

# POLICY BRIEF

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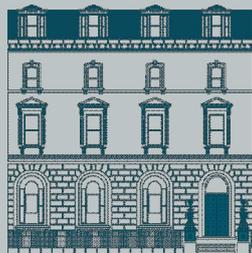
## EXTERNAL IMBALANCES AND THE G20

### WHAT IS THE PROBLEM?

*The Global Financial Crisis has not eliminated concerns about external imbalances, but the nature of the problem has changed. To date, the approach has been at the bilateral level, juxtaposing the unsustainable US deficit against China's huge external surplus. This bilateral approach, focused as it is on the undervalued renminbi, is too narrow and inevitably causes unproductive tension between the two countries.*

### WHAT SHOULD BE DONE?

*The debate should be broadened so that it covers a wider set of interconnected issues and takes place in a more multilateral setting. This will reduce the 'blame game' and may open the opportunity for mutually beneficial 'give and take' policy packages. Sorting out the analytics and defining the nature of the trade-offs might best be done in the less confrontational atmosphere of G20 meetings. Both the US and China will undergo adjustments to their external balances, domestic policies and exchange rates, and both have a strong interest in avoiding the exchange rate overshooting so often seen during these transitions. There is an opportunity for useful policy coordination which would, at the same time, recognise China's enhanced world status.*



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International external imbalances have been blamed for playing a central role in the Global Financial Crisis.<sup>1</sup> China's large external surplus usually figures prominently in these explanations. While a more balanced account of the causes of the crisis would give only a modest role to external imbalances<sup>2</sup> there seems little doubt that some adjustment of these imbalances over the next few years is both inevitable and desirable, not because external imbalances in themselves are inherently undesirable, but because some of the specific components of today's current balances are unsustainable. Markets could bring about these necessary adjustments over time. History, however, tells us that market-driven adjustments are often accompanied by exchange-rate overshooting and trade-threatening protectionist responses.

It is in the nature of external imbalances that if one country reduces its imbalance, other countries must change too. This necessary adjustment could usefully be the subject of international policy coordination that might explore a wider range of policy responses than seems to be on the agenda at present. The G20 meetings provide a suitable forum. This will still leave plenty of contentious conflicting-interests arguments to be resolved at the bilateral level, but the volume of unproductive head-butting might be reduced.

**The arguments**

*(a) Are imbalances bad?*

The first argument that needs to be dismissed is that the imbalances are somehow intrinsically bad. On the contrary, external imbalances and the international capital flows they imply

should be, in principle, as beneficial as international trade flows. Just as individuals benefit from the ability to spend more than they earn at certain stages in their lives while others benefit from being able to save, countries will in principle benefit from being able to run external deficits or surpluses which enable them to smooth business cycles and make use of investment opportunities beyond their capacity to self-finance. Other countries will do the opposite – build up foreign assets for saving and portfolio diversification purposes. Investors should not be confined to the domestic economy in seeking the opportunities with the highest returns. Just as international trade facilitates beneficial exchange *now*, international capital flows facilitate beneficial exchange *over time*. So we should start from the presumption that external imbalances are a Good Thing.<sup>3</sup>

*(b) When can imbalances be too large?*

Just as international trade raises welfare but presents some additional vulnerabilities compared with autarchy, capital flows can make countries more vulnerable to sudden forced adjustments. For that matter, capital flows give countries more opportunities to take risks (more rope to hang themselves), and make them dependent on the opinions and assessments of international markets, which may be fickle, ill-informed or subject to self-interested policy decisions by other countries.<sup>4</sup> Capital flows have two general vulnerabilities. First, that the funding partner may abruptly alter the terms on which it supplies capital (price or quantity). Second, the recipient country's situation is unsustainable. In either case, adjustment is required. Adjustments in economic textbooks are smooth, quick and painless: in the real world they can be

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traumatic and prolonged. They can also be lopsided: the borrowing party is inevitably the vulnerable one and almost always finds the adjustment much more painful than the creditor.

It would be wrong to think of overall external imbalances as necessarily temporary transitional phases, to be wound back to near-zero at some other phase of the cycle or at some later stage of development. Some will be, but others are part of long-term apparently sustainable strategies. Singapore illustrates the point on the surplus side, where the sustained current account surplus (20 per cent of GDP) has been used to build up substantial diversified foreign investment holdings which make sense for a small economy dependent on world trade for its high living standards. Australia illustrates the sustainability of long-term current account deficits.

There is another element in assessing whether an external deficit is sustainable: how the deficit is used. It is only in the last ten years that the US deficit has been driven by low household savings (i.e. used for household current consumption). It can be argued that the deficit should not be seen as unsustainable if it is used for productive investment (which would provide the wherewithal for servicing the foreign debt).<sup>5</sup> Thus a possible transition to a sustainable external position might involve expansion of investment (private and public) as the US budget deficit is wound back,<sup>6</sup> with no pressing need to get the overall external deficit much lower than it is at present.

