-term external debt.¹ However, perhaps because the currency mismatches in domestic balances sheets cannot be promptly unwound at the pre-crisis exchange rate, the authorities often end up using the reserves to resist the depreciation of the domestic currency – even when they have a floating exchange rate. With free capital mobility, the amount of reserves required to defend the foreign currency price of domestic assets may be a large fraction of M2 and even a multiple of M2 if speculators can borrow in domestic currency from domestic banks (Jeanne and Wyplosz 2003).

The experience of South Korea in 2008 is interesting in this regard. South Korea is a good example of an emerging market country having accumulated a substantial level of reserves and having – perhaps as a result – fared relatively well in the crisis. Furthermore, the Republic of Korea chairs the G20 and has been a very active contributor to the debates on reforming international financial safety nets (Lim 2010).

As shown by Figure 1, South Korea entered the crisis with about \$270 billion of foreign exchange reserves (amounting to approximately 30% of its GDP, and a multiple of its short-term debt). The level of reserves started to decrease (and the Won to depreciate) early 2008, a trend that took a sharp turn to the worse after Lehman’s failure in September. Reserves then fell to about \$200 billion while the currency sharply depreciated and Korean banks started to encounter difficulties in rolling over their short-term foreign debt. It is only after Korea entered a \$30 billion swap arrangement with the US Fed in October 2008 that the exchange rate and reserves stabilised. The Korean central bank was then able to reconstitute its stock of reserves (returning to the pre-crisis level by the end of 2009). The real economy was relatively spared throughout, with an unemployment rate that never exceeded 4%.

Figure 1. South Korea: International reserves and exchange rate



1 This is the justification behind the “Greenspan-Guidotti rule” of full coverage of short-term external debt by reserves, which was proposed as a substitute to the old three-months-of-imports rule following the 1994-95 Mexican crisis.

Whereas the experience of South Korea can be used to argue in favour of maintaining a high level of international reserves, it also highlights our uncertainty as to the adequate level of reserves as well as certain deficiencies in existing international financial safety nets. First, even a country with a large stock of reserves had to rely on external liquidity provision to restore confidence in its economy. If reserves amounting to 30% of GDP were not sufficient, then what is? Second, the access to international liquidity was provided by the US Fed, rather than by the existing international crisis-lending arrangements such as the IMF or the *Chuang Mai* arrangement.

It is important to understand why Korea relied on the US Fed rather than on crisis lending from existing arrangements at the peak of the crisis. Obviously, the Fed swap lines came with less conditionality and “stigma” than IMF loans. It could also be that, having an unlimited capacity to create dollar liquidity, the Fed was in a better position than the IMF to restore confidence for the kind of crisis that Korea was facing in the fall of 2008. This point is worth emphasising because, if what is required is true lending-in-last-resort in a foreign currency, no other institution than the central bank issuing that currency can fulfil this role effectively. The international safety nets would then need to involve the central banks issuing the main world currencies.²

Coming back to the IMF, its conditionality has been streamlined and there have been efforts to create more effective precautionary facilities since 2000, following the critiques against its heavy-handed intervention in the 1997-98 Southeast Asian crisis. In this regard, the Flexible Credit Line (FCL), introduced in March 2009 (a few months after the Fed swap lines), marks an important shift from traditional *ex post* conditionality for crisis countries to *ex ante* conditionality – or prequalification – for countries with sound fundamentals (Jeanne et al. 2008).³

Given the way that it is structured, however, it is clear that one dollar of FCL is worth substantially less than one dollar of country’s own reserves. The FCL works as a renewable credit line, which at the country’s discretion can initially be for either a six-month period, or a twelve-month period with a review of eligibility after six months. Thus, access is guaranteed for a relatively short period, and future pre-qualification is neither guaranteed nor easily predictable. The criteria for pre-qualification are somewhat vague, and their future interpretation by the Fund is uncertain.

Although it might seem desirable to make access to the FCL more predictable, moving in this direction involves hard trade-offs (Aizenman et al 2010). Lengthening the period of pre-qualification creates a risk that countries will have access even after their policies have deteriorated. Another approach would be to use quantitative criteria *à la* Maastricht to pre-qualify countries. However, this would make it difficult to adapt the criteria to constantly evolving sources of financial vulnerability, and may lend itself to manipulation by the participating countries. Those trade-offs are bound to arise in any liquidity arrangement that

2 For example, Truman (2008) proposed a multilateralisation of the Fed swaps through the IMF. However, participating in such an arrangement may be inconsistent with central banks’ mandates.

3 Three countries, Mexico, Poland and Colombia, have qualified for the FCL, for a total amount of \$79 billion of IMF resources. Those countries have not drawn on the FCL so far.

seeks to make access both predictable and selective, whether the resources come from the IMF or from the Fed.

The FCL or FCL-like arrangements can certainly be improved, but the trade-off between selectivity and predictability will remain a hard one. There will always be tight constraints on the predictability and automaticity of access to international liquidity. Thus, improvements to the FCL are unlikely to make IMF resources a very close substitute to countries' own reserves. Similarly, the US Fed is very unlikely to agree to a mechanism in which it would commit itself to unconditionally provide swap lines to emerging market economies, even a select group of them.

In conclusion, the impact of reforming international safety nets on global financial imbalances is uncertain because we know too little about the determinants of emerging market countries' demand for precautionary reserves. This being said, those safety nets are unlikely to provide a good substitute to reserves because of hard trade-offs between predictability and selectivity in the access to international liquidity. On this basis, one may be forgiven for being sceptical that the FCL or other international liquidity arrangements will have a significant impact on the accumulation of reserves by emerging market countries, and global financial imbalances.

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

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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 question 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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Such was the concern about the adverse consequences for the world economy of "imbalances" that G-20 Leaders, meeting in Pittsburgh in September 2009, adopted a Framework for Strong, Sustainable, and Balanced Growth. This step followed a growing body of expert opinion that took the view that large, persistent current account imbalances in the major industrialised economies and emerging markets since 2000 had, at the very least, contributed to the global financial crisis witnessed in 2007-8 and to the subsequent Great Recession. The purpose of this electronic book is to provide policymakers and their advisers with up-to-date, comprehensive analyses of the central facets of global economic imbalances and to identify and evaluate potential national and systemic responses to this challenge.

To break down the many facets of this collective economic challenge, leading experts were asked to address one of the following policy-relevant questions.

1. How large are contemporary current account imbalances? Why do they persist?
2. What are the systemic costs of imbalances?
3. What are the lessons from previous attempts to rebalance the global economy?
4. What would rebalancing entail? Which policies must change? Is collective action needed?
5. What is the political viability of proposals to rebalance national economies?
6. Are new system-wide accords needed to promote rebalancing or to discourage persistent imbalances?

This volume will be of interest to policymakers, their advisers, senior officials, as well as to anyone interested in the matter of limiting global economic imbalances.

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