

Global Imbalances and Developing Countries: Remedies for a Failing
International Financial System

Forum on Debt and Development (FONDAD)

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Director: Jan Joost Teunissen

Global Imbalances and Developing Countries

Remedies for a Failing International Financial System

Edited by
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Abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations (Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand, Vietnam)
BIS	Bank for International Settlements
CPI	consumer price index
ICA	International Clearing Agency
ECB	European Central Bank
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN); (in Spanish CEPAL)
EER	effective exchange rates
EFF	Extended Fund Facility
ELGS	economic losses given stress
EMEs	emerging market economies
EMS	European Monetary System
EMU	Economic and Monetary Union (of the EU)
ESF	Exogenous Shocks Facility
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
HIPC	Heavily Indebted Poor Countries
ICA	international clearing agency
IFIs	international financial institutions
IMF	International Monetary Fund
KIEP	Korea Institute for International Economic Policy
LTCM	Long-Term Capital Management
OECD	Organisation for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
PFS	probability of financial stress
PRGF	Poverty Reduction and Growth Facility

RMB	renmimbi (yuan)
ROA	return on asset
SBA	stand-by arrangement
SDR	special drawing right
UN	United Nations
UN-DESA	United Nations Department of Economic and Social Affairs
VIIT	vertical intra-industry trade
WTO	World Trade Organization

1

Introduction

Jan Joost Teunissen

A major risk for the world economy – and for developing countries – is an abrupt unwinding of global imbalances. This observation was made by authors who contributed to the first volume (*Global Imbalances and the US Debt Problem: Should Developing Countries Continue to Support the US Dollar?*) that resulted from a conference held in The Hague in 2006. “The scale of the US deficit, its rapid growth and that of US net liabilities, make the problem an increasing source of concern,” stressed Jane D’Arista and Stephany Griffith-Jones in their chapter in the first volume.

“There are serious concerns about how the unwinding of global financial imbalances might affect the external financing conditions in which emerging market economies operate,” writes Louis Kasekende, chief economist of the African Development Bank, in the chapter he contributes to this second volume. “The greatest risk would arise from an abrupt and disorderly adjustment of major exchange rates, combined with a higher-than-expected rise in international interest rates.”

Other authors in this volume share Kasekende’s concern. For example, Latin American economists Ariel Buira and Martín Abeles observe that “a sudden reallocation of portfolios away from dollar-denominated assets, or even just a gradual decline in the demand of US dollars as a reserve currency due to diversification, would entail large costs as the value of these assets falls and dollar interest rates rise, leading to a slowdown of the US economy and (given the structure of global demand) to a decline in worldwide economic activity.” Buira and Abeles warn that a fall in worldwide economic activity could in turn trigger pervasive “beggar-thy-neighbour” policy responses, including protectionism and extensive competitive devaluations. “Such a scenario

would affect economies across the globe, but would be particularly harmful to developing economies.”

While the previous volume gave special attention to the position of China in global imbalances, this volume gives special attention to Africa and East Asia. One chapter, by chief economist William R. White of the Bank for International Settlements (BIS), provides a fresh, unorthodox, long-term view on global imbalances. He does so by following the approach of the so-called Austrian School of economic thinking. The two subsequent chapters deal with the role of the International Monetary Fund in addressing global imbalances. The last four chapters discuss the need for reform of the international monetary and financial system.

Before highlighting a few of the observations and remedies presented in this volume, let me recall that several of the authors of the previous volume emphasised a fundamental flaw of the current international monetary system. For example, Jane D’Arista and Stephany Griffith-Jones stressed that the US deficits are not only the result of overspending by the United States, but also of an international monetary system that uses the dollar as the key currency, thus generating debt in the key currency country – the US. Fan Gang, an influential Chinese economist and member of the monetary policy committee of China’s central bank, went even further. He saw the international monetary system as the main cause of the US deficits and global imbalances. He stressed that the fundamental problem is not in US policies, but in a global currency system which allows the US to run high deficits and print as much money as it needs. Fan Gang favoured a reform of the international monetary system that would end the hegemony of the dollar. “The US dollar is no longer a stable anchor in the global financial system,” he observed, “nor is it likely to become one: thus it is time to look for alternatives.”

Africa and East Asia

In Chapter 2, Kasekende discusses different scenarios of how global imbalances might unwind and then looks at the possible implications for Africa. One of his observations is that a large share of Africa’s exports is priced in dollars while the imports are largely valued in euros, implying that any significant depreciation of the US dollar would be “a source of a double whammy on African countries”. Export earnings would be reduced in relative value while imports would be more expensive. Since many African countries depend on three or even fewer commodities for

most of their export earning, this makes Africa very vulnerable to volatility and downward movements in prices.

Another observation by Kasekende is that market-based counter-cyclical policies have limited applicability in Africa where the financial sector remains shallow and lacks sophistication. Therefore, he sees the urgent need for the IMF to probe various ideas presented in this and the previous FONDAD book (*Global Imbalances and the US Debt Problem: Should Developing Countries Continue to Support the US Dollar?*) with a view to designing counter-cyclical policies applicable for countries in Africa.

In Chapter 3, Asian economists Masaru Yoshitomi, Li-Gang Liu and US economist Willem Thorbecke identify the roles that both the US and East Asian countries can play in resolving the current global imbalances. The authors recall that the US deficit is the result of too little savings in the United States, and that the US deficit accounts for 70 percent of the world sum of current account deficits, implying that America absorbs 70 percent of net available global saving. In the authors' view, the present global imbalances cannot be sustained indefinitely.

The primary step necessary to resolving imbalances is for the US to increase domestic saving, but the East Asian countries, which have a large current account surplus, can also contribute to lowering global imbalances, argue Yoshitomi, Liu and Thorbecke. Given the high ratio of intra-regional trade in East Asia and the triangular production and distribution networks in the region, concerted increases of East Asian currencies against the dollar and concerted action to maintain mutual exchange rate stability among East Asian currencies are needed. Combining expenditure-increasing policies with expenditure-switching policies would be the appropriate policy mix for East Asian countries to reduce their massive accumulation of international reserves. In this way, they can move away from excessive reserve accumulation and simultaneously achieve external and internal equilibria in their own interests. "These policies would also contribute to easing global imbalances," say Yoshitomi, Liu and Thorbecke.

In Chapter 4, South African central banker Brian Kahn discusses the remedies suggested by Yoshitomi, Liu and Thorbecke. Kahn agrees with the need for concerted action by the United States and East Asia, but doubts whether it will happen. A major problem is that the main deficit country, the United States, can sustain its deficit as long as the surplus dollars in Asia are recycled back to the US. Therefore, he is

pessimistic that an orderly exchange rate adjustment will take place in the near future. In the meantime, peripheral countries, including those in Africa, will continue to suffer the consequences. One of Kahn's sobering but alarming observations is that experience tells us that concerted global action usually only comes when we are already in a crisis. "It is only when we find ourselves in a real systemic crisis that we tend to move towards global solutions. This implies that the longer the global imbalances continue in a benign way, the more complacent we are likely to be," says Kahn.

In Chapter 5, Korean economists Yonghyup Oh and Seun Jeong argue that East Asia should make an upward shift in investment relative to savings while the United States should do the exact opposite. They observe that the Asian crisis brought deepening integration between individual East Asian markets and the US market "rather than regional financial integration between the East Asian economies." In their view, an effective way to increase investment in the region would be to promote capital market integration in East Asia. They explore in-depth the many barriers to cross-border capital movements in East Asia and suggest how they could be removed. Oh and Jeong conclude that diminishing barriers to capital market integration would not only help East Asian capital flow more effectively to its own regional markets, but also facilitate financial cooperation in East Asia.

Addressing Global Imbalances and the Role of the IMF

In Chapter 6, William White of the BIS, contrasts the mainstream, "more orthodox" view of increased financial volatility and global imbalances with the less orthodox approach of the Austrian school. "Perhaps the most important message of these earlier thinkers is that policymakers should try to avoid the build-up of dangerous economic imbalances in the first place," stresses White.

In White's view, there is a need for a new macrofinancial stabilisation framework to insure against systemic financial imbalances that may eventually have a severe impact on economic output and unemployment. Such a framework requires a more symmetric policy response to the expansionary and contractionary phases of the financial cycle and implies a focus on longer-term outcomes of policy decisions than is currently fashionable. This framework, with its objective of containing financial imbalances, would ideally have both a domestic and an international dimension.

At the domestic level, monetary policy would have to react more to internal financial imbalances and put more emphasis on the health of the financial system as a whole, rather than the state of individual institutions, as is currently the case. At the international level, recognising that “keeping one’s domestic house in order” is not sufficient to ensure international stability, White sees the need for a new international monetary order to help prevent the build-up of external imbalances that could eventually culminate in stress on a global level. “Recall that, before they broke down, this is precisely what the gold standard and the Bretton Woods systems were designed to do,” says White.

In Chapter 7, Ariel Buira and Martín Abeles examine the main risks for developing countries posed by global imbalances and the potential role of the IMF in dealing with these imbalances. In their view, current global imbalances call for a strong involvement of the Fund. “The IMF should assume a central role in the resolution of global imbalances by promoting a coordinated shift of aggregate demand from countries running current payments deficits to countries running current surpluses,” argue Buira and Abeles. The IMF should adopt a proactive, pre-emptive policy stance, going beyond the policy of identifying sources of imbalances, monitoring the performance of countries and acting only after a crisis has developed. In addition, the IMF should establish a counter-cyclical facility to help developing countries sustain aggregate demand in the event of a major exogenous shock arising from a disorderly correction of international financial imbalances, say Buira and Abeles.

In Chapter 8, Mark Allen, director of the IMF Policy Development and Review Department, responds to the plea by Buira and Abeles. He reports that the IMF has had its first multilateral consultation – a new instrument adopted last year – providing a forum for the systemically important members and groups of members like China, the euro area, Japan, Saudi Arabia and the United States to discuss jointly what should be done to address global imbalances. “To date, the discussions have been candid and instructive and have contributed to a better understanding of the issues and each country’s position,” says Allen.

Allen also comments on the counter-cyclical facility proposed by Buira and Abeles. He suggests that the IMF’s traditional financing instruments and its two new instruments – the Exogenous Shocks Facility and the Policy Support Instrument (PSI) – and a possible new liquidity enhancement instrument would go a long way to providing the type of support that Buira and Abeles consider necessary to help protect emerging market countries from a possible adverse “unwinding” scenario.

Reform of the International Monetary System

In Chapter 9, John Williamson of the Institute for International Economics, gives his view on the likely shape of the international monetary system in the next 25 years. Williamson does not expect the US dollar to be displaced from its role as the key international currency in the next quarter century, “even if and when it ultimately undergoes another bout of severe depreciation.”

Williamson observes that there still seems to be an unwillingness to take actions to adjust the current global imbalances, “despite their evident unsustainability.” The likely result of this sort of obstinacy is a global recession, says Williamson. However, in his view, a stronger IMF might turn the tide. “The IMF needs a rulebook that commits it to active surveillance of the macroeconomic policies of its systemically important members, based on regular calculation of a set of mutually consistent reference exchange rates believed to be compatible with a generally acceptable set of current account balances,” argues Williamson.

In Chapter 10, US international financial expert Jane D’Arista advocates a more balanced international monetary system and comes up with two proposals to achieve this. Given “the phenomenal growth of institutional investors’ assets over the last two decades”, her first proposal is to create a public international investment fund for emerging economies. Such a fund would create a new channel for portfolio investments and provide flows “that are stable, in amounts appropriate to the size of a country’s economy and directed toward the goals of development rather than solely toward the short-term profits of investors.”

D’Arista’s second proposal is to create an international clearing agency (ICA) that would serve as the institutional platform for a new global payments system. The new ICA would clear transactions denominated in members’ own currencies by crediting and debiting their clearing accounts. These clearing accounts would constitute the international reserves of the system. “Thus the clearing process would change the ownership of reserves and reinstate the original intent of the Bretton Woods Agreement to maintain public control of international payments,” says D’Arista. The ICA’s ability to create and extinguish international reserves would also give it the power to change the availability of liquidity at the global level. “The need for that power has been increasingly evident throughout the post-Bretton Woods era as crisis after crisis has underscored the inadequacy of the current institutional framework,” stresses D’Arista.

In Chapter 11, Dutch central banker Henk Brouwer comments on D'Arista's proposal for the establishment of an international clearing agency (ICA). Brouwer observes that a similar proposal was made by Keynes at the Bretton Woods conference in 1944, and then was followed by similar proposals afterwards. "None of them has ever materialised, mainly because the major economies – most notably the US – opposed," says Brouwer.

Brouwer also comments on John Williamson's proposal of setting a "reference exchange rate" for the major economies. "This would not only require frequent policy negotiations among the major countries including China," observes Brouwer, "it will also be very difficult to reach an agreement on the level of this reference exchange rate, let alone doing so regularly." He doubts that the IMF or any other international institution has the ability to facilitate the regular negotiation process. "A more realistic approach is one where the exchange rates between the key currencies – the dollar, the yuan, the yen, and the euro – would be, by and large, freely floating."

In Chapter 12, Jane D'Arista responds to Brouwer's comments. In her view, designing reform proposals seems a particularly appropriate role for political economists – "not only for the sake of anticipating a breakdown in the system but because any system can benefit from ideas for improvements." D'Arista stresses that her reform proposals are modifications of earlier plans proposed by Keynes, Triffin, Kaldor and others. However, the structure of the International Clearing Agency (ICA) she proposes differs from those in earlier proposals in that it would allow each nation to use its own currency in international transactions; the ICA would clear transactions among national central banks in the way that these national institutions clear for their commercial banking systems. Moreover, stresses D'Arista, unlike the Keynes proposal or the IMF, the ICA could conduct open market operations at an international level and thus undertake counter-cyclical and lender-of-last-resort operations.

D'Arista sees two further limitations of the IMF: first, its dependence on contributions from member countries constrains its ability to lend, and second, its framework for issuing a non-national reserve currency (SDR) does not permit it to interact with private markets. "These limitations have marginalised the SDR and the Fund's ability to stabilise imbalances in a world in which trillions of dollars move through global markets on an annual basis," says D'Arista.

2

Global Imbalances and the Implications for Africa

Louis Kasekende

As indicated by D'Arista and Griffith-Jones (2006), the United States has for most of the past twenty five years carried current account deficits. In large part, the deficit has been sustained by a gradual depreciation of the US dollar vis-à-vis other major currencies, high growth rates in other parts of the world, and a willingness of non-US residents to increase their holdings of US dollars. The phenomenon of large and growing current account deficits of the United States (amounting to \$869.1 billion in 2006, or 6.5 percent of GDP) and the associated large positions that foreigners (especially emerging economies) are amassing in US securities have become a central feature of the global economy, particularly in recent years. It has predictably garnered much attention from the financial press, policymakers, practitioners and, of course, academics. The three chapters by Barry Eichengreen and Yung Chul Park (2006), Jane D'Arista and Stephany Griffith-Jones (2006) and Fan Gang (2006) in the previous volume¹ present an excellent discussion of many of the key issues and the way forward. My comments highlight some key issues to stimulate further discussion and then dwell briefly on the neglected region in the discourse – Africa.

¹ *Global Imbalances and the US Debt Problem: Should Developing Countries Continue to Support the US Dollar?*, edited by Jan Joost Teunissen and Age Akkerman, FONDAD, The Hague, 2006.

1 Why Worry About the Global Imbalances?

Some authors dispute that the large and rising current account deficit of the US is a cause for concern on both historical and conceptual grounds (see, for example, Cooper, 2005; Hausmann and Sturzenegger, 2005), culminating in what Summers (2006) calls “commentaries of the complacent”. According to Cooper (2005), the argument that the US current account deficit is unsustainable is highly questionable and he goes ahead to demonstrate that Americans save quite enough for future generations such that the startlingly large US current account deficit is not only sustainable but a natural feature of today’s highly globalised economy. Thus, a revaluation of the Chinese currency, far from alleviating global imbalances, would run the risk of precipitating a financial crisis.