*(c) Is there a problem at present? If so, how big, and how urgent is the adjustment?*

Figure 1 (see Annexure) shows current external imbalances. Prior to the Global Financial Crisis, the problem (and the solution) seemed simple to most observers: the US was running an unsustainably large deficit because its households were saving essentially nothing, with their profligacy encouraged by the 'wealth effect' of higher asset prices, especially house prices. China, on the other hand, was recording large and increasing surpluses due to constrained consumption and its export-oriented growth strategy.

In the current discussion there is still a strong belief that the core issue is reducing consumption in the US and increasing it in China. Indeed, both President Obama and Treasury Secretary Geithner put the issue in those terms at the US/China Strategic Economic Dialogue as recently as July 2009.

In fact, the nature and composition of the imbalances has shifted markedly as the GFC developed. The US external deficit has already fallen from over 6 per cent of GDP to less than 3 per cent and will fall further without additional policy measures (the IMF forecast 2.8 per cent for 2009). This does not, however, mean that external imbalances are no longer an issue. It is not so much the *overall* US deficit which is patently unsustainable, but its *components*, and these may give the best indication of the extent and speed of necessary adjustment.

Whereas the near-zero household savings performance in the years leading up to the GFC could until recently be seen as the measure of US unsustainability, the household sector has

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already gone a fair way to correcting its position, with households now saving close to 7 per cent of their income.<sup>7</sup> It looks as if the dramatic fall in household savings was a wealth effect associated with asset price booms – first, the Tech Boom and then the housing boom. With both of these clearly over and no repetition in sight, the prospects of sustained higher household savings seem good. With asset prices weak and balance sheets damaged, household saving may go higher still in coming years.

The overall saving/investment deficit is now being driven by the need for a substantial budget deficit (currently running at around 12 per cent of GDP) to maintain macro-economic balance. This will have to be wound back in due course (it is generally accepted to be unsustainable and the Congressional Budget Office sees it as averaging around 5 per cent of GDP over the next decade), but the immediate need is for continuing budget stimulus, so the wind-back is not (and should not be) imminent. This, rather than household savings, may be the central internal (domestic) issue in the USA.

The relevant issue from an international perspective is that there is no pressing need to wind back the overall external imbalance quickly (and a forced speedy adjustment would be unhelpful, both for the USA and the world). There is, however, a need for an exit strategy from the big budget deficit. The size and difficulty of the necessary adjustments are such that a start should be made now on plotting the path of adjustment, including the international ramifications of this adjustment.

What of the prospects for a counterpart change in Chinese ‘excess’ saving? China’s

demographics<sup>8</sup> and its transition from a command economy (where families find themselves no longer protected by the ‘iron rice bowl’, with no substitute pension policies in place)<sup>9</sup> would suggest that change will be slow.

*(d) Is the ‘export-led growth’ model dead?*

Just about all the discussion of imbalances assumes that countries which currently run big surpluses (China, Japan, and Germany) will have to radically change their economies to become less dependent on exports. There is a strong implication that these countries have exploited the international trade system at the expense of other countries.<sup>10</sup>

Why should this be so? Why is it assumed that we already have an optimal amount of world trade, and that if balance has to be achieved, it should be done by limiting export growth? If external deficits and surpluses *are* too big, why not fix the problem with more imports?

There is little doubt that export-orientated growth has served the cause of economic development well.<sup>11</sup> Post-WWII Japan provides the clearest example, with a very competitive fixed exchange rate (Y360/\$US until 1971) offering great incentive to export. Since that experience, there has been a succession of countries (basically almost the whole of East Asia) which have transformed their economies this way. The benefits are intuitively obvious (and desirable): successful export requires products which ‘meet the market’ with their mix of quality and price, and the international market is the most testing of all. Pressure for productivity increases is intense. This export-oriented production was often the channel by which technology and foreign capital came to developing and emerging markets. Moreover,

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the world as a whole benefited from the growth of these export-oriented countries, which fostered mutually beneficial globalisation and kept inflation low.

So why shouldn't China continue to pursue its export-oriented growth strategy, but trim its surplus through more imports? This argument is all the stronger as the last decade has seen the construction of an enormously complex and efficient multi-national supply chain behind China's exports, whose dismantling would be disruptive. To do so would imply that the benefits of international specialisation had reached their limits, which seems unlikely, to say the least.

