



**Global Economic Imbalances:  
Challenges for the International Financial System in Times of Crisis**

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## Introduction

Two months after the failure of Lehman Brothers in New York, financial activity in the U.S., Europe, and Japan basically had come to a halt, and the ongoing spill-over into the world's "real" economy raised even more questions about causes and consequences. Amidst much panic and hasty policy making, the focus of an international conference organized by the Friedrich-Ebert-Stiftung and the School of Economics of Renmin University of China however, was not the search for fast fixes, but sound analysis of the possible link between a more long-term global imbalance of over-consumption and deficits in the U.S. and some European countries, and the over-production and surpluses in Asia and Germany.

Although warning signs had been on the wall for long and had resulted in serious international discussions at the G8 summit in Heiligendamm/Germany already in summer 2007, neither international financial institutions nor the G-8 community had so far come up with effective strategies to rebalance the global patterns of financial and economic activity or the provisional contingency plans for the dealing with a global financial crisis. As follow up to a high level symposium the FES organized parallel to the official G-8 summit in Heiligendamm, the Beijing symposium therefore brought together financial and economic experts to focus on the long-term consequences and lessons of the crisis.

Three main topics were squarely put at the center of the discussion: the link between long-term global imbalances and the financial crisis, the position and consequences for the emerging new economic and political world powers in Asia, and the resulting necessary policy reforms on a national as well as international level.

### **Mapping causes and consequences of global economic imbalances – Perspectives from Asia and the G8**

despite the culmination of events during the unfolding of the financial crisis from September, it was the target of the conference to focus on long-term solutions and not just short-term fixes for financial difficulties or a breakdown in

private demand. Financial crises do not come out of the blue and their roots go much deeper than regulatory issues in one of the world's financial markets, even if that market happens to be the world's biggest market. The achieved level of financial development and global integration, on the other hand, requires appropriate and coordinated solutions at the national as well as the international level of surveillance and policymaking.

Chinese participants immediately pushed the point from an Asian perspective by stressing that East Asia has not only become the world's growth centre but also the world's largest regional economy. This basically has two consequences: 1) Any financial or trade imbalance with East Asia certainly matters to the world. 2) Singling out China in any trade or exchange rate dispute focusing on its high export surpluses misses the point. Its East Asian neighbors (especially Japan, Taiwan, and Korea) participate in a triangular trade and investment pattern that concentrates a high share of production in mainland China. Any solution therefore requires the cooperation of East Asian partners, who often are politically at loggerheads, before broader international cooperation could be possible.

In the discussions it has been stressed that the U.S. trade deficit is not limited to China but involves East Asia in general. As is evident in Chinese custom statistics, a triangular trade pattern on basis of production networks that include high skill technology and capital from Japan and Taiwan, processing plants in China, and customer relations in the U.S. In the discussion, Chinese participants added that these statistics currently paint a scary outlook for Chinese production and world trade in general because imports to China have already fallen sharply. Exports will most likely follow soon, which destroys any hope of China being able to pull the world out of recession.

Furthermore, Asia's structural problems run deeper than the unbalances build up of production networks. Given the high level of intra-Asian trade, China and her neighbors are certainly not interested in cutting back on trade. On the contrary, they will further promote international trade, which will wash up low-priced products at U.S. and European shores as well. The same is true for the high

level of savings in China. On the back of high growth and strong concentration in international production centers, workers and households save a high share of their income to build up a stock of wealth, transfer income to their relatives in the country side, and prepare for post-industrial life with much fewer kids. Even China's high level of currency reserves are much less a consequence of mercantilist policy than a result of global imbalances that play out on Chinese territory. Given the dynamics of international production in China, for example, speculative currency inflows beyond FDI need to be sterilized, which increases currency reserves that become invested in U.S. treasuries and further push U.S. interest rates lower, potentially leading to another cycle of cheap capital flowing into China. All this won't change if China pushes ahead with a unilateral revaluation of the Renminbi or forces limits on exports for its own industry.

From an Asian and particularly Chinese perspective, a solution for global imbalances therefore takes time. Of course, a major reduction of U.S. demand might lead to a breakdown of existing imbalances from the demand side. But this would put additional pressure on prices rather than lowering China's global export share. A solution of China's structural production problem therefore requires the gradual improvement of the quality of production along the value chain. To achieve this, higher-value investment of Asian partners in China are at least as important as efforts by the Chinese government to increase domestic demand.