Indeed Eichengreen and Park point to the merits of a huge current account deficit. It helps sustain growth and redistribute income in the rest of the world. Through trade flows between the US and the rest of the world, the US provides buoyant markets to the exports of the rest of the world and supports the accumulation of reserves by the exporting countries. The latter in particular has provided a cushion to the countries especially in Asia against currency crises. The savings of the exporting countries are recycled back to the US to finance the current account deficits through international capital markets. This process in itself is a source of comfort to some believing that the depth and flexibility in capital markets will be a source of an orderly adjustment to sustainable levels. They refer to it as global co-independence.

Also, Cavallo and Tille (2006) show how the adjustment of bringing the current account down to a more sustainable level would be affected by the high degree of financial integration across countries. The main consequence of financial integration is the growing relevance of valuation effects, where exchange rate movements lead to sizeable changes in the value of a country’s assets and liabilities. They consider an adjustment scenario where current account imbalances are re-absorbed, and the net asset positions of the various countries are kept constant. Their main finding is that high financial integration can potentially generate a “smooth landing” pattern, with a very gradual movement of the current accounts into balance.

However, according to Summers (2006), while arguments about “financial dark matter” or the US ability to issue debt in its own currency probably have some force in thinking about what level of external debt is sustainable for the US, they clearly do not make the case for indefinite

continued expansion of debt.

In addition, available evidence shows that the current state is different from previous global experiences. Indeed, the US current account deficit has been unusually high now for a long period, going from a current account surplus of 0.7 percent of GDP in 1991 to a current account deficit of 6.5 percent of GDP in 2006. Also, the US current account deficit is financing consumption rather than investment as the US net national savings rate is now at a record low level of under 2 percent. Moreover, investment is tilted towards real estate and the non-traded goods sector rather than the traded goods sector and away from exportables. Finally, the net flow of direct investment is out of the US and the flow of incoming capital appears to be of shortening maturity and coming increasingly from official rather than private sources (Summers, 2006).

Moreover, there are serious concerns about how the unwinding of global financial imbalances might affect the external financing conditions in which emerging market economies operate. The greatest risk would arise from an abrupt and disorderly adjustment of major exchange rates, combined with a higher-than-expected rise in international interest rates. Indeed, persistent structural weaknesses in banking and financial systems, particularly combined with high indebtedness or a record of macroeconomic mismanagement and default, render some low-income and struggling economies especially vulnerable to sudden reassessments of country risk by capital markets. In addition, a sharp depreciation of the dollar might lead to large capital losses in local-currency terms for developing economies with substantial dollar reserves though those with dollar-denominated debt would benefit from the erosion in the dollar value of their debt. In sum, the large US current account deficit is unsustainable in the long run (see Rajan, 2006).

The three chapters by Eichengreen *et al.* (2006), D'Arista *et al.* (2006) and Fan (2006) do warn of a real danger of a disorderly correction of the US current account with potentially devastating macroeconomic implications for the developing countries through both the trade and financial channels. Indeed, the US dollar will not be able to play the role of reserve currency and anchor that stabilises the global currency markets. D'Arista *et al.* (2006) reveal weaknesses in the global international financial system that would be expected to respond to such a crisis. In their view, the IMF may not be able to marshal and coordinate the necessary international response to such a crisis. This then calls for innovative corrective actions at the level of individual or a group of countries.

2 Global Adjustment Scenarios

Barry Eichengreen and Yung Chul Park identify a number of global adjustment scenarios by discussing the actions different country groups and economies could undertake. These can be categorised into three: the benign, disorderly, and coordinated adjustment scenarios.

The benign scenario is one in which the phasing out of the factors which caused the imbalances leads to a gradual and orderly adjustment. In essence, this scenario primarily involves an increase in savings in the United States, to levels that are compatible with the long-term rate of investment. The resulting slowdown in consumption would have a moderating effect on imports, thus gradually reducing the external deficit. However, this scenario could occur, in particular, if real estate prices were to stabilise, thereby moderating household indebtedness, which in recent years had grown very fast.

The disorderly adjustment, mainly led by financial markets, occurs due to doubts regarding the sustainability of the situation, resulting in abrupt changes in the prices of financial assets with serious adverse implications for corporate bodies, banks, households in both the US and emerging economies. In the third scenario, the adjustment is supported by coordinated economic policies, taking into account both domestic and external requirements.

Unfortunately, divisions appear to deepen over the global imbalances (Rowley, 2006) as exemplified by positions canvassed during the Asian Development Bank's 2006 Annual Meetings. While the US argues that there is still scope for orderly changes given that it is a general equilibrium problem that will require a general equilibrium solution, China cautions that the appreciation of the renminbi demanded by the US threatens to cause an implosion in the economy which is rapidly becoming the main driver of global growth. On the other hand, the Japanese observe that over-reliance on exchange rate adjustments could deal a blow to global markets, insisting that imbalances have to be addressed through "structural adjustment" in the real economy. Germany, on its part, warned that the possibility of a disorderly unwinding of global imbalances is by no means zero, thus raising the "chilling prospect" that a falling dollar could trigger a wave of global trade protectionism. Indeed, what are needed now are not discordant tunes but a coordinated global strategy to address the global imbalances. Such a coordinated approach would encourage the adjustment of imbalances and allow the global economy to grow in a sustainable manner.

D'Arista *et al.* (2006) explore two counter-cyclical instruments that individual developing countries could introduce as mitigating measures. The first is the GDP-linked bonds that would pay an interest coupon based on the issuing countries growth rate. Payments would be smaller in periods of lower growth. This would have the advantage of cushioning fiscal expenditures during periods of slower growth. The attractiveness of this proposal especially for developing countries lies in the fiscal flexibility that is introduced in fiscal management. In periods of high growth especially associated with commodity booms, the budget would be protected from unsustainable fiscal expansion. Contrary, a country would not be forced into social sector cuts during a period of slower growth. An added beauty of this instrument is the reduction in the risk of default. D'Arista *et al.* call on international financial institutions (IFIs) to consider issuing GDP-indexed bonds. The authors also call on IFIs to consider introducing explicit counter-cyclical guarantees that would be used as private lenders scale back exposure to emerging markets. I find these proposals appealing and think that they should be subjected to a serious evaluation with a view to implementation.

The second instrument is the issuance of local currency bonds. This would facilitate borrowing by a country in local currency and cushion it against currency mismatch. A number of IFIs are exploring ways of increasing issuance of local currency bonds. The African Development Bank has issued Naira and Cedi bonds and intends to explore further issuance in 2007.

In this volume, Jane D'Arista proposes a reform of the international payment system by setting up a clearing house system. Similar systems were proposed and set up to facilitate payments in the regional economic blocs. Given that most of these systems were based on the control model for foreign exchange, liberalisation of foreign exchange markets rendered them inoperative. The proposal, if it is to succeed, must be consistent with the policy environment in a country and should be efficient in its operations. Otherwise the private sector will shun it.

3 Where is Africa in All These?

The global imbalances effects, adjustment, approaches and recommendations in the two studies by Barry Eichengreen *et al.* (2006) and D'Arista *et al.* (2006) totally ignored assessing implications for Africa.

Table 1 Current Account Balance of Africa and Developing Asia, 2005

(in billions of dollars and percentages)

	amount	percentage of GDP
Africa		
Nigeria	12.3	12.4
Algeria	21.7	21.3
South Africa	-10.1	-4.2
Rest of Africa	-5.5	-1.5
Total Africa	18.4	2.3
9 surplus countries	43.2	
41 deficit countries	-24.8	
Developing Asia		
China	160.8	7.2
Malaysia	19.9	15.2
Rest of Developing Asia	-10.1	-0.6
Total Developing Asia (26 countries)*	170.6	4.2
11 surplus countries	190.3	
15 deficit countries	-19.7	

Note:

* The 26 countries of developing Asia are: Afghanistan, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, China, Fiji, India, Indonesia, Kiribati, Lao, Malaysia, Maldives, Myanmar, Nepal, Pakistan, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Thailand, Timor-Leste, Tonga, Vanuatu, Vietnam.

Source: Calculated from IMF, 2006.

Does it mean that Africa is insulated from the adverse effects of any disorderly unwinding of the US deficit? In what follows, I attempt to examine what has happened in Africa, especially in relation to the conclusions of the two studies relating to emerging economies.

A large share of Africa's exports is priced in dollars in the international markets while the imports are largely valued in euros. Any significant depreciation of the US dollar would be a source of a double whammy on African countries. Export earnings would be reduced in relative value while imports would be more expensive widening the current account in absence of contractionary policies. Associated with the above, most of the reserves are held in dollars in spite of efforts to

diversify holdings. Any depreciation in the US dollar would expose Africa to revaluation losses. Indeed, most of the African countries have limited room for reserves diversification. Many central banks match the composition of reserve currencies to the foreign liabilities. Given that most of the foreign liabilities are denominated in dollars or SDR, the space for diversification is very limited.

As shown in Table 1, Africa as a whole had in 2005 a small current account surplus of \$18.4 billion, while Developing Asia had a surplus of \$170.6 billion (IMF, 2006). However, in Developing Asia, China is responsible for almost the entire surplus, while Malaysia has a big surplus too (over 15 percent of GDP). If China and Malaysia are excluded, the total surplus of Developing Asia (4.3 percent of GDP) turns into a deficit (-0.6 percent). Of the 26 countries in Developing Asia, 16 had a deficit in 2006, up from 10 countries in 2003.

Of the 50 African countries, in 2005, 41 countries had a current account deficit, while 9 had a surplus; other recent years show a similar pattern. Algeria, Nigeria and South Africa dominate the picture, because their GDP together is \$366.5 billion, which is almost half of Africa's total GDP of \$807.1 billion. In 2005, Algeria and Nigeria had big current account surpluses (respectively 21.3 and 12.4 percent) because of their oil export, while South Africa had a big deficit (-4.2 percent). For all African countries together, the current account surplus was \$18.4 billion, which is 2.3 percent of total GDP. Excluding Algeria, Nigeria and South Africa, this surplus turns into a deficit of \$5.5 billion, which is -1.5 percent of total GDP of these 47 countries.

In comments by Henk Brouwer on the chapter by Jane D'Arista included in this volume, he refers to current account deficits of developing countries as evidence to counter the claim that capital is unfairly flowing from "poor" economies to "rich" nations. This observation is correct as sub-Saharan African countries sustain these deficits through either private flows including remittances and Overseas Development Assistance. Such flows would represent the recycling of flows back to developing nations. However, a word of caution is in order. There is a disproportionate distribution of these flows back to Africa. The donor countries and multilateral banks use performance-based allocations that favour the "good performers". These countries are also the ones most favoured by private flows. There remains a challenge of directing flows to "poor performers" or countries under stress.

A similar pattern as that of current account deficits emerges for external reserves. In 2005, Africa's external reserves stood at \$168.9 billion while

Table 2 External Debt of Africa and Developing Asia, 2005
(in billions of dollars and percentages)

Debt Category	Africa	Developing Asia
Billions of dollars		
External Debt	289.4	808.3
Debt Service	34.3	107.5
Share of Exports		
External Debt	92.4	53.3
Debt Service	10.9	7.1

Source: IMF (2006).

that of developing Asia was \$1,167.5 billion or about seven times that of Africa. China accounts for over 70 percent of Developing Asia's reserves (\$822.6 billion). Nigeria and South Africa account for 77 percent of Africa's reserves, leaving only \$38.9 billion for the rest of Africa. Again, there is a very significant difference in reserves in favour of Developing Asia.

Table 2 shows that Africa's external debt outstanding stood at \$289.4 billion in 2005 compared to \$808.3 billion for Asia, representing 92.4 and 53.3 percent of exports, respectively. Debt service as percentage of exports stood at 10.9 percent in Africa in 2005 compared to 7.1 percent in Developing Asia during the same year. The above figures clearly reveal that Africa in a large part lacks an effective cushion in foreign exchange reserves cover to resist an international financial crisis.

Africa is more integrated into the global trading environment than into the international financial markets. Commodity exports account for a large share of their merchandise exports and in a large measure determine the variability in the current account position, foreign exchange reserves build-up, and the government's fiscal performance. Many of the countries depend on three or even fewer commodities for most of their export earning. This makes Africa very vulnerable to volatility and downward movements in prices. In the past three years or so, a number of oil- and metal-exporting countries have recorded very impressive growth rates and current account surpluses due the high oil and metal prices. In Africa, adequate commodity risk management is a bigger development challenge than adequate financial crisis management.

A steep rise in US interest rates would affect a large part of Africa through indirect channels. Firstly, the likely global recession would

Table 3 Annual Changes in the Terms of Trade of Africa and Developing Asia, 2001-2005

(in percentages)

	Africa	Developing Asia
2001	-3.2	-0.1
2002	-0.6	1.3
2003	1.7	-0.3
2004	4.1	-2.1
2005	13.7	-1.5

Source: IMF (2006).

reduce global demand and the demand for the continent's exports. Secondly, the more sophisticated economies of South Africa, Nigeria and Egypt would be adversely affected by the increased costs of accessing financing from global financial markets. This would in turn affect the rest of Africa through spillover effects.

Eichengreen and Park indicated that from their perspective, the trade channel is the most important channel in examining the implications of the global imbalances and the approaches to deal with them. Of particular interest is the argument that a wide current account deficit supports a high global aggregate demand and helps sustain and redistribute global growth. An unwinding of the trade deficit may lead to global recession in the absence of compensatory expansionary policies in Asia and Latin America. Table 3 presents annual percent changes in the terms of trade of Africa and Developing Asia. The terms of trade were clearly less favourable to Africa in earlier years than more recently, following the rise in the prices of non-fuel commodities in response to strong global demand. Any reversal in global demand toward the historical mean would bring more suffering in Africa than in Developing Asia. This is more so the case given increased Africa-US trade following the African Growth and Opportunity Act (AGOA) and Everything-But-Arms (EBA) initiatives.

In both the chapters by Eichengreen *et al.* (2006) and D'Arista *et al.* (2006), there is extensive discussion of options for counter-cyclical policies that could be considered by developing countries individually or as a group. But as indicated above, a number of the market-based policies recommended have limited applicability in Africa where the financial sector remains shallow and lacks sophistication. There is an

urgent need for the IMF to probe these ideas further with a view to designing counter-cyclical policies applicable for countries in Africa.

4 Conclusion

From the analysis above, which has shown differing economic situations and experiences in Africa and Asia, it would be inappropriate to generalise on the implications of global balances and its adjustment approaches. Indeed, both country and regional analysis would be helpful in prescribing relevant and feasible policy actions. In addition, apart from a coordinated policy approach referred to earlier, the time is ripe for a reform of the international financial architecture to design more effective counter-cyclical measures plus oversight and regulation of the global financial system. In the case of Africa, there is an urgent need to design instruments that assist in mitigating the risk in highly volatile commodity markets. Previous efforts failed partly because they neglected long-term market trends or were based on only governments buying the insurance cover. There were also cases when disbursements from emergency schemes were not time sensitive. There is need for mechanisms that can supplement commercial systems of shock prevention designed to deal with all shocks as opposed to individual risks.

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3

East Asia's Role in Resolving the New Global Imbalances

Masaru Yoshitomi, Li-Gang Liu, and Willem Thorbecke

The world economy hangs in a precarious balance. The current account deficits of the United States have grown from 2 percent of GDP in 1997 to 4 percent in 2002 to 6.5 percent in 2006. It is doubtful that massive US borrowing financed by foreign monetary authorities can be sustained. If America's net external debt continues along its present trajectory, it will asymptote to 120 percent of GDP. As Obstfeld and Rogoff (2004, 2005) discuss, few countries have accumulated this much foreign debt without experiencing a crisis. If foreign central banks stop channelling resources into low-yielding US Treasury bonds, the value of the dollar would tumble. This could produce a large correction in the US trade deficit. Such a correction could destabilise the global economy, given the role that the US has played as an engine of growth.

The US deficit accounts for 70 percent of the world sum of current account deficits, implying that America absorbs 70 percent of net available global saving. In contrast, East Asian surpluses account for almost half of the world sum of current account surpluses, implying that the region provides almost half of the net global saving available to world capital markets. Thus, if the global economy is to be rebalanced, East Asia will have to play a significant part in the adjustment process.