*(e) What about capital flowing uphill from the emerging countries to the mature?*

Whatever arguments can be made in defence of continuing capital flows and imbalances, one characteristic of the current position does seem seriously anomalous: capital is flowing from the emerging countries (which should have many good opportunities for high-return investments) to the old mature economies, where the investment climate is lethargic and demand seems deficient.<sup>12</sup> In practice the issue is more complicated. China is, indeed, investing hugely at home, and the surplus is largely generated by the savings of state enterprises which have limited obligations to distribute profits.<sup>13</sup> The most plausible explanation is that the domestic financial infrastructure and corporate profit-sharing arrangements are such as to produce more surplus than can be absorbed by domestic investment. Similar institutional deficiencies greatly inhibit international outflows from China, so that rather than flowing to other emerging countries, the surplus has been channeled,

almost by bureaucratic accident, to FX reserves largely held in USD.<sup>14</sup> There are almost certainly inefficiencies in the Chinese governance and financial intermediation system which explain this outcome. The answer here would seem to be more vigorous and sustained financial sector institution building, domestically and internationally, rather than policy action to constrain the external imbalances *per se*.

One element of correction may already be in train: the US may be less of a magnet for foreign direct investment now that the GFC has shown how poor its financial sector is in identifying profitable investments and channeling funds to high-return projects.

*(f) Is it feasible and desirable to redistribute the external imbalances so as to make them more sustainable?*

One problem with the current discussion is that it takes place in a narrowly-focused bilateral world: the US has an unsustainable deficit so China must reduce its surplus<sup>15</sup>. But there are, even among the limited group of China's East Asian neighbours, countries which may well benefit from shifting their current near-balanced external positions, towards great deficits.<sup>16 17</sup>

Part of the 'capital flowing uphill' story is that some emerging countries are not making full use of the resources and technology that could come to them if they ran larger (but still moderate) external deficits. Why don't they do so? Part of the answer is the heavy legacy of the 1997-8 Asian Crisis. Capital reversals were at the heart of this crisis, and the safety net (IMF emergency lending) is generally perceived to have worked poorly. The GFC will have

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reinforced their perceptions that the safest policy is to run a near-balanced external position<sup>18</sup>.

We noted above that running surpluses and deficits does entail some risks (for both debtor and creditor) compared with autonomy. These risks are greater in immature markets, where institutions and commercial law are not well developed. As financial markets in other emerging countries get greater maturity and develop a reputation for stability, there is very likely to be an opportunity for countries such as China to diversify their counterpart deficit partners. This is not going to dramatically change China's surplus: if the 'ASEAN 5' shifted from their current small external surpluses so that they ran a deficit equal to 3 per cent of GDP, the rise in their net imports would only be \$US50-60 billion. But it is a contribution to the readjustment.

To the extent that the positive external position of these countries reflects concerns that there is no effective lender-of-last-resort for international capital flows, the response might be that the IMF has lifted its game since 1998, and since the London G20 meeting seems to have both extra funding sources and new facilities which seem more flexible than the old. Regional arrangements to share foreign exchange reserves (e.g. the Chiang Mai Initiative) could help, but they need to be given more substance and operational facilities.

*(g) Does the US/China bilateral trade imbalance have to be corrected?*

It is commonly held (particularly in the US Congress) that China's large bilateral trade surplus with the USA has to be reduced as a matter of 'fairness'. Economists are unanimous

in rejecting this as a legitimate argument: individual bilateral balances are an accident of resource endowment and the only thing that matters is the *overall* balance, aggregating a country's total trade with all countries. The US overall deficit may be an issue, but the bilateral balance with China should not be. Certainly, workers (and bosses) in the industries where Chinese goods have displaced American manufacture might argue that they have been disadvantaged, but workers in export industries to countries where the US has a surplus (like Australia) have benefited.

*(h) Is the renminbi undervalued?*

The increasing current account surplus (until recently more than 10 per cent of GDP), strong rise in the share of exports in GDP and rapid rise in reserves, now over \$US 2 trillion (40 per cent of GDP) are presumptive evidence that China's exchange rate is substantially undervalued. It is only the authority's purchase of foreign currency that stops the exchange rate from appreciating. Goldstein and Lardy<sup>19</sup> estimate the undervaluation to amount to 15-25 per cent. US pressure is focused on the exchange rate, including threats to declare the currency to be 'manipulated', which would invoke US Congressional trade sanctions.

The exchange rate does seem to be undervalued<sup>20</sup>, but the usual policy conclusion – that China should be encouraged to appreciate substantially, perhaps via a free float – requires more discussion. Four broad arguments are relevant. First, that whatever adjustment is necessary should keep in mind real-sector transition costs, allowing time for production redeployment. Second, that if China moves to a float, there is a very real danger that the exchange rate will overshoot substantially.