Discussants made the point that, while current account surpluses in East Asia have contributed to global imbalances, their virtues for developing countries are obvious as well. Current account deficits often run the risk of allocating incoming resources in the wrong sectors. This can be seen even in the case of the highly developed U.S. with its asset bubbles. It is therefore very difficult for the government to counter such macro imbalances as long as they provide positive incentives for the national economy. Especially the development of financial institutions, which is an important precondition for any privately driven growth, can become as much a driver of growth as a source of financial imbalances (which is why

governments usually keep a tight regulatory lid on risks in banking). Appropriate regulatory steps therefore need to be taken while the good times continue.

The key is effective corporate governance that contributes to transparency. While banks are active globally, most countries still refuse to give up on their purely national control of banking regulation. Additional oversight of the IMF, for example, is blocked by the U.S.; possible countercyclical measures of a Basle II agreement have been on a backburner internationally in favor of growth and self-insurance of global banks; developing countries meanwhile have acted as free riders of explosive capital flows on most accounts.

Chinese participants added that the combination of leveraged finance and global trade indeed became a very powerful and seductive source of growth. It should also not be forgotten that the division of labor that has been built up over the years remains one of the most important achievements of the world economy. A positive heritage of growth in Asia therefore remains, even though the boom has been partially built on an unsustainable demand and credit expansion in the U.S. Consequently, support, not just blame, should be added where necessary, including the U.S., which currently needs international support in solving the immediate crisis.

For appropriate policy steps, the close relationship of finance and trade makes it impossible to focus on just monetary or fiscal measures. Both must be integrated into major, global rescue packages. At the same time, however, diversified oversight of the world's financial and trade system must be established. Otherwise the next bubble is sure to evolve from the roots of expansionary government action. While global imbalances do not have one explanation or source, simple national links between savings and investment surely are broken, which causes a huge problem to policy makers. In today's world, savings and investment decisions in one part of the world affect savings and investment balances in another. Solutions for a future finance and investment framework therefore need to be built on a global scale, with a special focus on the interconnections and mechanics of finance, capital flows, and investment. This conclusion

was forcefully illustrated by the Korean experience. Korea is carrying the heaviest load of the global correction because it has been one of the foremost investors in China and builder of regional production networks. At the time of the conference, the Korean Won was hit by a 60% depreciation and corporations were engulfed in a life-threatening crisis, even in their home market.

Not just regulatory restraints but also appropriate investment strategies can become an important part of the solution of global imbalances, as Chinese participants stressed. Today, China's investment abroad is only 1.4% of the global share. FDI is growing fast, however. Soon, China's FDI will be balanced with U.S. investment in China, and growth won't stop at that point. Instead of building currency reserves, China's government and, increasingly, its major corporations will invest earned dollars in neighboring Asian countries, and the U.S. and Europe. While this won't solve global imbalances immediately, the increasing "real" investment in the U.S. (beyond dollar recycling in treasuries) will increase production facilities and potentially U.S. exports as a counterweight to Asia's outflows. Furthermore, development support in countries that China sees as potential raw material and agricultural product sources, such as many countries in Africa, will contribute to a reduction in the "other" global imbalance - between developed and underdeveloped countries.

Indeed, since an important part of the global production-consumption imbalance is due to extraordinarily high savings rates in Asia, and since Asian households won't be convinced to stop saving and start consuming anytime soon, an increase in domestic and overseas investment should play an important part in global rebalancing. This rises the important question of appropriate management of China's enormous currency reserves. Invested properly, beyond just U.S. treasuries, they can become an effective tool for income stabilization and risk reduction. The development of effective bond markets and more flexible exchange rates could become as much an important tool for such policy as they would become a result of more diversified corporate investment activity.

### **Is there common understanding of risk bearing and risk sharing between rising Asian Powers and G8 countries?**

Discussions on this issue have been opened with the comment that a policy-induced adjustment of global imbalances should have exceptionally high priority for two reasons. 1) Building up imbalances in trade and finance is potentially inefficient and risky. 2) Market-induced correction of imbalances proves to be brutal and disorderly. After analyzing causes and consequences, the focus therefore needs to be on a possible collective policy response.