The contours of the adjustment process for the US and East Asia are clear. First, the US should increase domestic saving (S) relative to investment (I). Second, East Asia should increase I relative to S. Third, these changes in I and S will necessarily be accompanied by exchange rate depreciations of the US dollar and appreciations of East Asian currencies in order to accommodate external adjustments and to simultaneously

help individual countries maintain external and internal balance.

For East Asia, there are several advantages to coordinated as opposed to unilateral exchange rate appreciations against the dollar. First, since about half of East Asian trade is intra-regional, a joint real appreciation against the dollar would cause effective exchange rates (EER) in the region to appreciate by less than half as much. The fact that the EER in Asia would increase by less than half as much implies that the recessionary impact would be attenuated and more able to be corrected by macroeconomic and structural policy measures. Second, the region is characterised by efficient production and distribution networks, with higher skilled workers in countries like Japan, Korea, and Taiwan producing intermediate goods and shipping them to China and ASEAN for assembly by lower skilled workers and re-export to the rest of the world. Stable exchange rates within the region would provide a steady backdrop for these regional production and distribution networks. Third, by reducing exchange rate volatility, stable intra-regional exchange rates can continuously increase FDI flows and hence encourage FDI-trade linkages. Fourth, policy coordination can prevent unpleasant outcomes such as “beggar-thy-neighbour” policies or “free-rider” problems that might arise because economies in the region are not only trading partners but also competitors in third markets.

It may thus be desirable for the region to coordinate the next round of exchange rate realignments relative to the dollar. As manifested by the East Asia Summits, countries in the region are determined to embrace further economic integration.

The purpose of this chapter is to identify the roles that both the US and East Asian countries can play in resolving the current global imbalances. To do this, we first discuss the nature (Section 1) and sustainability (Section 2) of the imbalances. We then recommend necessary external adjustment policies for the US (Section 3). Finally, we consider the role that East Asia can play, acting in her own interest, in rebalancing the global economy (Section 4) and draw conclusions (Section 5).

1 The Nature of the New Global Imbalances

The new global current account imbalances have emerged since 1997-98. Simultaneous US saving-investment deficits and East Asian saving-investment surpluses arose due to serendipitous and mirror-imaged patterns of capital flows and business cycles.

US Current Account Deficits

The US current account deficits in the late 1990s were driven by a domestic investment boom. Investment as a share of GDP averaged almost 3 percentage points higher over the 1997-2000 period as compared with the 1990-1996 period. Businesses invested heavily in information and communication technology. This in turn lowered production and management costs and increased total factor productivity (Bailey, 2003). Total factor productivity growth between 1995 and 2000 averaged 1.13 percent per year, after growing only 0.38 percent per year between 1973 and 1995. This increase in productivity growth lifted real rates of return. The NASDAQ Stock Index, for instance, rose 200 percent between January 1995 and its peak in March 2000. The Standard & Poors' 500 and the Dow Jones Industrial Average both rose more than 100 percent over this period.

Soaring stock prices in the late 1990s and soaring housing prices in the early 2000s raised spending relative to income and reduced private saving as a share of GDP. Econometric estimates indicate that a one hundred dollar increase in private wealth increases spending by about six dollars (see Belsky and Prakken, 2004). The US aggregate stock market capitalisation equaled about 100 percent of GDP in 1997 and more than doubled by 2000. As the US economy entered a recession in 2000-01, the Fed lowered the federal funds rate from over 6 percent to 1 percent. This raised housing prices. Housing wealth in 2000 equaled about 109 percent of GDP, and it increased by 48 percent over the next five years. These increases in wealth raised consumption and reduced saving. In 2006, the housing markets cooled down, but this was not reflected in consumption and investment figures.

Until 2001, fiscal policy had nothing to do with the decline in national saving in the US. Unlike in the 1980s, the initial deterioration of the trade balance in the late 1990s was associated with an improving budget balance and even with budget surpluses until the second half of 2001. Since the US recession of 2000-01, however, large US budget deficits have reappeared due to expansionary Keynesian fiscal policy and increased military expenditures. The fiscal balance shifted by nearly 6 percent of GDP between 2000 and 2004, moving from a surplus of 2 percent to a deficit of 4 percent. This deterioration in the fiscal balance was the proximate cause of the decline in national saving and the resulting further deterioration of the current account deficit after 2001.

East Asian Current Account Surpluses

While the US experienced an investment boom and a swing to current account deficits beginning in 1997, East Asia experienced the opposite. The 1997-98 Asian financial crisis can be characterised as a capital account crisis that could develop even in the presence of sound macroeconomic fundamentals. Short-term foreign bank loans that had been attracted by “miraculous” macroeconomic performance in East Asia exited rapidly and in massive quantities. In Thailand, the reversal of capital flows between 1995 and 1998 amounted to 16.8 percent of GDP and in Indonesia the change between 1996 and 1998 amounted to 13.4 percent of GDP (see Yoshitomi *et al.*, 2003).

Local banks and firms were badly exposed to these outflows. Before the crisis, they had borrowed short-term in dollars and invested long-term in domestic real estate and manufacturing projects. There was thus a double mismatch (a currency and a maturity mismatch) on their balance sheets. When the capital outflows caused local currencies to depreciate, banks' and firms' liabilities soared in domestic currency terms and their balance sheets were decimated. As domestic balance sheets deteriorated, financial intermediation was destroyed and investment spending by borrowers plummeted. This occurred not just because the intermediation system had become dysfunctional but also because the prolonged debt repayment process (including the restructuring of balance sheets and the shedding of excess capital) deprived firms of new investment opportunities.

While saving as a share of GDP has more or less remained stable in Asia, investment relative to GDP has fallen and remained low. The result has been large current account surpluses, standing in sharp contrast to current account deficits in crisis-hit economies before 1997. Real GDP growth rates fell from their “miraculous” pre-crisis levels of around 8 percent to 5 or 6 percent after the crisis subsided.

Exchange rates in emerging East Asia initially collapsed by 50 percent or so due to the massive reversals of private capital flows associated with the capital account crisis. Afterwards they remained about 20 percent on average below their pre-crisis levels. Low exchange rates have helped to keep Asian current accounts in surplus after the crisis.

The more or less similar pattern of stable saving, weaker investment, and depreciated exchange rates has also been seen in non-crisis Asian countries such as Singapore and Taiwan. Investment as a share of GDP plummeted in these countries after the crisis, causing the current account balances that were already in surplus before the crisis to improve further

after the crisis. In addition, exchange rates in these non-crisis countries are substantially lower now than before the crisis.

Under strong pressure for currency appreciation in recent years, East Asian central banks have kept exchange rates low by intervening in foreign exchange markets and purchasing US securities. Official holdings of US assets by foreign central banks between 2002 and 2005 have increased by more than \$965 billion out of a cumulative US current account deficit of \$2.46 trillion.

Emerging East Asian central banks in both the crisis-hit countries (Indonesia, Korea, Malaysia, the Philippines, and Thailand) and other countries (China, Singapore, and Taiwan) have accumulated foreign exchange reserves for the following reasons: (i) to be prepared for another capital account crisis characterised by massive reversals of short-term capital that can trigger both a currency collapse due to the drain on foreign reserves and a banking crisis due to the sharp increase in external liabilities on the balance sheets of banks and firms; and (ii) to maintain competitive exchange rates in order to sustain the export-oriented thrusts of their economies. The first objective was more important after the crisis, and the second objective has been more or less persistently important.

Japan has also accumulated reserves through foreign exchange market intervention, although for a different reason. It has sought to fight price deflation by preventing the yen from appreciating too much. It resorted to this only after having exhausted traditional Keynesian fiscal and monetary policy remedies as the public debt/GDP ratio approached 200 percent and short-term interest rates became zero after 2001.

The next section considers whether the current global arrangement, with the US running current account deficits that are financed largely by Asian central banks, will prove sustainable.

2 The Sustainability of the New Global Imbalances

The shortfall of saving relative to investment in the US has caused it to borrow trillions of dollars from private investors and Asian central banks, among others. A question of particular concern is whether the current equilibrium will remain stable, or whether the world economy will have to pass through a possibly painful adjustment process. The sustainability question can be divided into two parts: (i) the sustainability of large US deficits, and (ii) the sustainability of reserve accumulation by Asian monetary authorities.

The Sustainability of US Current Account Deficits

As the US runs current account deficits, it accumulates debt against the rest of the world. The sustainability of these deficits can be judged by considering whether foreign investors will willingly hold the amount of debt that the US must issue to finance her continued deficits. This analysis should take into account dynamic changes in interest rates and risk premia on US liabilities. Assuming that US current account deficits continue to equal 6 percent of GDP and that the underlying US nominal GDP growth rate equals 5 percent and that the net interest rate on net foreign liabilities remains negligible as it is now, net external debt will eventually reach 120 percent of GDP (6 percent/ 5 percent) in the long run.

These assumptions also imply that after 10 years net external debt will reach 65 percent of GDP, representing 18 percent of the wealth of the rest of the world. Such a level might be willingly held by international investors and thus be sustainable thanks partly to the key currency status of the dollar.

However, interest rate dynamics get progressively worse over time. Despite the fact that since 2004, US external liabilities exceed US foreign assets by more than 20 percent of GDP, until recently, net international investment income remained slightly positive for the US. This is because, up until now, investment income earned by US residents (mainly from equity investments including FDI abroad) has exceeded investment income paid by US residents (mainly on US bonds held by the rest of the world). However, recent data show that the US net international investment income became negative in 2006, suggesting that the turning point has been reached (Heath, 2007; Bergsten, 2007). Income yields on US liabilities have increased with rising US debt and rising interest rates, narrowing the difference between the yields on net debt and net equity.

Even assuming that the current rates of return on US investments abroad and foreign investments in the US remain unchanged, the massive amount of US liabilities that are projected to accumulate over the next 10 years will raise the net interest rate to almost 1 percent. In this case the long-run debt/GDP ratio would be 150 percent of GDP ($6\%/[5\%-1\%]$), equal to 40 percent of the net wealth of the rest of the world.

Notwithstanding the key currency status of the US dollar, it is implausible that foreign investors would hold such high shares (as exemplified above at 40 percent) of their total wealth in US assets without receiving a higher rate of return, especially if they feared that the dollar would depreciate. If after 10 years the required return on US

assets rose by only 1 percent, the eventual debt/GDP ratio would be greater than 300 percent of GDP ($6\% / [5\% - 3\%]$). This would exceed the total wealth of the US! Thus current borrowing levels in the US will at some point prove to be unsustainable.

If current account deficits remained below 3 percent of GDP, on the other hand, the eventual debt/GDP ratio would remain below 60 percent of GDP in the long run, which should be sustainable, particularly given the key currency status of the US dollar.

The Sustainability of Reserve Accumulation by Asian Central Banks

Foreign reserve accumulation by Asian monetary authorities increases base money and hence creates excess liquidity in the banking system. This in turn increases the money supply and exacerbates inflation. To offset this, central banks in the region have engaged in sterilisation policies. Sterilisation involves selling government bonds or central bank bills to keep the monetary base unchanged and to mop up excess liquidity in the banking system.

Sterilisation policy in East Asia has so far been largely successful in preventing money supply growth rates from accelerating. The CPI inflation rate has also remained low, between 1 to 3 percent per year.

However, there are still several difficulties associated with sterilisation operations. First, they cause commercial banks to hold more and more central bank bills, eroding bank profitability and interfering with the allocation of credit through the banking system. Second, sustained sterilisation may fail in the long run because, as the stock of central bank bills or government securities grows large, interest rates on these instruments may have to rise in order to induce investors to willingly hold them. Higher interest rates would then attract further capital inflows and defeat the purpose of sterilisation (the self-defeating hypothesis). Third, continued accumulation of US Treasury securities (external reserves) results in an increasingly inefficient allocation of resources since both private and social rates of return would be much higher for investments in the domestic economy.

3 Necessary Adjustment Policies in the US

How should the US respond to her own unsustainable external imbalances? Since the large US current account deficits originated from her

own I-S imbalances and account for three-quarters of total world deficits as already mentioned, the primary responsibility for resolving global imbalances rests on the US and her willingness to increase national saving. The importance of increasing national saving is reinforced by the fact that the dollar, after having depreciated since 2002, returned in 2005 more or less at its long-run average and thus is not greatly misaligned. Nevertheless, the current account deficit remains huge. This implies that US external imbalances are being driven by shortfalls of saving relative to investment in the US and not by overvalued exchange rates.

Increasing national saving would involve fiscal consolidation and also policies to reduce consumption in order to raise household saving rates. However, these absorption-reducing policies would be recessionary, particularly if such policies alone were assigned to external adjustment, and hence should be offset by switching policies to stimulate net exports. Therefore, a dollar depreciation, which increases net exports by changing the terms of trade between tradables and non-tradables in favour of the former, together with absorption-reducing policies, could help to both achieve and maintain external and internal equilibria (i.e. a sustainable current account balance and full employment with low inflation). If the dollar depreciated alone without any absorption-reducing policies, inflation could accelerate. Thus the optimal policy mix for the US would involve fiscal consolidation combined with a depreciation of the dollar.

If fiscal consolidation were not undertaken, however, market forces could drive the dollar down in response to the rising share of US assets in international investor portfolios (i.e. the aforementioned unsustainable US current account deficits). The weaker the fiscal consolidation initiated, the more the dollar could fall. While this depreciation process might well be benign and gradual, there is a risk that it could be sudden and precipitous.

Chinn (2005a, 2005b, 2005c) concludes based on estimates of price and income elasticities that a depreciation of the dollar, if not accompanied by a decrease in expenditures in the US or an increase in expenditures in the rest of the world, would be unlikely to substantially reduce the US trade deficit.

Obstfeld and Rogoff (2001, 2004, 2005) reach the same conclusion using a multi-country, intertemporal, general equilibrium model. They state that most theoretical and empirical models (including theirs) indicate that a 10 percent depreciation of the dollar would be associated with a reduction in the US current account deficit of around 1 percent of GDP. They

thus argue that reducing the current account imbalance to a sustainable magnitude would require not just a dollar depreciation but also a change in the level of expenditures (e.g. a decrease in consumption in the US).

There are two policy steps that the US can take to adjust domestic absorption. First, it should seek to curtail speculative excesses in the housing market. Belsky and Prakken (2004) report that the increase in housing wealth has increased consumption by a substantial amount. Alan Greenspan (2003) also underscores the importance of housing equity in explaining the recent decrease in private saving. Continued interest rate increases by the Fed could have a salutary effect by checking the currently unsustainable rise in housing prices in the US. Second, the US can reduce its budget deficit. Increases in the budget deficit were the proximate cause of the large drop in national saving relative to investment after 2001. A decrease in the budget deficit could help to close this saving-investment gap.

Such I-S rebalancing policies would be consistent with further depreciations of the dollar in order to reduce the current account imbalances. A 30 percent depreciation of the dollar accompanied with I-S adjustment policies in the US would go a long way towards reducing the presently unsustainable US current account deficit of 6 percent down to a sustainable level of about 2.5 percent of GDP. We thus take as a working hypothesis that the dollar should depreciate by 30 percent.

4 East Asia's Role in Resolving the Current Global Imbalances

Basic Rationales for Concerted Appreciations

How should East Asian countries respond to the risky scenario of a 30 percent depreciation of the dollar, as implied by the aforementioned working hypothesis? Concerted action to maintain mutual exchange rate stability in the region would be helpful for the following reasons: First, since intra-regional trade accounts for about half of total trade, concerted increases of East Asian currencies against the dollar would attenuate effective exchange rate changes in the region. This in turn would mitigate the recessionary impact if Asian currencies appreciated against the dollar. Second, exchange rate stability in the region would encourage continued FDI flows and provide a stable backdrop for regional production and distribution networks which have been the basis for the high intra-regional trade share. By allowing fragmented

production blocks to be allocated across countries based on comparative advantage, these networks have acted as an engine of growth. Of course, the comparative advantage of individual countries and thus these production networks themselves will change dynamically over time. Third, it would help overcome prisoner's dilemma problems that arise because the fear of losing competitiveness relative to Asian trading partners sometimes prevents countries in the region from allowing their currencies to appreciate.