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While the exchange rate is in transition to the new equilibrium, large and volatile capital flows are likely, first inward as market participants see the appreciation and then reversing when the exchange rate overshoot becomes apparent. Third, that there are currently binding administrative constraints on private capital outflow, and if these were lifted in a move towards greater market-based outcomes (as will surely happen over time), the exchange rate might not be significantly overvalued. Fourth, even if the exchange rate is undervalued, this is a symptom of another imbalance (the savings/investment imbalance, by national-accounts definition, equal to the current account balance) and would have to be corrected at that level, with the exchange rate finding its equilibrium level as an endogenous response.<sup>21</sup>

This last argument, developed at some length in McKinnon and Schnabl,<sup>22</sup> is worth spelling out. The historic evidence of, say, Japan's experience, suggests that a substantial appreciation does not automatically change a current account surplus. Between 1971 and 1995 the yen appreciated from 360/\$ to 80/\$, but in that time the current account moved from small surplus to large surplus. It is easy enough to see the intuitive link between a stronger exchange rate and reduced net exports, but harder to see the linkage (which must be true by identity) to the savings/investment balance. The more useful approach is to ask how this savings/investment balance might be changed over time, accept that the current account will mirror this change, and ask whether the resulting behaviour of the exchange rate (with its likely overshooting) can be constrained by other policies such as intervention. A pure free float

would seem a very bold policy change (and is not recommended even by those who argue strongly for a substantial appreciation).<sup>23</sup>

*(i) What about the US dollar?*

Within the broader picture of overall imbalances, it can also be argued that a Chinese appreciation wouldn't have much effect on the US current account. China accounts for 15 per cent of the Fed's trade-weighted exchange rate, so a 20 per cent appreciation would translate into only a 3 per cent change in the effective exchange rate, which might change the current account by \$40-55 billion.<sup>24</sup> For a bigger effect, it is the US dollar which has to change.

A significant exchange rate depreciation of the US dollar may be the key to promoting the necessary domestic redeployment of resources towards net exports (more production of exports and import-substitutes). In an economy where the household sector can't provide much boost to demand (as it needs to maintain its new-found saving capacity), more net exports would provide the extra demand to maintain full employment while the unsustainable budget deficit is being wound back over coming years.

Exchange rates are, however, notoriously fickle. America is now more vulnerable to erratic changes in market sentiment, with its accumulated foreign debt and reliance on continuing foreign capital inflows, needed to fund both the external deficit and the domestic budget deficit. Foreign investors (not least the Chinese authorities, with their huge US dollar exposure) face a dilemma: maintain their risky exposure or precipitate a fall in the dollar by withdrawing, knowing that there will be a rush for the exits when the adjustment begins, with exchange-rate overshooting almost inevitable.

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There is cold comfort in the historical knowledge that countries with large government debt burdens find it hard to resist reducing the burden through inflation. The flightiness of foreign capital, in this case, seems to have its logic. The dismal performance of many US financial institutions over the past five years doesn't help.

*(j) Can the pressure on deficit countries be made less asymmetric?*

One of the central issues in the 1944 Bretton-Woods discussion on post WWII financial architecture was the problem of asymmetric adjustment for external imbalances: surplus countries were under no pressure to assist in a smooth adjustment, and if the adjustment was painful, it was the deficit country that suffered.<sup>25</sup>

While this is still largely true, floating exchange rates have altered this to a degree, and there are some pressures on the surplus country that limit the extent that sensible policy-making would pursue continuing large surpluses. Forgoing consumption to build up assets for later generations has a limited appeal for emerging countries, particularly as these future generations are going to inherit the improved living standards that come with development.

Perhaps more powerfully, countries like China take a very large foreign exchange risk in accumulating foreign assets (they can't, in practice, lend much in yuan), and the balance of risk is clearly against China (i.e. it is more likely to see its dollar holdings depreciate rather than appreciate). US government bonds might be safe in one sense, but the exchange rate risk is very high, particularly if the yuan is either undervalued currently or will be undervalued

owing to differential productivity growth.<sup>26</sup> To put order of magnitude on this, a 25 per cent appreciation<sup>27</sup> on China's US dollar reserves administers a \$350 billion valuation loss (around 8 per cent of GDP).

China has succeeded in containing the money-supply increase that might ordinarily accompany a big rise in reserves,<sup>28</sup> but at the cost of filling the bank balance sheets with government assets rather than commercial lending.

**A new agenda**

The main action so far has been bilateral discussions between the US and China, and these tend to take place in an environment of public pressures and Congressional grandstanding based on bilateral imbalances and domestic regional lobbying. The Chinese response is ad hoc measures to stave off reciprocal protectionism and WTO wrangling. This may involve a reluctant and modest appreciation of the yuan which will just reinforce speculative capital inflows.<sup>29</sup> This response will be coloured by general resentment of external pressure and interference. The GFC makes it timely to look for a different mechanism, one better suited to the realities of the contemporary global economy.

What forum could be found for a wide-ranging multilateral discussion of these issues? There have been very few examples of substantive international policy coordination in recent decades. The Plaza Accord and the Louvre Agreement are still the case studies, now over twenty years old and dating to a time when the international system was very different. Perhaps

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the GFC may have provoked a greater scepticism that the market alone can sort out all the issues optimally. Just as importantly, the GFC led to the creation of the G20 Leaders' meeting, which would seem to be the right place for the multilateral-level discussions envisaged here.