In this regard, some discussants brought in a skeptical tone by stressing that governments so far have rather contributed to global (and well-known) imbalances more than bother with their solutions. Deficit countries have provided and accepted ever more credit growth to maintain growth in spending. Surplus countries have backed their export industries by implicit guarantees for low and stable currencies, and have continued to invest in export infrastructures. So far, as oddly as it might sound, the WTO is the only existing and effective instrument to balance trade (and potentially investment as well) on a global level in the long-run. Despite setbacks during the last years, the WTO should therefore be backed and upgraded. Backing is especially necessary because current short-term measures to deal with the crisis might easily result in increasing protectionism. Upgrading is necessary because the WTO needs teeth to discipline national government policies beyond (relatively simple) trade liberalization.

While continued growth in China and India is a key-element in avoiding a global crash, effective policymaking with a focus on long-term stabilization is at least as necessary. The fiscal deficit in India, for example, was already high before the crisis hit, which leaves only limited leverage for the support of global demand. Korea, at the same time, is still borrowing short in foreign currency markets, which had been a major problem already (during the 90's Asian crisis) and puts further strain on country risks and global liquidity. For China, the vulnerability and orderly reorganization of production is of utmost importance and would surely dominate any

initiatives for global coordination. Even if agreement for a global surveillance institution could therefore be achieved, the main question remains: How to get teeth into such an institution to effectively discipline national governments?

Adding to the problem, Chinese discussants stressed that while there are clearly common roots of the current crisis and a cause for an international surveillance institution beyond the IMF, it should not be forgotten that this financial crisis is also just one crisis in a long line of crises, especially in Asia. There are still differences in the development of financial markets and the specifics need to be taken into account. In Asia, for example, much of the deregulation that spilled over from the U.S. was already overwhelming bank managers before the crisis hit. This resulted in potentially fruitful international partnerships on the one hand, but on the other hand also led the governments to provide additional stability by fixing or pegging exchange rates. By doing so, they clearly provided to global imbalances, and potentially to the current crisis. Other discussants reinforced this view by adding that pegged exchange rates indeed seem to contribute to corporate growth in developing countries but that they can become an instrument that adds to long-term imbalances and vulnerability in a deregulated environment as well. Reserve accumulation, for example, easily turns from risk precaution and price stabilization to supporting over-production, discouraging risk management at the corporate level and the provision of a platform for carry traders who drive exchange rates beyond equilibrium levels.

One important problem therefore is that a half-open, half-fixed system of exchange rates and capital flows might be worse than a deregulated or controlled one. An international surveillance institution would have to deal with this problem, which had already hampered policy advice by the IMF during the Asian crisis. Tellingly, commentators at the conference did not agree on this point as well. Some preferred a fully fixed system a la Bretton Woods; others were looking for regional cooperative solution or advocating for more flexible markets with governance upgrades and appropriate risk management at the corporate level.

## **Policy Implications and Institutional Reforms**

The review of possible policy reforms has been started with a sobering view of what seems to be possible in Asia without major upgrades of policy plans. Without doubt, a fall in U.S. demand and a correction of current account imbalances will have a strong impact on ASEAN countries. As a reaction to the immediate impact of the crisis, macro policies, especially fiscal policies, will swiftly be implemented. But as long as these policies are not coordinated, they will have only a limited impact.

Still, political reality points to the opposite direction. For the sake of production and employment, countries will try to avoid or postpone strong corrections of current account imbalances, not least by exchange rate policy, which might lead to a race to the bottom if the U.S. dollar starts to depreciate. This leads to two important consequences: 1) More exchange rate flexibility in Asia is necessary (while for the time being support for the U.S. dollar cannot be given up). 2) Long-term policies, such as the upgrading and deepening of capital markets to allow corporations and households to reduce their exceptionally high saving rates, need to be implemented without delay.