We briefly discuss intra-regional trade patterns and prisoner's dilemma problems below before considering the appropriate policy mix for East Asia and ways of overcoming these coordination problems.

Triangular Trading Patterns in East Asia

A high degree of economic interdependence in East Asia, with intra-regional trade accounting for about half of total trade, is based upon intricate production and distribution networks in the region that have led to triangular trade patterns. FDI flows in East Asia have played an important role in strengthening the international production networks, reducing costs, and transferring technological know-how. Japan, Korea, Taiwan, and multi-national corporations in ASEAN produce sophisticated technology-intensive intermediate goods and capital goods and ship them to China for assembly by lower skilled workers. The finished products are then exported to markets throughout the world. These processed exports account for 55 percent of China's total exports. The lion's share of China's processed exports is from FDI enterprises. Trade within these networks can be classified as vertical intra-industry trade (VIIT).

VIIT differs both from the exchange of final goods emphasised by traditional trade theory for vertical inter-industry trade between the North and the South (e.g. between capital goods and apparel) and for horizontal intra-industry trade between the North and the North (e.g. between two differentiated types of automobiles). VIIT allows the production processes of an industry (e.g. the electronics industry) to be split into fragmented production blocks that can be located in different countries. Production blocks are allocated across developing, emerging, and developed economies in the region based on comparative advantage as determined by relative endowments of capital, skill, and labour and by physical and institutional infrastructure. VIIT has led to large efficiency gains and helped to make East Asia as a whole the manufacturing centre of the world.

Because of these trading networks, Chinese value added in processed exports appears small (about 20 percent) relative to the predominant costs of the intermediate goods imported from the rest of Asia. Thus a unilateral RMB revaluation would not affect much the dollar costs of processed final products and hence China's trade surplus. Furthermore, in the triangular trading patterns, China imports sophisticated intermediate goods essentially from East Asia but not from the US and exports final products all over the world, including to the US. Hence, these triangular trading patterns imply that bilateral trade imbalances between China and the US would remain large even if China's global trade surplus disappeared. One policy implication that follows is that it is totally inappropriate to demand a unilateral RMB appreciation simply because America's bilateral deficit with China is large.

Complementary and Competitive Trade Relations in East Asia

Because Asian countries compete with each other both domestically and particularly in third markets, they may not follow regional partners in exchange rate appreciations. As implied by the triangular trading patterns and by VIIT, relatively more developed East Asian countries export large amounts of technology-intensive capital and intermediate goods, while relatively less developed countries in the region export large amounts of low skill-intensive consumer goods. Therefore there is essentially a complementary relationship between China and less developed Asia on the one hand and developed Asia on the other. Furthermore, there is a complementary relationship between China and multinational corporations located in ASEAN that export sophisticated technology-intensive parts and components there for processing. In contrast, there is largely a competitive relationship between China and less developed Asian countries in labour-intensive consumer goods trade. Existing studies indicate that if one Asian country's exchange rate appreciates relative to other Asian countries' exchange rates, that country's exports (particularly of labour-intensive consumption goods) to third markets will fall.

All in all, elements of competition exist in any international trading relationship and hence fear of losing competitiveness relative to other countries may prevent individual countries from allowing their currencies to strengthen. This may explain the unwillingness of some countries in the region to allow their currencies to appreciate unilaterally. There could thus be a collective action problem or coordination failure: all

countries would be better off if their currency values increased together but individual countries sometimes resist such increases because they are suspicious of whether other countries will allow similar increases.

The Appropriate Policy Mix for the Region

In view of (i) the high ratio of intra-regional trade to total trade, (ii) the intricate production and distribution networks, and (iii) the need to overcome coordination failures, concerted action to maintain mutual exchange rate stability among Asian currencies would be beneficial. One form of concerted action would be for all countries in the region to appreciate more or less jointly against the dollar under the aforementioned working hypothesis. However, this concerted appreciation would not sufficiently take into account individual differences among economies (e.g. policy options, macroeconomic variables, trade/GDP ratios, and structural factors) and would also ignore the actual appreciations of some Asian currencies since 2002. How can the benefits of concerted action be reconciled with the need to accommodate differences in individual economic conditions?

Since concerted action is aimed at mutual exchange rate stability, currencies that have not appreciated while the dollar fell between 2002 and 2005 should catch up with currencies that have already appreciated. This catch up would be achieved more easily if countries in the region adopted more flexible exchange rate regimes.

More flexible regimes could be characterised by two elements: a multiple currency basket-based reference rate instead of a dollar-based central rate, and a wider band around the reference rate.

These two elements would provide policymakers with greater flexibility in managing the speed and magnitude of any necessary appreciation while still taking into account their own individual economic conditions.

A free float would cause exchange rates to more accurately reflect market fundamentals. However, given the shallow and narrow domestic capital markets in some East Asian economies, a free float for some countries would generate excessively volatile exchange rates and harm economies in the region that are highly exposed to fluctuations in international trade.

We thus advocate neither a free-floating regime nor a fixed dollar peg but rather greater exchange rate flexibility in the context of a multiple currency basket-based reference rate with a band. If individual

countries adopted greater flexibility in this way, a dollar depreciation under the working hypothesis would tend to produce appreciations across the region and keep mutual real effective exchange rates among Asian currencies relatively stable.

Greater flexibility would benefit China for a couple of reasons. First, China will begin to increasingly face de facto capital account convertibility with the free entry of foreign banks and other financial institutions for renminbi-based financial activities due to the terms of her WTO accession commitments. In this case, wider bands would enable her to maintain greater monetary policy autonomy in the face of volatile capital flows. Second, increased flexibility would provide Chinese banks and traders with experience in managing exchange rate risk and allow Chinese forward markets and related infrastructure to develop quickly. At the same time, China should purposefully build needed financial institutional infrastructure (e.g. prudential regulation, supervision, accounting, a credit culture, etc.) as quickly as possible so that she can accommodate greater flexibility in the very near future.

If Asian countries allowed their currencies to appreciate instead of accumulating reserves, it would have a recessionary impact. This could be offset by appropriate macroeconomic and structural policies. Switching policies such as exchange rate appreciations thus need to be combined with absorption-increasing policies.

Absorption-increasing policies include employing fiscal and structural policies to build both physical and human infrastructure (particularly in rural areas) and using deregulation to promote competition and productivity growth in the non-tradable sector. These policies could promote production for domestic markets and thus rely more on domestic markets rather than exports to create jobs.

Combining expenditure-increasing policies with expenditure-switching policies would thus be the appropriate policy mix for Asian countries that had previously accumulated massive reserves. On the one hand, without exchange rate appreciations, policies aimed simply at increasing domestic demand could produce overheated economies. On the other hand, without policies to increase domestic demand, exchange rate appreciations would be contractionary. Only by combining these two, namely by implementing an appropriate policy mix, could Asian economies move away from excessive reserve accumulation and simultaneously achieve external and internal equilibria in their own interests. These policies would also contribute to easing global imbalances, thus providing a harmonised way of advancing regional and international interests.

5 Conclusion

The present global imbalances cannot be sustained indefinitely. The primary step necessary to resolve them is for the US to increase domestic saving. Absent I-S imbalance corrections in the US, the dollar could depreciate substantially due to the excessive amount of dollar assets in the portfolios of international investors as explained in Section 3. This decline could be gradual and benign, but it could also be sudden and precipitous.

In the face of an incipient depreciation of the dollar as a risk scenario, Asian countries ought to engage in concerted action to keep exchange rates as stable as possible given their individual economic differences. This could be done if countries with less flexible exchange rate regimes adopted more flexible regimes characterised by a multiple currency basket-based reference rate and a reasonably wide band. The challenge for East Asian policymakers is to harmonise exchange rate policies in this way.

Policy coordination to stabilise effective exchange rates mutually in the region through selecting more flexible exchange rate regimes would provide several advantages. First, concerted exchange rate changes against even a relatively large drop in the dollar's value would reduce the magnitude of "effective" exchange rate increases in East Asia, since about half of trade is intra-regional. This in turn would minimise the deflationary effect of a rise in the value of Asian currencies against the dollar. Second, exchange rate stability would facilitate the flow of FDI and preserve production and distribution networks in the region that have exploited comparative advantage and functioned as an engine of growth. These networks will change, though, as the comparative advantage of countries change over time. Third, it should help overcome prisoner's dilemma problems that prevent individual countries from allowing their exchange rates to rise unilaterally, even when joint increases would be mutually beneficial.

Exchange rate increases should be accompanied by absorption-increasing policies. These would offset the recessionary impact of the currency appreciations and also be consistent with the new economic strategy in East Asia of encouraging domestic demand rather than relying excessively on net export expansion.

In coordinating exchange rate policy, a regional forum would be helpful. A regional forum could develop the needed surveillance mechanisms and peer pressure in the context of exchange rate coordination policies

aimed at stabilising mutual exchange rates among East Asian economies, which would in turn promote continued economic integration.

The East Asian Summits should be an appropriate venue to begin discussing policy options along the lines spelled out here, in order to advance the interests of countries in the region.

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4

An African Perspective: Comments on Yoshitomi, Liu and Thorbecke

Brian Kahn

Some of the arguments and prescriptions that came out of the chapter by Professor Yoshitomi *et al.* were similar to what came out of the discussions on the papers by Eichengreen and Park, and D'Arista and Griffith-Jones. In line with these and other papers included in the previous volume,¹ the prescription by Yoshitomi *et al.* is that the United States should be increasing domestic savings primarily through fiscal consolidation as well as by implementing policies to reduce consumption to raise the household savings rate. To prevent a recession in the US, a depreciation of the dollar is required to bring about expenditure-switching to stimulate net exports. If a decline in absorption is not achieved, the depreciation would be substantial and inflationary. At the same time, the Asian countries should allow their currencies to appreciate in the context of some form of concerted action in order to prevent a recession through increased absorption.

1 The Investment-Savings Balance and Exchange Rate Policies

Let me raise a number of points on the chapter by Yoshitomi *et al.* First, I agree with the emphasis on the investment-savings balance as well as exchange rate issues. It is not just one or the other, and I think this focus

¹ *Global Imbalances and the US Debt Problem: Should Developing Countries Continue to Support the US Dollar?*, edited by Jan Joost Teunissen and Age Akkerman, FONDAD, The Hague, 2006.

makes it clear that it is not simply a US problem or an Asian problem, but a combined problem. But what I feel is missing is how Europe fits into the picture. Obviously, the focus of the chapter is on East Asia and the US, but I think, following the earlier discussion of the paper by Jan Kregel, that Europe plays an important part in the adjustment process. Furthermore, Japan is also missing from the discussion. Japan is important in Asia and it would be important to explain Japan's role in the adjustment process. It would also have been interesting to have seen some differentiation between the different countries in Asia and the respective policies that they should follow. The prescription for Asia assumes that all countries are more or less in the same situation, but as was pointed out in the earlier discussions, China has a high investment rate, whereas a number of the other Asian countries suffered a collapse of investment in the wake of the Asian crisis. It would have been useful to see some differentiation in policy prescriptions to understand exactly what policy should be followed. In particular, I would like to ask whether all countries need to expand their fiscal policies and to what extent some of them are constrained in this respect. We saw in the paper by Eichengreen and Park, that the room for manoeuvre with fiscal policies was constrained in certain countries, for example Indonesia and Philippines, and in some countries it is more difficult than others. What would seem to be a very sensible solution for China isn't necessarily the same for a number of these other countries.

The second issue that I wish to raise relates to the exchange rate. Firstly, it is asserted by Yoshitomi *et al.* that although the United States current account deficit remains high, the dollar is not overvalued. This is on the basis that the dollar is more or less at its long-run average and therefore not misaligned. It is always difficult to calculate the equilibrium real exchange rate. As we know, the equilibrium level can change in response to changes in the fundamental determinants such as productivity changes and other structural changes, both in the United States and Asia. I would have thought that some notion of the sustainable current account deficit would also be relevant. If the underlying assumption in the chapter is that the current account deficit in the US is not sustainable, I would have thought that this would imply that the US dollar is currently overvalued or misaligned. Furthermore Yoshitomi *et al.* argue that a 30 percent depreciation on an effective basis is required, which suggests that the dollar is in fact currently misaligned.

With respect to the East Asian exchange rates, even though China did not devalue in the wake of the Asian crisis and the other countries

have not gone back to pre-crisis levels, there nevertheless appears to be a strong case for arguing that there is an undervaluation of the Chinese yuan. We saw, for example, in the paper by Fan Gang (in the previous volume) that unit labour costs in China were in fact falling as wage gains have not kept pace with productivity increases. Similarly, the idea that real exchange rate adjustment would take place through relative inflation changes has also not materialised. Inflation in China has remained low.

In our discussions, we have been concentrating on the implications of these developments for global imbalances with a focus on the US, the euro area and Asia. However, there are also important implications for African countries, which generally tend to be forgotten about. I think that the point that is raised by Yoshitomi *et al.* about intra-industry vertical trade is very insightful. However, from an African perspective, what is of concern is the area where China competes directly with Africa in third markets and in African home markets. These are generally the wage goods markets. So it is not the intra-industry, highly sophisticated goods that are the problem, but rather those goods that are highly labour-intensive, in particular clothing, textiles and footwear. These industries have been negatively affected in many African countries. Although some would argue that perhaps African wages should be reduced, it is difficult to reduce wages that are already extremely low. We have experienced this in South Africa as well.

A further issue relating to the exchange rate is the prescription of what countries should do with respect to concerted movements of the exchange rate. There are a number of good reasons to argue for a coordinated response. From what we heard in the discussions, it appears to me that there are a lot of potential problems relating to exchange-rate stability and coordination which have been glossed over. From what I understand, Japan would not want to be part of this because the yen is already floating, but there are likely to be political economy problems that may be extremely difficult to coordinate.

2 Systemic Crises and Concerted Action

A further comment relates to the issue of how long imbalances can persist. It is argued in the chapter that the resolution could be very quick, that it could be benign or that it could go on for some years depending on a whole range of assumptions. This uncertainty creates a

potential problem for the whole adjustment process and undermines the chances of achieving concerted reforms of the international global architecture. There is a strongly held view that capital markets are now broader and deeper than ever, and are therefore likely to be far more resilient in the face of adjustments to global imbalances. The belief is that ultimately things will work themselves out in the adjustment process. So although there may be a recognition of the problem, the sense of urgency is not there. I think we have seen from experience that concerted global action usually only comes when we are already in a crisis. Very often things do work themselves out before any major reforms can be agreed upon. It is only when we find ourselves in a real systemic crisis that we tend to move towards global solutions. This implies that the longer the global imbalances continue in a benign way, the more complacent we are likely to be.

3 Accumulation of Foreign Reserves

The final point that I want to pick up on is the question of reserve accumulation. Yoshitomi *et al.* have made it quite clear that reserve accumulation has gone beyond what is required for precautionary motives. The other issue they emphasised is the need to maintain a competitive exchange rate. In terms of foreign reserves, there is no doubt that China has more reserves than necessary for maintaining a competitive exchange rate. There are other interpretations of why the Chinese have pegged to the dollar. There is the Dooley, Folkerts-Landau and Garber² argument that China's foreign reserves act as a collateral that reduces political risks. I think what is interesting in the Dooley *et al.* study is the focus on how long reserve accumulation can persist. In the opposite case, when a country is losing reserves, we know that a crisis will come about, that there will be a depreciation of the currency and there has to be some adjustment. What they found is that in all instances of reserve accumulation there has never been a speculative attack that has caused an appreciation and a need for adjustment. The Chinese have been able to control inflation and there doesn't seem to be any particular

² Michael P. Dooley, David Folkerts-Landau and Peter M. Garber (2004), "The US Current Account Deficit and Economic Development: Collateral for a Total Return Swap", NBER Working Paper No. 10727, National Bureau of Economic Research, Washington D.C., September.

pressure for the whole process to end. I am a little bit concerned that the issue can last for quite some time, so that the pressures to end this reserve accumulation are not necessarily there, unless there is something that forces China to move on that front.