We have to be realistic about what can be achieved by international dialogue, but this seems to be a case where some modest benefit might be gained. It might usefully take place at various levels: bilateral, multilateral and regional. The multilateral level represents an opportunity to sort out the analytical issues and digest the arguments in a non-confrontational forum, but one which – usefully – creates an expectation of concrete progress. The G20 can also make *in principle* decisions about the conduct of the International Financial Institutions (e.g. the IMF) on issues such as governance and the development of more appropriate lending facilities, framing the decisions in a more precise and outcomes-oriented manner than can be achieved within the IMF's own cumbersome governance processes. The regional level provides the possibility of developing institutional support for regional capital flows, regional reserve pooling and crisis insurance, and greater reciprocal give and take than can be achieved at the multilateral level. The bilateral level presents the opportunity for more intimate arguments to be made (after the general discussion has digested the analytical inputs), many of them sensitive political economy rather than analytical.

The aim is to process and 'package' the issues so that there is room for productive bargaining, with give-and-take opportunities on all sides. It

should also broaden the discussion of surplus countries to include Germany and Japan, as well as China. The discussions should recognise the obvious point that the US economic and political system is not the relevant model for China, and there will be the opportunity to involve some of the emerging-country members of G20 which are more aligned to the evolutionary path of the China model.<sup>30</sup>

Here are some suggested approaches and 'headings for discussion':

- Find a less confrontational mode of engagement. Put the discussion in the context of the exit strategy from the GFC. Don't try to blame China for the GFC.<sup>31</sup> Acknowledge that it wouldn't make sense to wind back the principal underlying driver of the US imbalance (the budget deficit) until the US economy is more robust. Accept that whatever changes to imbalances are to occur, this should take place *over time*, as structural adjustment has to occur (rejigging the pan-Asian supply chain).
- As the song says, 'accentuate the positive'. Rather than think in terms of constraining exports and ending export-driven growth, see the solution in terms of encouraging more Asian imports and current account deficits. Although export restructuring in these surplus countries may well be part of the answer, it is not the *only* solution. The US deficit would be more sustainable if it reflected strong investment in the US, and this possibility should be explored. Why was it that, when US interest rates were so low in the post-Tech-Wreck period, the only people who wanted to borrow were those who couldn't repay?

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- Widen the policy debate. Part of the adjustment may be income redistribution in the US in favour of the workers (to help them with their debt and help them spend, so that the government deficit can come down over time). The same might apply in China. Focus on financial institution-building. China is already a large capital exporter, and will inevitably get larger<sup>32</sup> whatever happens to its aggregate external balance. The current unsatisfactory outcome reflects the dominance of government in the process so that, for want of a better outlet, the current account surplus finds its way into US dollar exchange reserves, largely because the necessary institutions to promote alternative foreign investments have not been developed.
- Measures could be explored at a technical level to broaden the opportunities for Chinese capital outflow. (Sovereign wealth funds? Pensions along the lines of Singapore's Provident Fund, channeled overseas via GIC and Temasek? ADB/IFC guarantees on some outflows? A role for the World Bank in funding global public goods?)<sup>33</sup> Why does so little capital flow between the East Asian countries, despite their strong trade links?<sup>34</sup>
- A start should be made on the long-term task of institution building which would take more Chinese funds into non-US markets, particularly the countries of East Asia which will be important in linking China seamlessly into its global environment. One area of fruitful exploration would be to address the wariness on the part of the recipient countries for China's investment, reflected in various failed investment proposals (Unocal? Rio?). The discussion should address how to make the world more comfortable with the inevitability of more Chinese FDI, which might address the sensitivities which arise because of state ownership of the investing companies. Disbursing the money at the receiving end should also be the focus of attention.<sup>35</sup> Why has the Chiang Mai Initiative been so slow to develop real substance, which would allow it to be a strong form of insurance against capital reversal? If there was better insurance against capital reversals, the countries of East Asia might be readier to run deficits, giving China a productive outlet for its excess saving.<sup>36</sup> The Asian Bond Fund Initiative set up two working bond funds, but this has not developed the momentum needed to make it an important link in regional financial markets.<sup>37</sup> While a regional East Asian currency union may be out of reach in the foreseeable future, there is a compelling logic in regional exchange rate coordination, to maintain some stability of external competitiveness, consistent with the high degree of trade integration.
- Recognise that exchange-rate flexibility is a powerful element of adjustment. Exchange-rate change did the job for the US imbalances in the mid 1980s, although the lags were long and the resulting over-appreciation of the Japanese yen very unhelpful for that country. It is in America's interests to have a lower exchange rate (to help the transition) so it should do everything it reasonably can to encourage a graceful depreciation (without actually advocating a lower dollar publicly). It should also be in America's interest to redirect a good part of any increase in