As in the U.S. and some other Asian and European countries, China saw the development of its own asset bubble as a consequence of global imbalances. This bubble has already burst in 2007 and now adds to the strain on the economy. China has, however, already shown that it is able to reform during the Asian crisis of 1997. In fact, some of the policies that are a problem today, such as the focus on a fixed exchange rate are a consequence of these reforms. Today, another currency reform is needed; the SME sector needs more support and flexibility (which may lead to even more exports at first, however); housing reform is necessary; and most importantly, further strengthening of the social security network is required as part of the national rescue package. Concrete steps would include a deepening of the banking and capital market, with an effective financial service agency and central bank for surveillance and as lender of last resort. The issuance of local

government bonds (which would be more efficient than hidden transfers and invisible debt) should become an important tool during times of rising government debt, and the privatization of infrastructure should limit government involvement. The important point here is to not shift a global imbalance of production and consumption to a national imbalance of government and private consumption and production at a time when governments reach deep into the market to rescue the economy from the global credit and demand crunch. Discussants pointed at the risk that Asian governments might easily turn from having an insatiable appetite for production and saving to an insatiable appetite for credit and market intervention.

Much emphasis was given to the enormous challenges for Asian governments. A crisis of consumption in the U.S. seems almost unavoidable, which will lead to major and unavoidable corrections in the surplus countries as well. Fortunately, however, there has already been a decoupling of Asian trend-growth from the U.S., while the business cycle remains closely linked. This means that coordinated fiscal policies have the potential to rescue the countries from the severe business cycle recession in the U.S. while long-term policies need to become the tool for rescuing and reinforcing independent trend growth. International institution building policies must be added, however. This is because protectionist policies that result from current inward-looking crisis fixing must be avoided. Intervention policy needs to be coordinated, and future frameworks for capital flows and credit creation need transparency and surveillance. For that matter, China and India should support the WTO as an instrument of continued free trade, and the IMF needs to become a policy instrument and forum of Asian countries, which requires the European shares to come down and the U.S. veto-right to be eliminated.

In Asia, an Asian Financial Stability Forum, which should seriously review Asia's continued vulnerability to currency swings and financial crises should be created. The latter seems especially important because another round of enormous capital inflows is possible after the immediate crisis subsides. Countries should be able to deal with the risks of the resulting

appreciations in a coordinated way. Such regional policy advice is seen as particularly important because regional governments sit in boat during the crisis and there is a serious risk of a lasting recession (of about 3-5 years) on the back of a loss in trust in financial markets.

Basically everybody at the conference agreed that adjustment will be brutal for the surplus countries as demand from deficit countries vanishes almost overnight. But while the global imbalance of too much consumption in the U.S. and too much saving in Asia is about to correct itself in the short-run, countries still need to base future growth policies on a more sustainable basis. In the final discussion, two extreme positions of possible long-term cooperative policies were presented again. In one corner, Participants from Europe stressed the need for a new exchange rate system (Bretton Woods II), which needs to be fixed at fundamental levels, possibly with a dynamic adjustment process along fundamental equilibria such as interest rate parities. In the other corner, Chinese participants emphasized also the importance of global cooperation, but with a degree of freedom and flexible exchange rates that allow for fast catch-up growth in the East, even if this leads to some imbalances in global current accounts and elevated risk-levels.

It is probably not without some irony that the European participants tended to support a policy-driven approach with strong international institutions for global financial regulation, while the Asian participants stressed the importance of dynamic markets, further liberalization, and flexible exchange rates. Broad agreement was achieved on a number of important issues, however. Global imbalances have worsened over time with support or benign neglect from all directions, so nobody remains without blame and everybody is paying a price now. In the short run, the U.S. is cutting back on consumption and effectively nationalizing its financial system. Asia, with China at the front, is cutting and redirecting production while seeing losses in the U.S. (dollar) assets balloon. To buffer this extremely painful process, monetary and fiscal policies certainly need to be expansionary worldwide. But this is only medicine, and not the cure.

In the long run, it is necessary to strategically redirect growth policies from focusing only on given strengths towards solutions for the weaknesses of growth models in each region. This means that surplus countries (such as China, Japan, and Germany) need to focus on structural reform of domestic demand, while deficit countries (such as the U.S. and the UK) need to focus on sustainable sources of growth beyond finance innovation and credit creation. International cooperation is necessary as broadly as possible, but realistic steps should be a centerpiece of reform. Such steps should

include exchange rate cooperation and regional initiatives for sound financial market development and growth, such as regional bond markets, in Asia. They should also include support for existing international institutions such as the WTO and the IMF to improve international surveillance and transparency at a time when global crisis and restructuring puts the world at risk for heading in the wrong direction (again).

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