4 Concluding Remarks

The chapter by Professor Yoshitomi *et al.* has highlighted the need for adjustment in both China and the United States, and the need for concerted action on exchange rates. Unfortunately, the pressures on surplus countries are not symmetrical to those of deficit countries, and in this instance the major deficit country, the United States, can sustain its deficit as long as the surplus dollars in Asia are recycled back to the US. I am therefore pessimistic that an orderly exchange rate adjustment will take place in the near future. In the meantime peripheral countries, including those in Africa, will continue to suffer the consequences.

5

Rebalancing Savings-Investment Gaps in East Asia

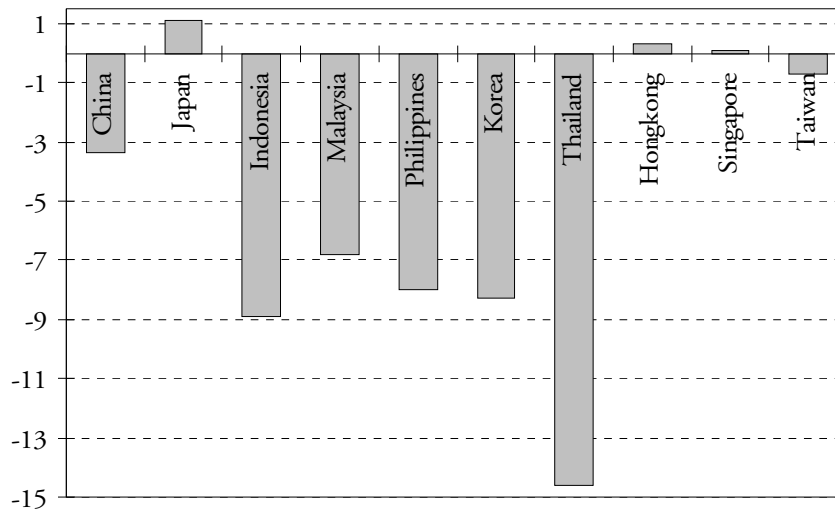
Yonghyup Oh and Seeun Jeong

Yoshitomi, Liu and Thorbecke address three issues in their chapter: the magnitude of global imbalances, their sustainability and what the United States and East Asian countries can do to resolve them. The chapter concludes that these imbalances are already too large (the US current account deficit is 6.5 percent of GDP in 2006), and cannot be sustained. The East Asian current account surpluses as well as reserve accumulations are not sustainable and East Asia can no longer finance US debt. Yoshitomi *et al.* explain that the optimal policy mix for the United States would involve recessionary fiscal policies with dollar depreciation. For East Asian countries, the authors propose a policy mix of a simultaneous currency appreciation and absorption-increasing policies. The chapter was written primarily from an East Asian perspective, as the authors' policy focus is on East Asia.

The recent appreciation of some East Asian currencies and the slowing pace of reserve accumulations of East Asian economies could be seen as signs toward a balance. However, East Asia's still-increasing trade balance with the United States and the high savings surplus relative to investment in most East Asian countries certainly point to the fact that the magnitude of imbalances is not diminishing.

Yoshitomi *et al.* argue that a simultaneous currency appreciation by East Asian economies would be the most effective way to resolve the imbalances. However, Figure 1 and 2 indicate that the trade balances of the US with Asia do not show any signs of improvement despite currency appreciation. In addition, those currencies that have sharply appreciated – the Thai baht and the Korean won – are recovering, while

Figure 1 Exchange Rates Changes with Respect to the US Dollar in East Asia (end-2005 to end-2006)
(annual change in percentages)

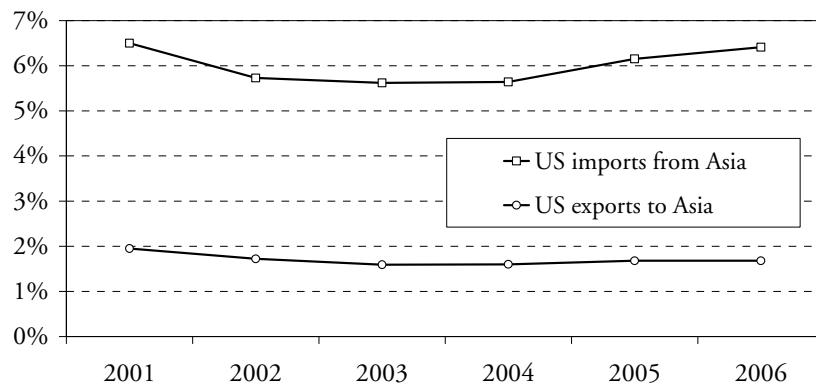


floating currencies that have actually depreciated with respect to the US dollar such as the Japanese yen are not yet showing signs of appreciation. The currency appreciation of most East Asian economies has not seemed to help in resolving global imbalances. How much exchange rate adjustment would suffice to turn the imbalances? Will East Asian economies be willing to make a commitment to simultaneous appreciation?

The role of China is very important, as their trade surplus with the United States is the largest among the East Asian economies. The picture may drastically change if China reacts by, say, floating its yuan. Yoshitomi *et al.* argue that the trade relations between China and other East Asian economies are a reason for concerted appreciation: China is a deficit economy in trade with respect to other East Asian economies and much of Chinese exports are processed goods that use imported goods from other East Asian economies. Thus Yoshitomi *et al.*'s argument can be rephrased to say that Chinese goods are in fact not purely Chinese, but rather East Asian, and that the imbalances caused by trade imbalances between the United States and China need to be taken as an East Asian responsibility, not just China's responsibility.

Yoshitomi *et al.* cover a wide spectrum of issues, and their policy suggestions are relevant. Concerted exchange rate appreciations would,

Figure 2 Recent Trade Balances Between the US and Asia
(as percentage of United States' GDP)



Note: 2006 is up to November.

Source: IMF, Direction of Trade Statistics, 2006

if done, be very effective. However, we doubt whether East Asia is ready for this type of arrangement, at least in the short run, considering the differing impacts of external shocks on East Asian economies due to an enormous degree of heterogeneity across East Asian countries. Below we would like to argue that market-driven initiatives are as important as exchange rate arrangements in East Asia and should be taken as necessary steps to achieve a concerted exchange rate arrangement.

1 Should East Asian Capital Be Relocated Within the Region?

As the high level of savings relative to investment in East Asia is, as far as East Asia is concerned, the principal source of global imbalances, policy measures to directly reduce this gap would be desirable. Table 2 shows that the savings-investment gap evaluated at the regional level has increased: the GDP-weighted average gap of nine East Asian economies, exclusive of Japan, were 2.92 and 4.63 percent of regional GDP in 2003 and 2005 respectively.

Fixing the so-called investment-savings mismatch so that investment and savings move in opposite directions has been demanded of both East Asia and the United States; this would require East Asia to make an upward shift in investment relative to savings while the United States would have to do the exact opposite. A large portion of the US current

Table 1 The Savings-Investment Gap in East Asia as a Percentage of GDP

	1990	1995	2000	2003	2005
Taiwan	4.5	0.6	1.5	6.3	2.8
Thailand	-7.1	-4.8	10.4	7.9	-2.2
Singapore	6.9	16.1	15.9	33.3	30.0
China	4.0	1.7	2.6	-1.7	2.8
Philippines	-5.5	-7.9	-3.9	1.4	4.4
Malaysia	2.0	-3.9	20.0	21.1	23.5
Korea	-0.5	-1.1	2.9	3.4	3.2
Indonesia	1.5	-1.3	9.5	5.5	4.1
Hong Kong	7.6	-5.5	3.6	8.7	12.5

Note:

1990–2003 are from Yoshitomi *et al.*

Source: Key indicators, Asian Development Bank.

Table 2 The Savings-Investment Gap in East Asia as Percentage of Regional GDP

	2003	2005
Taiwan	0.28	0.12
Thailand	0.35	-0.09
Singapore	0.96	0.84
China	-0.87	1.52
Philippines	0.03	0.10
Malaysia	0.68	0.74
Korea	0.65	0.60
Indonesia	0.40	0.28
Hong Kong	0.43	0.53
Total GDP-weighted average	2.92	4.63

Note:

Calculated from Table 1 with nominal GDP in US dollars. The GDP of the above countries comprise the regional GDP.

account deficit is accounted for by the surplus in East Asian countries; this phenomenon clearly shows how the mismatch in the investment-savings ratio creates a global imbalance between the two regions. On the balance sheet, these imbalances are recorded as high foreign reserve levels in East Asian countries, which leads to the depreciation of the US dollar vis-à-vis East Asian currencies.

Regarding this issue, it would be unfair to leave the entire task of encouraging firms to increase domestic investment up to policymakers since the current level of domestic investment is probably just an outcome of best practice business methods. Because markets for domestic capital have these inevitable limitations, it would be interesting to turn to markets for capital in other East Asian markets, namely East Asian real capital markets, for capital coming from other East Asian economies. A real capital market is a market in which a company's direct investment is traded; therefore, unlike equity capital or money market capital, this type of capital is heavy in transactions, slow in the execution of cross-border trades and is not very reversible. The good part is, when the markets are integrated, firms will find it easier to allocate their resources more effectively. For instance, if companies are earning unequal rates of return from domestic and foreign investment, then *ceteris paribus*, capital will be allocated in such a way that greater profit is earned from foreign investment. This will not only increase the efficiency of investment, but also stimulate economic growth in East Asian countries.

Since the 1990s, trade in goods has increased significantly in East Asia, leading to greater economic integration. China has been a driving force behind this new trend. However, despite considerable achievements in trade, studies show that the integration of financial markets in East Asia is sluggish at best and it has even been suggested that East Asian markets have become more dependent on the United States in recent years (Jeon *et al.*, 2006). However, as studies show, it is generally easier to cooperate regionally, as market forces seem to work better at that level. Thus, real capital market integration will help increase regional investment and may have the potential to bring extra growth to the region. This is generally accompanied by financial market integration and it is likely that monetary cooperation in East Asia will eventually be needed.

Table 3 shows how different the country rates of return for real capital are in East Asia. The rates of return are controlled for their respective risk profiles using a simple CAPM relation: a rate of return is

Table 3 Risk-Controlled Rates Of Return Of East Asian Firms

	1996–2004(Reg. 1)		96, 99–2004 (Reg. 2)		1999–2004 (Reg. 3)	
	Coefficient	t-stat	Coefficient	t-stat	Coefficient	t-stat
$\beta_{i^*}(\rho_{mt}-r_t)$	1.38	9.57	1.37	0.25	1.39	5.2
Japan	-0.76	-2.06	-0.03	0.33	0.57	1.54
Hong Kong	-0.34	-0.6	0.03	0.51	0.44	0.77
Korea	-6.49	-13.29	-2.42	0.44	-1.15	-2.34
Singapore	-0.21	-0.35	0.33	0.53	0.47	0.8
China	-4.02	-5.56	-3.15	0.64	-1.87	-2.58
Indonesia	-13.09	-22.54	-6.14	0.52	-5.97	-10.25
India	-0.71	-1.48	-0.16	0.43	-0.39	-0.8
Malaysia	-0.81	-1.61	-0.66	0.45	-0.96	-1.91
Philippines	-8.67	-10.84	-7.24	0.71	-7.62	-9.48
Thailand	-6.38	-11.65	0.52	0.49	1.11	2.01
No. Obs.	19356		15059		12904	
R ² adjusted	0.12		0.08		0.08	

Note:

Returns are firm level ROA's from DataStream. See eq. (1) in the annex for the full specification.

$\beta_{i^*}(\rho_{mt}-r_t)$ represents the compensation of the intrinsic risks of firm i .

Sector and year dummies are included in the regressions to control the sector and the time effects, which are not reported here.

compensation for the risk the underlying asset has with respect to market rates. The underlying asset is the firm value and the market is East Asia. We use firm-level rates of return (return on asset or ROA) converted to the same currency – US dollars – with national inflation controlled. Rates of return are thus real – expressed in US dollars. ROA is a measure of firm performance valid for capital providers to the firm regardless of the type of the capital, equity, loans, bonds or their derivatives. It is based on a firm's business performance. Thus it differs from the price earnings ratio (P/E) that is based on a firm's performance in the stock market or return on equity (ROE), which is return from firm's businesses attributed only to equity holders. As investment in this chapter refers to both real business investment as well as financial investments, ROA is appropriate. This is the empirical

Table 4 Should East Asian Capital Be Relocated Within the Region?

	S-I gap 2005	Pressure on capital flows	Country rates of return 1999–2004	Pressure on capital flows	
Singapore	29.98	Push+++	Thailand	1.11	Pull++
Malaysia	23.50	Push+++	Japan	0.57	Pull+
Hong Kong	12.47	Push++	Singapore	0.47	Pull
Philippines	4.37	Push+	Hong Kong	0.44	Pull
Indonesia	4.10	Push+	Malaysia	-0.96	Push+
Korea	3.17	Push+	Korea	-1.15	Push++
China	2.84	Push	China	-1.87	Push++
Thailand	-2.23	Pull	Indonesia	-5.97	Push+++

Note:

+ signs indicate the subjective degree given by the author.

framework used in De M n l (1999) for European real capital markets. The detailed model specification and the data description are given in the annex.

Due to a lack of available data on Chinese firms prior to 1996, our analysis begins from that year. The three regressions are: including the crisis period, not including the crisis period and including only the post-crisis period, respectively. The rates of return are well-modeled for regression (1) and (3), but not for (2), as the risk prospects represented by $\beta_{i,t}(\rho_{mt}-r_t)$ are very significant in (1) and (3). This leads us to suppose that the crisis may not have affected the East Asian capital market system to such a degree that a deletion of the crisis period might distort the picture of the East Asian capital market. Table 3 shows the levels of country rates of return after firm-level profitability ratios are controlled for their risks. The discrepancy across country rates of return is not small, both for the post-crisis period as well as for the whole period. This discrepancy should trigger capital movement in East Asia, helping to rebalance the savings-investment gaps in the region.

Country rates of return together with the savings-investment gaps can be interpreted as push-pull factors of cross-border capital flows. Countries with higher rates would attract foreign capital (pull) *ceteris paribus*, while savings-affluent economies would look for better investment opportunities abroad (push).

Table 4 indicates that East Asian markets are more attractive than their savings-investment gaps would indicate. There are significant pulling factors within the region. For instance, all the other countries are attractive destinations for Indonesian capital. Thailand is the only country with a higher investment ratio to savings and highly positive rates of return. Her capital market is therefore pulling. This coincides well with the fact that the Thai baht has recently been the most appreciated currency in East Asia. However, low returns may not just imply that the country needs to export capital to countries of higher return; in particular, Malaysia and Korea may do well to export their capital further, but too-low returns for Indonesia might suggest instead that she try using industrial policies to improve domestic firm competitiveness first.

While the other countries are in the position of being capital abundant, Japan, Singapore and Hong Kong show market pulling characteristics. This is a complex phenomenon and it would be too simplistic to say that their capital should be mobilised internally. It is not always easy to mobilise capital within a country from savings-created industries to high-yield industries. The suggestion that Japan internalise its capital while allowing more capital imports from abroad would probably be more reasonable. This implies that there is room for appreciation for the yen, the only East Asian currency that has been consistently depreciating in recent years. In short, Tables 4 and 5 seem to suggest that East Asian countries can gain by mobilising more of their capital between them to rebalance the savings-investment gaps in East Asia. This will help in resolving global imbalances.

2 Barriers to Capital Market Integration in East Asia

One of the reasons why financial capital generated in East Asia has been bound for the US market is because the US market is very mature and offers sound investment returns. This is certainly not the case in East Asia. Aside from Singapore and Hong Kong, there is no market in East Asia that can compete with US financial centres. Furthermore, there is no anchor currency in East Asia to match the US dollar. After the crisis with abundant financial capital, East Asia needed dollar-denominated assets. However, the level of dollar reserves has reached a very high level and the US dollar has been losing its competitiveness somewhat as an international currency as the macroeconomic stability of the United States erodes. East Asia could be described as passive in

its reserve accumulations and capital outflows to the United States in the post-crisis era, and the region can now take the initiative by making efforts to rebalance savings-investment gaps.