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China's FX reserve holdings to other currencies. This would give China the benefit of diversification and, if done in a measured way, would put acceptable downward pressure on the US dollar, which will be part of the medium-term adjustment process. An easy initial step in the right direction would be to unhook the yuan from its informal *de facto* tie to the US dollar, so that as the US currency weakens against all foreign currencies in general (which seems more likely than not), the yuan does not go down with it.<sup>38</sup>

- Clearly China runs a very substantial risk of capital losses on its US-dollar reserve holdings. If America were able to offer some insurance or offset against this, it might be a powerful bargaining chip in achieving an overall package of measures. Just what that insurance might be is, however, unclear. Swapping China's dollars for SDRs within the IMF would give China more diversification, but if the IMF holds the dollars, it also holds the exchange risk of a currency which seems more likely to depreciate than appreciate. But without some such compensation, China has another powerful reason (in addition to wanting to maintain its export competitiveness) for maintaining its *de facto* peg to the dollar. What central bank governor wants to preside over a massive loss of capital value of his bank's balance sheet?

Conclusion

The GFC has altered the shape of the long-standing global imbalances problem and may have reduced the immediacy of the issue.

Nevertheless, a difficult adjustment lies ahead, especially for the US, with its lacklustre international competitiveness, large domestic budget deficit, growing government debt and intrinsically limp domestic demand.

Exchange rates will be an important element in the adjustment. So far this has been seen largely in terms of a substantial appreciation of the renminbi. This seems a necessary element, however unpalatable this is to the Chinese authorities. But harder still will be the achievement of a substantial overall improvement in US international competitiveness. This is the key to replacing budget-supported demand (as at present) with a substantial expansion of net exports.

Changes in international competitiveness tend to be traumatic rather than smooth. The last major correction of US external imbalances, in the mid 1980s, led a reluctant US to use international policy coordination (Plaza Accord and Louvre Agreement) to ensure that exchange rates helped the adjustment, rather than hindered. The current circumstances are different, but resonate strongly.

Flighty financial markets may take some comfort if they see the exchange rate as being just one element, embedded in a larger set of internationally endorsed adjustment-supporting measures.

If international economic diplomacy is to play a role here, it must facilitate the construction of a package of measures which offers each of the two central players – China and the US – a net positive outcome. The G20 provides a forum for sorting out some of the general analytical issues in preparation for more detailed bilateral

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discussions. At the London G20 meeting last April, China showed a new readiness to put the issues of saving and exchange rates on the table.<sup>39</sup> There are enough dangers in an unmanaged market-driven adjustment process to justify a serious discussion of the sorts of measures explored here.

There may be broader, if more nebulous, benefits in shifting the adjustment discussion to G20. Economic policy coordination may be a small step towards a less unipolar view of the world, with the recognition that a two-speed world (with most of G7 countries growing slowly while the emerging countries expand quickly) will produce a palpable shift in the world power balance.

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NOTES

<sup>1</sup> See Ben Bernanke. The global saving glut and the U.S. current account deficit. Sandridge Lecture. Virginia Association of Economics, Richmond, Virginia, 10 March 2005; Paulson, quoted by Krishna Guha, Paulson says crisis sown by imbalance. *Financial Times*, 2 January 2009. Martin Wolf, *Fixing global finance*. Baltimore, MD, Johns Hopkins University Press, 2008.

<sup>2</sup> See, e.g. Stephen Grenville, *International imbalances and international policy coordination*. Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, 2009.

<sup>3</sup> For a more analytical exposition of this point, see Max Corden, Those current account imbalances: a sceptical view. *The World Economy* 30 2007.

<sup>4</sup> Jagdish Bhagwati, The capital myth: the difference between trade in widgets and dollars. *Foreign Affairs* 77 (3) 1998.

<sup>5</sup> Adam Posen (Adam Posen, American saving is no excuse for Schadenfreude. *Welt am Sonntag*, 19 July 2009) argues that 'the failure of the US economy was not in maintaining a persistent trade deficit; the failure of the US economy was in wasting the money it borrowed from abroad in recent years.'

<sup>6</sup> Spending a greater proportion of the current deficit on productive public investment would help to make the external deficit more sustainable.

<sup>7</sup> See Martin Feldstein, US saves its way into strife. *The Age*, 28 July 2009.

<sup>8</sup> See Guonan Ma and Haiwen Zhou, *China's evolving external wealth and rising creditor position*. BIS Working Papers No 286 2009.