This section attempts to see what factors serve as hurdles to cross-border capital movements. When national capital markets are completely integrated, capital is completely free to move across national borders. Departures from this state of integration are captured by country effects. The diminution of the country effects implies that markets are integrating and cross-border capital flows would increase in the process. Note that cross-border mergers and acquisitions have increased in Europe in the course of the integration process leading to EMU and with the inclusion of new EU members from Eastern Europe. Oh (2006) lists several variables to show that heterogeneity in East Asia is a hurdle to achieving monetary coordination. Some of these variables were used in Lemmen and Eijffinger (1996) and others in La Porta *et al.* (2000). Lemmen and Eijffinger studied the interest rate parity relation to test the progress of European financial integration and found that some macroeconomic factors, such as inflation, liquidity, current accounts, seignorage, openness, domestic credit, etc., indeed account for the cross-country interest rate disparity among EMU countries. La Porta *et al.* show that the degree of legal protection of stockholders and creditors has impacts on the efficiency of corporate governance and performance, which can influence returns.

We have tried to use as many variables we could gather for East Asia to test how relevant these variables were in accounting for country effects as barriers to integration. However, due to a lack of public data for these countries, we were confined to the use of only a few variables, which we classify as either macroeconomic or institutional. The macroeconomic variables included are *CA* (current account balance as a percentage of GDP), *Credit* (domestic credit as a percentage of GDP), *GDPR* (GDP growth in percentage), *INF* (inflation in percentage), *M1* (= $M1/GDP$), *M2* (= $M2/GDP$), *M2M1* ($M2/M1$), and *Openness* [= (Exports + Imports)/GDP]. *M1* is defined as “currency in circulation + holdings of sight deposits” and *M2* as “*M1* + holdings of time deposits.” Institutional factors include shareholder protection, creditor protection and efficiency of the judicial system, values of which are obtained from La Porta *et al.*

The results are presented in Table 5. Regression 1 is the output we get when only macroeconomic factors are included in the regression as explanatory variables. In Regression 2 only institutional factors are used.

Table 5 Real Capital Market Integration in East Asia and Impediments

	Regression 1		Regression 2		Regression 3	
	Coefficient	t-stat	Coefficient	t-stat	Coefficient	t-stat
$\beta_{i^*}(\rho_{mt}-r_i)$	1.39	5.19*	1.42	5.25*	1.43	5.34*
CREDIT	0.57	1.04			-0.77	-1.09
M2	-0.96	-2.60*			0.63	1.48
M2M1	-0.23	-4.04*			-0.27	-3.89*
GDPR	0.23	4.78*			0.38	6.16*
Openness	1.12	3.71*			0.38	0.96
CA	-0.21	-4.98*			-0.21	-4.10*
INF	-0.60	-10.84*			-0.51	-7.36*
Shareholder			-0.53	-2.66*	-1.19	-4.08*
Creditor protection			0.16	0.69	0.69	3.68*
Efficiency in judicial system			0.64	7.91*	0.62	4.81*
No. Obs.	12755		12665		12516	
Adj. R2	0.07		0.07		0.07	
F-stat.	34.02		35.41		33.88	

Note:

* refers to the variables that are significant at the 95% level. See eq. (2) in the annex for the full specification. The sample period is 1996-2004. Time and sector dummies are included in the regressions, the results of which are not reported here. Credit (domestic credit as a percentage of GDP), M1 (= M1/GDP), M2 (= M2/GDP), M2M1 (M2/M1), GDPR (GDP growth in percentage), Openness (= (Exports + Imports)/GDP), CA (current account balance as a percentage of GDP), and INF (inflation in percentage) are averages of annual figures from 1996-2004. M1 is defined as "currency in circulation + holdings of sight deposits" and M2 as "M1 + holdings of time deposits" and are calculated by the author from national sources. The values of the other three institutional factors are from La Porta *et al.* (2000). See also complementary tables in J.J. Teunissen *et al.* (2006), Chapter 8.

In Regression 3 both factors are included. While Regression 3 looks to be the most complete of the three, the estimated results of Regression 3 are very similar to cases 1 and 2, especially with regard to the *beta* coefficient.

The first term on the right hand side is significant for all cases, indicating that the risk factor is significant when accounting for returns.

The high number of significant variables reveals that the country effect is indeed strongly felt in the real capital markets of East Asia and shows that these markets are not as integrated as originally thought. The statistically significant macroeconomic variables are the real rate of growth, inflation, the *M2M1* ratio and the current account balance. A company's excess return tends to increase as the growth rate or current account balance increases and inflation or its *M1M2* ratio decreases. This result is hard to accept because common sense tells us that the allocation of capital becomes more efficient as financial markets develop. In this case, though, the increase in real excess returns seems to be caused by legal institutional characteristics: a company's real excess return increases as stockholder protection weakens, creditor protection strengthens and the efficiency of judicial systems improves. Legal institutional characteristics seem to matter strongly.

If capital markets were perfectly integrated, country-specific macroeconomic or institutional factors would not be important in explaining the risk-adjusted rates of return for firms. However, our results show that this is not the case and suggest that the factors that come up as significant could be interpreted as responsible for segmenting and putting wedges in East Asian markets. The results in this section are only suggestive as not all the factors could be included in the current exercise. What these results imply is that East Asia needs to find ways to minimise the impacts of these barriers.

3 Concluding Remarks

What is the relation between global imbalances and regional capital market integration? Could regional capital market integration lead to greater global imbalances? Could it result in even more savings flowing from the region, or flowing within the region from the poorer countries to the richer ones? Are current global imbalances preventing deeper financial integration in East Asia?

We think that financial integration between East Asian economies and the US has led to greater global imbalances. There is much evidence that the Asian crisis brought deepening integration between individual East Asian markets and the US market rather than regional financial integration between the East Asian economies. Capital market integration is important, as it automatically involves the set-up of a regional financial market system. East Asian economies became capital

exporters in the post-crisis period, with saving exceeding investment and financial market opening. Yet there are no financial market developments at the regional level in East Asia that could continuously attract regional capital. This combined with domestic fiscal policies directed to expand domestic absorption could cause the savings-investment gaps in East Asia to be more effectively balanced. Regional capital market development for real capital, which includes financial capital, will absorb wealth created in East Asia.

Capital tends to flow generally from capital-abundant countries to capital deficient countries, provided the recipient countries offer good returns. A substantial part of regional capital will still flow outside of the region, since it is not optimal to lock the capital within the region. Capital will continue to flow from outside of the region. How much of the exported capital from East Asia should be circulated within the region is hard to quantify, although it is certain that the level needs to be increased substantially. This movement will obviously force the United States to respond and may have important consequences on the geography of global financial markets. When this mechanism is visibly working and sends positive signals to both market participants and policymakers, concerted efforts toward any form of an exchange rate arrangement in East Asia will have a better chance of success.

East Asia needs an upward shift in investment in order to help resolve global imbalances. An important way to increase investment is enhancing the facilitation of real capital flows, such as FDI, within the region. For this to take place, cross-border barriers across East Asian markets have to be lifted to deepen regional capital market integration. By examining the degree of integration that East Asian real capital markets achieved from 1996–2004, this chapter argues that real capital markets in East Asia should be more integrated. By using firm-level ROA data from eleven East Asian countries, we attempt to verify macroeconomic and institutional factors that cause segmentation in the capital markets of East Asia. Our empirical results indicate that the differences between countries are still large, especially with regard to the level of economic development and institutional factors. Differences in the level of investor protection and efficiency in judicial systems seem to act as barriers to integration among East Asian real capital markets. The weak degree of market integration in East Asia reveals that potential profits can be accrued through increasing international investment in the East Asian region. This present disparity between investment and savings in East Asia clearly shows that East Asia has excess capital. Much of it is retained either

within the nation of its origin, as asset bubbles, or is invested abroad in low-risk US securities, thus exacerbating global imbalances. In order to resolve them, East Asia needs to increase its investments relative to savings. Diminishing barriers to capital market integration will help East Asian capital flow more effectively to its own regional markets. This move, if successful, will facilitate financial cooperation in East Asia, which in turn will help East Asian economies to tackle even greater obstacles, such as monetary cooperation and currency union.

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Annex 1 Methodology and Data

We examine the convergence of real rates of return at the firm level across countries in order to analyse the degree of integration in East Asia. Equations we use are as follows.

$$\rho_{isct} - r_t = \alpha_0 \text{beta}_i^*(\rho_{mt} - r_t) + \sum_t \delta_t D_t + \sum_s \gamma_s D_s + \sum_c \lambda_c D_c + \varepsilon_{isct} \quad (1)$$

$$s = s_1, \dots, s_m : c = c_1, \dots, c_n : t = t_1, \dots, t_T$$

$$\rho_{isct} - r_t = \alpha_0 \text{beta}_i^*(\rho_{mt} - r_t) + \sum_t \delta_t D_t + \sum_s \gamma_s D_s + \sum_c \lambda_c Y_c + \varepsilon_{isct} \quad (2)$$

$$s = s_1, \dots, s_m : c = c_1, \dots, c_n : t = t_1, \dots, t_T$$

ρ_{isct} is the rate of return of company i of industry s in country c (adjusted for the country's risk) during period t . As these data are nominal and expressed in local currency, we first convert them to real rates of return – corrected for the rates of inflation expressed in a reference currency.¹ r_t is the risk free interest rate of the reference country. $\text{beta}_i^*(\rho_{mt} - r_t)$ is $\text{beta}_i^*(\text{excess market return})$ where ρ_{mt} is the market rates of return of all companies. beta_i is $\text{cov}(\rho_{ist}, \rho_{mt})/\text{var}(\rho_{mt})$, where beta is industry beta and is calculated using the rate of return of all companies in that industry. Often industry beta reflects the true risk profile of the company's return.² D_t, D_s, D_c are dummy variables for period, industry and country, respectively. $\alpha_0, \delta_t, \gamma_s$, and λ_c are coefficients.

In equation (1) the company's rate of return is adjusted for appropriate risks (first term on the right hand side) and the time and the sector effects have been controlled. The country effect is summarised in $\sum_c \lambda_c D_c$. Y_c refers to selected macroeconomic and institutional factors to see more specifically which of these variables would account for the country effect. If national markets are perfectly integrated, the country effect should be insignificant. However, this was not the case – as our results show – when we assigned specific variables that have been suggested in the literature to Y_c in order to test their validity as barriers to capital market integration.

¹ $\rho_{isct} = {}^n \rho_{isct} - \ln(E_{ct}^f/E_{ct-1}) - \ln(P_{it}^f/P_{it-1})$. Nominal rates of return, ${}^n \rho_{isct}$, are converted to real rates of return in reference currency with correction of forecasted exchange rate depreciation, $\ln(E_{ct}^f/E_{ct-1})$ and forecasted inflation, $\ln(P_{it}^f/P_{it-1})$. See De Ménil (1999), Oh (2003).

² Koller *et al.* (2005), Chapter 10.

For our reference currency, we use US dollars and firm-level return on assets (ROA) data for the period 1996–2004 (there were, however, several missing values for this period). ROA represents the profitability that accrues from a firm's total capital, not just equity or debt capital. All data are sourced from DataStream. The countries included in this study are Japan, Korea, Taiwan, Singapore, Hong Kong, China, Indonesia, Malaysia, Thailand, the Philippines, and India. The firms we examine are from 18 industries: automobile and parts, beverages, chemicals, construction and building materials, electrical and electronic equipment, engineering and machinery, food processors, paper, clothing and footwear, consumer electronics, textiles and leather goods, IT hardware, oil and gas, pharmaceuticals, software and computer services, steel and other metals, tobacco, and utilities.

We see that Japan has a large number of firms in the areas of chemistry, construction and building materials, electrical and electronic equipment, textiles and leather goods, and IT hardware, which indicates that Japan has strong competitiveness in these industries. In addition, both Japan and Singapore have a large number of firms in engineering and machinery, while Korea, Taiwan and Hong Kong only have a small number of firms in this industry. Moreover, there are a large number of sample cases for Korea, Taiwan and Japan in the steel and other metals industry, whereas there is only a small number for Hong Kong and Singapore. Compared to other developing countries, China has a relatively smaller number of companies in all industries; this is mainly because most companies in China only began reporting their rates of return after 2001.

6

The Need for a Longer Policy Horizon: A Less Orthodox Approach

*William R. White*¹

Global imbalances might be addressed better by analysing them from other viewpoints than the orthodox views. The Austrian school of economics provides some clues as to the origins of internal and external imbalances and other worrisome developments. Perhaps the most important message of these earlier thinkers is that policymakers should try to avoid the build-up of dangerous economic imbalances in the first place.²

At the heart of the analytical framework used by most modern policymakers still lies the IS/LM model. David Laidler (1999) contrasts the IS/LM model with the analysis by the Austrian school. He notes that the IS/LM model is essentially static, whereas “the passage of time is a central feature of Austrian theory”. While the accumulation of stocks (say, debt levels) is evidently impossible in a one-period model, the evolution of such stocks and related “imbalances” is another central feature of the more dynamic Austrian approach. Moreover, while modern macroeconomics has many ways of dealing with expectations about the future, few, if any, follow the Austrians in assuming systematic errors of judgment about future investment returns and associated

¹ A revised version of a lecture delivered at the Kiel Institute’s Advanced Studies Programme on 28 February 2005. The views stated herein are those of the author and are not necessarily the views of the Bank for International Settlements. Nevertheless, my thanks to Claudio Borio and Kostas Tsatsaronis for helpful comments.

² Keynes had doubts about the efficacy of monetary policy in deep contractions and thus recommended the use of fiscal policies. The Austrians doubted the efficacy of both monetary and fiscal policies, and therefore tended to put more emphasis on preventive actions rather than *ex post* interventions.

misallocation of resources. Further, whereas most modern models assume a smooth adjustment from one equilibrium situation to another, the Austrian approach stresses growing imbalances and periodic crises. Finally, whereas the IS/LM approach implies a highly activist policy response to shocks, Austrian theory suggests some policy actions might, over time, make things worse, not better. As Laidler concludes: “It would be difficult in the whole history of economic thought to find coexisting two bodies of doctrine which so grossly contradict one another.”

There is a need for a new *macrofinancial stabilisation framework* to insure against systemic financial imbalances that may eventually have a severe impact on economic output and unemployment. Such a framework would be based upon two main principles. First, it requires a more symmetric policy response to the expansionary and contractionary phases of the financial cycle. This would imply a focus on longer-term outcomes of policy decisions than currently is fashionable. Second, it is essential that all agencies of government involved cooperate more closely. This framework, with its objective of containing financial imbalances, would ideally have both a domestic and an international dimension.

At the domestic level, monetary policy would have to react more to internal financial imbalances than it currently does. This is defined below as a framework of *augmented inflation targeting*.³ As for the domestic regulatory authorities, they might be advised to adopt a *macroprudential regulatory framework*, one that puts more emphasis on the health of the financial system as a whole, rather than the state of individual institutions as is currently the case. Finally, recognising that “keeping one’s domestic house in order” is not sufficient to ensure international stability, there is also a need for a *new international monetary order* to help prevent the build-up of external imbalances that could eventually culminate in stress on a global level. Recall that, before they broke down, this is precisely what the gold standard and the Bretton Woods systems were designed to do.

This chapter is divided into four parts. Section 1 focuses on the past.

³ Morris Goldstein (2002) has suggested something similar, “managed floating plus”, for use in emerging market economies. For Goldstein, the “plus” is avoidance of the currency mismatch problems which caused so much damage during the Mexican (1994), East Asian (1997-98) and Argentine (2001) crises. Evidently, this is only one form of financial imbalance among many.

After identifying some stylised and often puzzling economic trends observed over the last few decades, some alternative explanations for these trends are suggested. It is concluded that a “less orthodox” analytical approach in the Austrian tradition has significant merit. Section 2 focuses on the present. Assuming the correctness of the less orthodox analysis, it describes existing financial imbalances and suggests ways that policymakers might deal with them. Section 3 looks to the future. Following the less orthodox interpretation of what has been going on, it proposes a new domestic policy framework that might reduce the chances of generating harmful financial imbalances in the future. Section 4 looks at some parallels between a domestic macrofinancial stabilisation framework and the international monetary system.