<sup>9</sup> 'The rate of corporate savings to GDP in China is high compared with other countries in the world. This is closely related to the unsolved distortion of cost/profit of enterprises during China's economic transition. Under the planned economy, housing, healthcare, and pension were provided by the enterprises and the government, and weren't

accounted for in wages. This had dampened people's incentives to save. Savings were even considered "involuntary" as people had to regularly line up in queues at shops for consumer goods in short supply. After the reform in the 1990s, the "iron bowl" (lifelong secure job and welfare) system was smashed and the enterprises stopped providing pension and housing for free. However, effective social security system had not been in place either. These significantly increased the incentive for precautionary savings.' Zhou Xiaochuan. *On savings ratio*. 24 March 2009:

<http://www.pbc.gov.cn/english/detail.asp?col=6500&id=179>.

<sup>10</sup> This is not the first time that this sort of 'demand-deficient' world has been seen as the norm. The general assumption following WWII was that demand would slump back into something akin to the pre-war depression. Of course this did not happen, at least in part because the post-WWII era broke out of the protectionist constraints of the 1930s.

<sup>11</sup> Dani Rodrik. *The real exchange rate and economic growth*. 2008:

<http://ksghome.harvard.edu/~drodrik/RER%20and%20growth.pdf>.

<sup>12</sup> See Richard Cooper, Living with global imbalances. *Brookings Papers on Economic Activity* 2 2007 and Ricardo Hausmann, Why the US current account is sustainable. *International Finance* 9 (2) 2006.

<sup>13</sup> Steven Barnett and Ray Brooks, *What's driving investment in China?* IMF Working Papers 06/265 2006.

<sup>14</sup> Ronald McKinnon and Gunther Schnabl, *China's financial conundrum and global imbalances*. BIS Working Paper No 277 2009.

<sup>15</sup> The most extreme version of this bilateral view is seen in the concept of 'Chimerica' see Niall Ferguson and Moritz Schularick, 'Chimerica' and the global

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asset market boom. *International Finance* 10 (3) 2007.

<sup>16</sup> ‘The top priority at present is to facilitate the rational flow of savings and improve their allocation efficiency. One option is to redirect surplus savings to other developing countries and emerging markets, those with abundant resources, low labor cost, but lack of capital. These economies are the future growth engines of the global economy.’ Zhou Xiaochuan. *On savings ratio*.

<sup>17</sup> See Alicia García-Herrero, Philip Wooldridge and Doo Yong Yang, Why don't Asians invest in Asia? The determinants of cross-border portfolio holdings. *Asian Economic Papers* 8 [Forthcoming].

<sup>18</sup> ‘The high savings ratio and large foreign reserves in the East Asian countries are a result of defensive reactions against predatory speculation. During the Asian Financial Crisis, the rampant speculations of hedge funds caused large capital inflows and subsequent reversal in these countries, which exacerbated their economic woes. People in these countries were shocked, and disgusted by these speculative attacks. Afterwards, many suggested that unregulated predatory speculation caused the crisis, and appropriate international regulation was needed. However, for various considerations, some countries were against such regulations, and failed to see the need to adjust the regulatory frameworks. International organizations also failed to perform their regulatory responsibilities over abnormal capital flows, forcing the East Asian countries to amass foreign reserves to fend for themselves.’ Zhou Xiaochuan. *On savings ratio*.

<sup>19</sup> Morris Goldstein and Nicholas R. Lardy, *The future of China's exchange rate policy*. Washington, DC, Peterson Institute, 2009.

<sup>20</sup> This discussion avoids distinctions between real and nominal exchange rates; what matters is, of course, the real rate. Thus China could achieve a real appreciation via faster inflation vis-à-vis its trading

partners. For more discussion of changes in the Chinese exchange rate, see Warwick McKibbin and Andrew Stoeckel, What if China revalues its currency? *Economic Scenarios* 2003.

<sup>21</sup> ‘Opinions also diverge on whether exchange rate is correlated with savings ratio. They are correlated to some degree, but the coefficients are generally low and the correlation usually statistically insignificant. It therefore seems over simplistic to believe that adjusting exchange rate may influence savings ratio.’ Zhou Xiaochuan. Some observations and analyses on savings ratio: Speech at the High Level Conference hosted by Bank Negara Malaysia. Kuala Lumpur, 10 February 2009.

<sup>22</sup> McKinnon and Schnabl, *China's financial conundrum and global imbalances*.

<sup>23</sup> Goldstein and Lardy, *The future of China's exchange rate policy*.

<sup>24</sup> *Ibid.*, p 65.

<sup>25</sup> Robert Skidelsky, Keynes, globalisation and the Bretton Woods institutions in the light of changing ideas about markets *World Economics* 16 (1) 2005.

<sup>26</sup> Productivity generally rises faster in the export-oriented sector and with fast overall growth; countries such as China would find their equilibrium exchange rate appreciating over time (the Balassa/Samuelson theorem). Hong Kong illustrates the point, where the appreciating real exchange rate comes about through faster inflation than its trading partners.

<sup>27</sup> Goldstein and Lardy, *The future of China's exchange rate policy*.