1 Secular Trends

1.1 Stylised Economic Facts

Looking back over the last few decades, four sets of observations stand out.⁴ The first two must be judged welcome, the last two less so. The first is the general reduction in both the level and the volatility of inflation. The second is the robustness of real economic growth and, again, a general reduction in short-term volatility. The third is the increasing prominence of credit, asset price and investment “booms and busts”, often accompanied by financial crises of various sorts. The fourth observation is that of increasing global imbalances, not least in importance, the rising external deficit and debt of the United States. The objective of Section 1.2 below will be to suggest a single set of factors capable of explaining the simultaneous observation of all four phenomena.

Since the peak levels of the late 1970s, *inflation* has fallen sharply on a worldwide basis. While most attention has been focused on the industrial countries, emerging market countries have had the same experience. Even in Latin America, where many countries previously were afflicted with recurring bouts of hyperinflation, inflation has now almost everywhere been reduced to single digits. Perhaps even more remarkably, this trend was not permanently interrupted in the aftermath of very large currency depreciations in Argentina and Brazil

⁴ For more explicit documentation of these facts, see Borio and White (2004) and Borio *et al.* (2003).

in the late 1990s. Indeed, inflationary pressures have receded so much in some countries that outright deflation has either actually emerged for some time (for example in Japan, China and Hong Kong SAR) or threatened (for example in the United States, Germany and Sweden). At these low inflation levels, the variability of inflation has also decreased. Shocks to inflation now seem less persistent, with inflation following a more mean-reverting path. In sum, inflation seems much better anchored at low levels than in the past.

Over the last two decades, the trend of global *output growth* has risen while the variability of output growth (excluding crisis-hit countries) has fallen. Periods of expansion in the industrial countries have lengthened while growth rates in many emerging countries have risen sharply. China, for example, has been growing at nearly 10 percent per annum for almost 20 years. India's trend growth rate has also risen sharply compared to 20 years earlier. As for volatility, output fluctuations have generally diminished since the mid-1980s, with the United States perhaps showing the greatest improvement. In contrast, countries hit by crisis (Japan, the Nordics in the late 1980s and East Asia in the late 1990s) experienced rapid output growth and low volatility, but only until the crisis hit.

If these first two sets of facts – low inflation and steady growth – are rather satisfying, the third and fourth – booms and busts and increasing global imbalances – are less so. Over the last few decades, the global financial system has been subject to a growing number and increased variety of disruptive incidents.⁵ Short-term price volatility in financial markets has at times been a source of disruption. Various systemic events (e.g. the Mexican crisis of 1994 and the subsequent Asian crisis of 1997-98) remind us of the growing capacity of financial markets to transmit shocks, not only across borders, but across markets as well. A number of high-profile institutional failures (Drexel Burnham Lambert and Barings) have also drawn attention to the potential of bankruptcies to cause systemic problems, even if such problems have to date been avoided. Finally, losses due to operational risks in the financial sector have been rising, reflecting the decline of prudent governance during recent boom years⁶ and the increasing complexity of modern financial systems.

⁵ For a fuller analysis, see White (2004a).

⁶ See Fisher (1933), who emphasises the influence of greed and outright fraud at the end of the financial cycle.

But perhaps the single most remarkable development in financial markets over the last few decades has been the prominence of credit and asset price *booms and busts*, often associated with rapid rates of growth of real fixed investment. In the industrial countries, there was a sharp run-up in credit and asset prices, particularly equity and real estate, in the early 1970s. A second cycle began in the mid-1980s, which turned to bust (particularly in the Nordic countries and Japan) in the early 1990s. Moreover, we appear to be well into the boom phase of a third cycle, dating from the upturn of the late 1990s. While rapid credit growth in the industrial countries has been evident throughout this last cycle, equity prices were affected first (leading in particular to very heavy investment in the telecommunications sector) but have since been supplanted by rapidly rising housing prices (and associated heavy investment in residential construction). This house price phenomenon now has almost global reach, with a number of emerging market economies (especially China) also showing large increases. Among the major economies, only Japan and Germany have avoided such increases, presumably because they are still recovering from the bust phase of the last credit, asset price and investment cycle.⁷ In many emerging market economies, domestic tendencies to credit, asset price and investment booms were reinforced by capital inflows turning subsequently into outflows, initiating and aggravating the following busts (see White, 1998).

In many instances the bust phase of the cycle has been accompanied by a crisis in the financial system. Examples include the banking crises in the Nordic countries and Japan in the late 1980s, the Mexican crisis of 1994 and the severe banking problems encountered in East Asia in 1997 and 1998. The resulting costs for the real economy were greatest when banking crises and foreign exchange crises coincided.⁸ Even in cases where the bankruptcy of financial institutions was avoided, the stress put on the financial system by incurred losses was often intense and led to significant economic “headwinds”.

⁷ The fact that it has taken Japan and Germany so long to recover fully from these earlier experiences of credit excesses attests to the potentially enormous costs of these boom-bust cycles. For a further analysis of such costs, see Hoggarth and Saporta (2001).

⁸ It is important to note that, in most cases, the banks themselves had no direct currency exposure and thus thought that they were safe from the effects of currency depreciation. In reality, they were still exposed indirectly to market risk because their customers were exposed.

Similar “headwinds” are arising from high levels of corporate and household debt, and an associated overhang of the capital stock. The overhang of corporate debt and unprofitable capital investment in Japan has been the primary reason for Japan’s very poor economic performance over the last decade (see Koo, 2003). A similar point can be made for Germany, in the light of the massive expansion of the construction sector in the early 1990s induced by German reunification. The weakness of corporate investment in Asia (ex China) in the aftermath of the excesses leading up to the Asian crisis is also notable. More recently, the weakness of investment (and therefore corporate borrowing) in the United States and continental Europe in the aftermath of the shared boom of the late 1990s warrants particular attention.

The fourth observation about longer-term trends is that of growing *external imbalances*. These must be judged unwelcome in the light of historical precedents which have commonly involved recessions as debtor countries adjust (see BIS, 2003, Chapter IV). The trade deficit of the United States has been trending upwards since the early 1980s. While this trend was interrupted in the late 1980s, it then re-emerged to such a degree that by 2006 the US deficit stood at 6.5 percent of GDP. Moreover, while the implications for external debt were mitigated for a long while by net services inflows on the US international asset/liability position, these flows have recently turned negative. They are now compounding the effects of the trade deficit on external debt accumulation. Similar external trends seem evident in the case of a number of other English-speaking countries. In contrast, most other regions have recently run either larger external surpluses (continental Europe, Asia) or smaller deficits (Latin America).

The same factual points about financial imbalances leading to periods of stress over the last few decades can also be made in a more chronological way. First, there were the sovereign debt crises of the early 1980s followed by the global stock market crash of 1987. After this, the property bubble burst in many countries in the late 1980s. The Mexican crisis of 1994 was followed by the East Asian crisis of 1997-98. The Russian default of 1998 had repercussions for the Brazilian real, and contributed to the failure of LTCM. In 2000, the NASDAQ crashed and subsequently took a large number of broader indices with it. More recently, sizeable monetary and fiscal easing has helped to buoy the prices of financial assets globally. Nevertheless, risks to the sustainability of the current global economic expansion continue to receive widespread attention, as will be discussed in Section 2 below.

1.2 *Alternative Explanations*

The Orthodox Explanation

What has been referred to elsewhere as the “*more orthodox*” explanation of these secular trends can be simply put (Borio and White, 2004). Recognising from long experience the problems caused by high and variable inflation, central bankers collectively determined to reduce both. They have succeeded admirably, and we are now reaping the real side gains associated with that success. Trend growth is now higher, absent the dead weight losses associated with high and variable inflation, and cyclical fluctuations are now less pronounced. This is because monetary policy no longer has to lean periodically against rising inflationary pressures, with the associated likelihood of tipping the economy into recession. Thus, we have a coherent explanation for two of the four secular trends outlined above.

As for the third secular trend, i.e. the episodes of financial volatility and instability, the orthodox explanation provides two essentially benign interpretations. On the one hand, these could be only transitional problems. Learning to live with low inflation, a more liberalised financial sector, and the phenomenon of constantly improving financial technology is bound to take time. With time, and ongoing improvements to the financial infrastructure, the frequency and severity of financial disturbances are bound to decline. On the other hand, there is also a train of thought that higher financial volatility might actually be welcome since it is the vehicle through which we obtain less real side volatility. More “complete” financial markets allow a transfer of risk to those most capable of bearing it. Shocks capable of having disruptive effects on the real economy are, therefore, increasingly being harmlessly dispersed before the real side is affected.

Finally, the orthodox view of the fourth secular trend, i.e. widening global imbalances, links them to improved relative growth prospects in deficit countries and inflows of foreign capital driven by higher expected rates of return. In particular, the relatively rapid rate of productivity growth in the United States has led to capital inflows which have in turn strengthened the dollar and led to a current account deficit (see Greenspan, 2005). A variation on this theme is that high saving propensities in Asia, in particular, have outstripped the potential for profitable domestic investments (Bernanke, 2005). The upshot has been a capital inflow into the United States in particular and, again, an associated current

account deficit. Underpinning these orthodox interpretations are the highly liberalised financial markets found in many countries with external deficits. Such financial markets provide many alternative investment opportunities, thus promoting capital inflows which in turn drive the current account.

Whichever strand of “more orthodox” thought one wishes to emphasise, the bottom line is that these third and fourth secular trends (increased financial volatility and global imbalances) are not a source of concern and need not prompt any rethinking of the basic policy lessons learned during the earlier period of high inflation.

A Less Orthodox Explanation

However, a “less orthodox” explanation emphasises the interactions between three profound structural changes that have been ongoing over the last 20 years and that have allowed domestic financial imbalances to build up, with subsequent effects on external imbalances.

The first structural change has been “real side” developments, not least the re-entry of China and other command economies into the market economy, which have put persistent downward pressure on global inflation since the late 1980s. The second has been the increasingly single-minded focus of monetary policy on keeping inflation at low levels, with its corollary that “with inflation under control, all is well”. The third development has been the liberalisation of financial markets, again globally, with the pace of change augmented by technological progress. The interaction of these three forces provides another set of explanations of the stylised facts. Unfortunately, this less orthodox approach also leads on to the conclusion that current circumstances of steady low inflation and robust real growth may not be sustainable. Moreover, this approach suggests that a new policy framework may be needed to help stabilise the financial system, since it leads to the conclusion that current problems are not transitional but rather endemic in the new global economy.

Turning first to persistent *disinflationary forces* in the 1990s, it must be recalled that the decade began with widespread recession and large amounts of excess capacity, in Japan in particular. Throughout the decade, there was persistent liberalisation in many industrial countries and the growing influence of technological advances on productivity growth, particularly in the United States. Globalisation and the impact of massive increases in the supply of many kinds of manufactured

goods, especially from China, were a further disinflationary factor, with the prices of many traded goods falling consistently over the decade. The increasing contestability of labour markets in many industrial countries, and the threat of production being moved to lower-cost countries, were further disinflationary influences. Moreover, these additions to global supply were occurring at a time of fiscal retrenchment in many countries, especially those in Europe, and a collapse of investment demand in Japan and Germany, as well as East Asia (ex China) after the Asian crisis. Finally, the longer these forces have been acting to keep down inflation, the more strongly entrenched low inflationary expectations have become. This has particularly been the case against the backdrop of the effectiveness of new inflation targeting regimes in some countries, and anti-inflationary rhetoric from central banks almost everywhere.

Turning to the second structural development, the growing focus of *monetary policy* on resisting inflation, it seems paradoxical, in face of the tough rhetoric in the industrial countries, that the occasions when it seemed necessary to raise policy rates became rather less frequent. Indeed, an evaluation of real interest rates in the major industrial countries indicates a persistent trend towards easing, with the sharpest declines being seen after 1997. By the middle of 2005, real policy rates in most large countries were still not much above zero, in spite of record global growth in 2004, while the gap with potential growth rates remained large.⁹ In Japan, where the policy rate has been zero for many years, the policy of “quantitative easing” pushed up the Bank of Japan’s balance sheet to 28 percent of GDP in early 2005. The more single-minded focus on inflation made it less evident that policy rates needed to be tightened materially in upturns. Perhaps still more important, it implied that there could be much more substantial policy easing in the face of actual or potential economic slowing and the associated threat to job creation. The implications of these generally low levels of policy rates, as well as the asymmetric nature of policy responses, are returned to below.

⁹ A Wicksellian perspective would contrast the level of the “financial” rate with the “natural” rate, with longer-term estimates of the latter generally related to the potential growth rate of the economy. See BIS (2004), pp. 71-3, for an analysis of the “real policy rate gap”. Perhaps the greatest gap of all is seen in the case of China, where real policy rates are around zero while the real potential growth rate of the economy is thought to be around 9-10 percent per annum.

It should also be noted that the trend towards policy ease in the face of persistent disinflationary pressures in the industrial countries, has also had repercussions in many emerging market economies (EMEs). In particular, as the value of the US dollar has trended down since 2001, many EMEs (particularly in Asia) have intervened heavily in foreign exchange markets to prevent their own currencies from rising in response to capital inflows. While vigorous attempts have been made to ensure domestic sterilisation of the associated injection of cash reserves, and thus avoid associated inflationary pressures, these efforts have not been wholly successful. Consistent with this interpretation, real policy rates in Asia (ex Japan) also hovered around zero in the early years of this millennium. Moreover, the subsequent recycling by official reserve managers of these inflows, back into the industrial economies and in particular the United States, has arguably helped push down long rates further. Given the continuing primacy of the US dollar as the global reserve currency, and the dominant role of the Fed, these international developments might be judged consistent with a global trend to easier monetary policies. These expansionary monetary policies, carried out in an environment of continuing price stability, have certainly contributed to the maintenance of global spending at high levels. They have raised growth in the upturns while reducing the severity of downturns to date. In themselves, both outcomes must be judged welcome.

Yet, even before turning to some other longer-term potential side effects, it should be noted that the kind of spending that has been stimulated is not as self-evidently welcome as the effect on aggregate spending. In a number of English-speaking countries (the United States, the United Kingdom, Canada, Australia and New Zealand), what has been observed is a decade-long reduction in the household saving rate and a significant increase in consumption as a share of total aggregate demand. In Japan and a number of other countries (in both Europe and Asia), a similar phenomenon can be recorded. In China, in contrast, the proportion of spending which is now made up of fixed investment was thought to be almost 50 percent. Clearly, very low household saving rates could well rise again to more normal levels. As well, very high investment rates could fall back and also imply the potential for significant resource misallocations. Both sets of imbalances imply some limits to the sustainability of the good growth performance seen to date.

The third structural aspect of the less orthodox interpretation has

been the *liberalisation of the global financial system* supported by associated technological progress. These developments have sharply increased competitive pressures in the financial services industry. Such pressures, in turn, increase the incentives to engage in risky behaviour (see Rajan, 2005), particularly if boards of directors increase the emphasis they put on “shareholder value”, and if structural rigidities impede cost cutting. These pressures will be augmented by any safety net provisions that might be in place. It is well known from options theory that the value of guarantees goes up as the environment becomes riskier.

Competitive pressures have led over time to changes in both financial structure and financial behaviour. While the process of adapting to a more deregulated environment will eventually end, as the orthodox interpretation stresses, the process of change with its associated risks could go on for a long time.¹⁰ Moreover, there is an important argument supporting the view that these are not just transitional problems. Periodic financial crises were part of the landscape prior to the 1930s when heavy financial regulations were imposed for the first time. This clearly raises the possibility that a re-liberalised financial structure could permit forms of behaviour that could also pose dangers to sustained economic expansion, and potentially the health of the financial system (see Bordo and Eichengreen, 2000).