<sup>28</sup> See Corrinne Ho and Robert McCauley, The domestic financial consequences of reserve accumulation: some evidence from Asia, in *Exchange rate, monetary and financial issues and policies in Asia*, ed. Ramkishen S. Rajan, Shandre Thangavelu, and Rasyad A. Parinduri. Hackensack, NJ, World Scientific Pub., 2009.

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<sup>29</sup> McKinnon and Schnabl, *China's financial conundrum and global imbalances*.

<sup>30</sup> 'At present, many East Asian countries, including China and Malaysia, have high savings ratios and considerable foreign reserves. In this regard, there are a number of issues of common interest worth discussing.' Zhou Xiaochuan. Some observations and analyses on savings ratio: Speech at the High Level Conference hosted by Bank Negara Malaysia.

<sup>31</sup> 'The distinct feature of the current crisis is that it originated in the advanced economies and spilled over to the rest of the world.' Ibid.

<sup>32</sup> See Ma and Zhou, *China's evolving external wealth and rising creditor position*.

<sup>33</sup> Arvind Subramanian. *The G-20: an idea from India*. 2009:

<http://www.piie.com/publications/opeds/oped.cfm?ResearchID=1286>.

<sup>34</sup> Alicia García-Herrero, Doo-yong Yang and Philip Wooldridge, *Why is there so little regional financial integration in Asia?* BIS Papers No 42, October, 2008; Ric Battellino, Regional capital flows. *Reserve Bank of Australia Bulletin* July 2006.

<sup>35</sup> If Indonesia were to encourage more capital inflow through an external deficit, it would also need to overcome the critical shortages of capacity to implement government infrastructure projects, which may be one of the most productive investment outlets.

<sup>36</sup> The idea of a regional support fund (an Asian Monetary Fund) was rejected by a territorially-sensitive IMF (among others), but the Fund seems to have recognised its error, or at least reconciled itself to rival regional arrangements.

<sup>37</sup> When Australia and Japan provided stand-by funding for Indonesia during the GFC, this was done through a new ad hoc World Bank facility rather than by putting funds in the Asian Bond Fund Number 2, which would have been more effective in

addressing the immediate need and at the same time helped to develop this institutional mechanism.

<sup>38</sup> 'The top priority at present is to facilitate the rational flow of savings and improve its allocation efficiency around the world. One way to do so is to redirect surplus savings to other developing countries and emerging markets, those with abundant resources, low labor cost, but inadequate capital for development.' Zhou Xiaochuan. Some observations and analyses on savings ratio: Speech at the High Level Conference hosted by Bank Negara Malaysia.

<sup>39</sup> Zhou Xiaochuan. *On savings ratio*.

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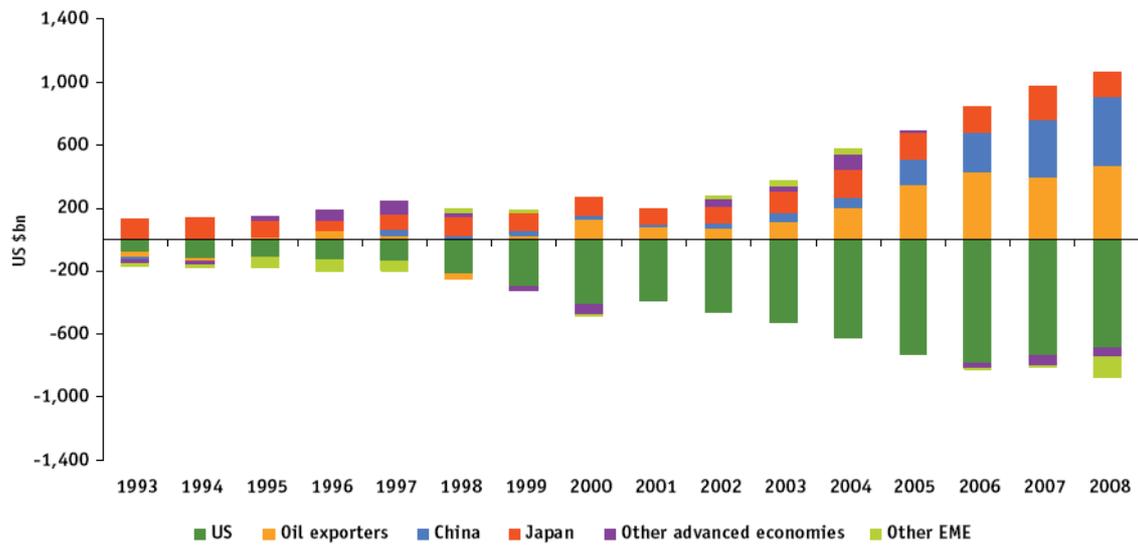
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ANNEXURE

Figure 1. Current external imbalances



Source: IMF, FSA calculations



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