As to recent changes in financial structure, the growth of financial markets in recent years has been remarkable, as has the process of globalisation and consolidation within the financial industry. The upshot of these developments is that the financial system is now much more complex, opaque and fast-moving than ever before. For example, risks can now be quickly transferred off balance sheets, but who finally bears that risk can no longer be easily established. Nor can the resilience of the system to shocks be easily determined. These changes have also implied a marked increase in the variety of credit sources and, generally speaking, reductions in both the costs of financial services and the intermediation costs of credit. Clearly, there are both advantages and disadvantages attached to these recent developments. These must be carefully assessed and weighed before passing on the policy conclusions.

¹⁰ It is now generally accepted that periods of financial deregulation can be particularly dangerous periods, potentially leading to financial instability as both markets participants and supervisors cope with unfamiliar circumstances. Technological breakthroughs might have similar side effects.

As to changes in financial behaviour, Borio, Furfine and Lowe (2001) document the extent to which financial systems are “inherently pro-cyclical”; that is, perceptions of value and risk move up and down with the economy as does the willingness to take risks. This tendency can be seen clearly in a large number of financial measures. Credit spreads, asset prices, internal bank risk ratings, and such accounting measures of expected losses as loan-loss provisions all move pro-cyclically. Moreover, this pro-cyclicality then interacts with the real economy in ways that can amplify economic fluctuations. In an upswing, the greater availability of credit leads to higher asset prices, which then serve as collateral for more borrowing. Moreover, similar incentives may lead to higher levels of fixed investment, which increase demand in the short run and promise increased profits over time.

To some degree, such behaviour patterns are perfectly natural and desirable. If, in an upturn, real prospects for gain are improving, markets should recognise this. However, problems of “excessive optimism” can easily arise if markets extrapolate good times in an unwarranted way. There are many precedents for this in history.¹¹ A modern example would be to misinterpret a cyclical upturn as marking the beginning of a permanent “New Era”, perhaps reflecting some technological improvement. In fact, history is replete with such examples.¹² The danger then becomes that disappointed expectations revert too far in a pessimistic direction, and that balance sheet exposures slow spending further. On the one hand, this could reflect a spontaneous drawing-back by an overextended household or corporate sector. On the other hand, an exaggerated unwillingness on the part of the financial sector to provide credit could also be the problem. And, as Bernanke (1983) reminds us in his reflections on the Great Depression in the United States, a combination of both forces could produce a result more damaging than just the sum of the parts.

In addition to a general tendency for liberalised financial systems to

¹¹ Evidence that this is a long-standing failure of the human psyche is to be found in the Bible in the Book of Genesis. In the parable of Pharaoh’s dream, the story of the seven fat years and the following seven lean years leads on to the conclusion that, while we might hope for the best, we should prepare for the worst.

¹² The introduction of toll roads, canals, railways, the automobile and urban electrification were all associated with expectations of massive profit increases. Many years later, the users of the new technology profited from it, but the original providers almost universally failed to do so given the extent of competitive pressures.

be more prone to boom and bust behaviour, these tendencies could become more evident in the context of easy monetary policies. At the heart of the matter is the “search for yield” when nominal risk-free rates are very low, a problem that could well be compounded by lingering elements of money illusion after a period of high inflation. Moreover, it now seems well documented that the appetite for risk in financial markets rises as policy rates are reduced (see, for example, Tsatsaronis, 2000). Being able to borrow at very low interest rates provides incentives to credit creation, carry trade behaviour and leverage, all of which have been increasingly evident in financial markets in recent years. In particular, it is clear that credit expansion has been highly correlated with asset price increases in each of the three medium-term cycles referred to above.

Asymmetric monetary tightening and easing also has significant implications. In the upswing, bubblelike tendencies emerge, but meet with relatively little resistance from monetary policy. Moreover, the expectation that monetary easing will be the response to any emerging difficulties could possibly accentuate such risk-seeking behaviour. In effect, it provides a kind of macro safety net to go along with the more traditional micro ones (e.g. deposit insurance, lender of last resort, too big to fail).¹³ As noted above, the subsidy value of all these safety net provisions rises along with the degree of risk in the system. Given the combined incentives provided to pro-cyclicality by a liberalised financial system and a generally accommodative but asymmetric monetary policy, the building-up of financial imbalances and the recurrence of bouts of financial instability would not seem surprising.

This line of thinking also leads to a less orthodox explanation of the secular trend towards growing global imbalances. Those countries with the biggest external deficits (the United States, the United Kingdom, Australia and New Zealand) also tend to have the biggest internal imbalances. Rising asset prices in such countries (recently, for housing in particular) have led to higher perceptions of wealth, and more spending. Domestic absorption has thus, gradually, exceeded domestic production and the external deficit has risen accordingly. But this observation must then logically raise the question of why countries

¹³ See White (2004a) for a fuller description of the increasing use and changing character of safety net instruments. In particular, as markets have become more important, there has been a trend to more “generalised liquidity infusions” to deal with market disruptions.

with external deficits are more prone to internal imbalances than other countries. A possible answer is suggested by the fact that these countries have also been among the most advanced in developing complete, liberalised financial markets.¹⁴ Moreover, it could also be argued that such countries have also tended to have relatively easy monetary conditions,¹⁵ sometimes accompanied by the asymmetric conduct of monetary policy.

Nevertheless, in evaluating the implications of the interacting structural changes identified by the less orthodox approach, a puzzle remains. Continuing low inflation is relatively easily explained. So too is the observed tendency for occasional but recurring financial crises and growing trade imbalances. But focusing on the reality of intermittent “busts”, how can one reconcile this approach with the remarkable steadiness of real growth in the industrial countries in recent decades? One possible explanation is the success to date of aggressively asymmetric monetary policies designed to lean against the economic downturns associated with the end of financial cycles. Consider that policy rates in many countries were lowered sharply at the beginning of the 1990s in response to the property collapse and the weakness of banking systems.¹⁶ Indeed, they have remained very low in Japan ever since. In 1997, when traditional macroeconomic considerations would have called for a tightening of policy, rates were generally left unchanged in the light of the Asian crisis. In 1998, still further into the upturn, policy rates were lowered in some countries in response to the Russian debt moratorium and the LTCM crisis. After the collapse of the NASDAQ, rates were again lowered aggressively and have only recently begun to rise again in some countries.

The success of policy in stabilising the economy in each of these individual cases could, however, have had some unwanted side effects. The first has to do with time inconsistency. Monetary easing in each

¹⁴ Recognition of this fact raises still more starkly the trade-off between the allocational efficiency of liberalised financial markets (at a moment in time) and their possible instability (over time).

¹⁵ One measure of this is the “real policy rate gap” as defined in a footnote above and as documented in BIS (2004), pp. 71-3. This “gap” at the end of 2003 was significantly greater in the United States than in either continental Europe or Japan.

¹⁶ It is noteworthy that the easing in the United States at the beginning of the 1990s, and after 2001, was significantly greater than would have been called for by a Taylor rule. See BIS (2002), Chapter IV.

case implied that existing imbalances were never addressed throughout restraint. Rather, each new phase of expansion either wound up expanding initial imbalances (say, external trade or internal debt imbalances) or served as the starting point for increases in asset prices in some new financial market; first equities, then bonds, then yield spreads, then houses, and so on. The second side effect is essentially arithmetical. If policy rates are to be lowered more aggressively in downturns than they are raised in upturns, then they are more likely eventually to be pushed to the limit of the zero nominal bound. According to this way of viewing recent developments, the legacy of the three structural changes identified above raises concerns. Should there be a belated unwinding of financial imbalances, cumulated over a long time period in response to asymmetric policy easing, it would be hard to resist them with further monetary easing to the extent that policy rates are already very low. Moreover, with initial inflation levels also low, such developments might easily tip some economies into an outright deflation that could prove hard to manage given the cumulative build-up of debt that has occurred over time.

Such considerations serve to raise the two questions discussed in Sections 2 and 3. First, what evidence is there that the global economy is currently exposed to some of the dangers noted above? Second, assuming that one accepts the less orthodox interpretation of recent events as plausible, if not necessarily compelling, where might prudent policymakers think about going from here?

2 Current Exposures: Do They Warrant a Policy Response?

Viewed from the perspective of the less orthodox approach, a number of indicators pointed in mid-2005 to significant internal and external imbalances in the current global economy. Here, imbalances are defined as persistent and significant deviations from long-term norms.¹⁷ To the extent that there were to be a tendency for these imbalances to revert to the mean, implicitly a statement that these significant imbalances were also unsustainable, there would also be the potential for some slowing of global economic growth. Whether this reversion was gradual and

¹⁷ As will be discussed in Section 3, the simultaneous observation of a number of such imbalances has historically been a useful predictor of subsequent financial crises and slowdowns in output growth. See Borio and Lowe (2002).

more likely to be benign, or more rapid and disorderly, would depend very much on real/financial interactions that are hard to predict. In particular, the dampening effects on inflation of the positive supply shocks noted in Section 1 might, or might not, be overwhelmed by the effects of the easing of monetary policy over the last few years. And the financial system might prove more or less resilient in the face of macro-economic shocks, given the offsetting forces of more risk-taking versus better risk management and supervision.

2.1 Internal Imbalances

With respect to *internal imbalances*, in the United States and a number of other countries (primarily but not exclusively English speaking), the principal indicators of potential difficulties would be the currently historically low ratio of household saving and an associated historically high ratio of household debt. The capacity of modern financial systems to facilitate the withdrawal of equity from higher house prices has given strong support to both trends. Moreover, even as the supply of credit has risen, the demand for this credit has been encouraged by historically low interest rates. While debt service requirements have generally not risen sharply, and asset levels greatly outstrip liabilities, both of these positive factors might be considerably reduced were interest rates to rise back to more normal levels. Moreover, it must be recognised that the liberalisation of financial and other markets has fostered the transfer of risk to households in many new ways,¹⁸ and it is not obvious that households have the expertise to adequately¹⁹ limit their prospective exposures.

¹⁸ First, consider the trend away from defined benefit pension schemes to defined contribution schemes. Second, consider the extent to which pension funds (and insurance companies) have deviated from “immunisation” principles in recent years. Both trends threaten the security of post-retirement income. Third, consider the growing use of variable pay and contract employment, which threaten the security of household income prior to retirement.

¹⁹ In the United States, for example, there has been a marked increase in the use of variable rate mortgages, albeit from low levels, particularly by people on lower incomes who would not have been eligible to receive a mortgage carrying a higher fixed rate. The use of “interest only” mortgages has also been rising sharply. Finally, the proportion of US houses purchased to rent (i.e. to generate income) has also been growing rapidly – a trend also seen in the United Kingdom and Australia.

In continental Europe, both corporate and government debt levels as of mid-2005 remained very high, measured against historical norms. The former reflects, in part at least, heavy corporate borrowing associated with the period of strong investment in the “New Era” environment of the late 1990s. The latter reflects many decades of large government deficits, followed by an inadequate degree of fiscal consolidation in the late 1990s in spite of the incentives provided by the Stability and Growth Pact and the opportunities provided by relatively rapid growth. In Japan, corporate debt levels are much reduced and household balance sheets remain strong. Yet the level of government debt is historically high and a massive deficit increases it each year. In China and a number of other Asian countries, the debts of many state-owned enterprises (SOEs) are likely in the end to prove unserviceable. Given the recent very high level of credit growth and investment spending in China, it is possible that some more recent loans will also prove unserviceable, the ultimate indicator of capital misallocation.

Debt, *ceteris paribus*, acts as a claim on future revenues and slows spending over time. To some degree, this can be offset by the positive effects of higher wealth on spending. However, it needs to be stressed that a large part of what statisticians (and common sense) define as wealth at the level of the individual is not obviously the same thing at the aggregate level. It could be argued that the higher house prices are simply a change in relative prices and do not increase wealth in aggregate. In effect, the higher price of a house (of benefit to the owner) is offset by the discounted costs of higher rents in the future (either explicit, or implicit, for owner-occupied dwellings). Any associated increase in net spending generated by such “wealth” is a borrowing from the future that will have to be repaid. If house prices fall, the homeowner, who borrowed against higher equity, will have to retrench. If house prices do not fall, then those purchasing more expensive housing services will have to economise on something else. In contrast, real wealth is generated by increased saving, investment and/or increases in total factor productivity.²⁰ Only with respect to the third of these factors are there some grounds for optimism, at least in the United States. Finally, the “headwinds” posed by debt must be evaluated against the backdrop of unfavourable demographic trends in many countries. These will slow the rate of growth of potential output and make it increasingly likely

²⁰ Such changes can legitimately drive up the price of equity. Here, unlike the case of house prices, there are winners but no offsetting losers.

that debt burdens will enter the realm of “unsustainability”.²¹ This could lead to an increased likelihood of financial disturbances as creditors seek to “outwit the crowd and pass the bad or depreciating half-crown to the other fellow”.²²

It must also be noted that the prices of many assets, both financial and real, also looked high as of mid-2005 against the benchmark of historical valuations. This also implies some scope for unwinding, with attendant risks. In spite of recent, measured, upward movements in the US policy rate, the US long bond rate did not rise significantly, and long rates in Europe even fell. Corporate spreads have also narrowed, driving those on high-risk bonds to historical lows. Spreads for sovereign issues have moved similarly. Valuations for equities in industrial countries, based on actual earnings, are lower than they were in 2001, but still remain well above the ratios observed before the IT boom. And, while valuation levels still look reasonably modest in EMEs, the price increases seen over the last year or so have been very great. As for residential property, there has been, as noted above, almost a global trend towards sharply higher prices.

With respect to each of the prices cited above, idiosyncratic arguments have been presented to justify what is being observed in the light of underlying fundamentals in that particular market. However, a complementary but simpler explanation also suggests itself. All these prices are high because of strong demand for assets induced by very low global policy rates. In effect, existing ample liquidity is being used to purchase “illiquidity”. This interpretation is also consistent with the very low level of implied volatility (uncertainty) in options markets, made more extraordinary given the increased uncertainties about the future currently being expressed by many economists. In practice, liquidity is being sold in the form of put options by those eager to receive premia inflow in an environment of very low interest rates (see Rajan, 2005). However, if this is part of the explanation for higher asset prices, it must also be asked why recent moves to tighten policy in the United States have not had more effect. One explanation is that

²¹ Sustainability is defined here in the rather narrow sense of the primary deficit needed to stabilise the relevant debt/GDP ratio. This required primary deficit depends on the gap between the real rate of interest on the debt and the potential growth rate, multiplied by the initial ratio of debt to GDP.

²² As described by Keynes (1936), p. 155, in his famous chapter on “The state of long term expectations”.

“measured tightening” lowers rather than eliminates the expected rates of excess return from purchasing such assets. Indeed, it is not inconceivable that well anticipated tightening of this sort might even reduce risk premia and encourage more leverage to maintain expected rates of return (see Kaufmann, 2005). If so – and this is highly speculative – the eventual reversion of valuations to levels closer to historical norms would be sharper, and the interaction with higher debt levels more contractionary.²³

2.2 External Imbalances: The US Deficits

If a case can be made for being concerned about current internal financial imbalances, *external imbalances* are receiving even greater attention. In particular, the US trade deficit is now increasingly seen as being unsustainably large, and the services deficit will also widen as interest rates rise back towards normal levels. The root cause of this deficit seems to have been the secular shift down in the household saving rate analysed above. The US fiscal deficit, which is currently very worrisome, was in fact improving throughout the 1990s even as the current account was worsening. Nor can relatively high investment levels in the United States be the principal contributing factor. In fact, business investment collapsed in the early years of this decade, but the current account continued to worsen. If household consumption has been the principal counterpart to foreign lending, debt service will eventually prove more onerous than it would have been had borrowing been directed to productive investments capable of generating foreign currency returns.

To date, the quantity of inflows of longer-term private capital to the United States has remained adequate. Nevertheless, their quality has been steadily deteriorating. Durations have been shortening, and flows have increasingly been into “safe” assets like Treasuries or Government Sponsored Enterprises often perceived to benefit from a government guarantee. Central banks (particularly in Asia) have in recent years provided the largest share of the required financing for both the US current account and fiscal deficits. Dooley *et al.* (2003, 2004) have suggested that this support is likely to continue for many years. However, Roubini and Setser (2005) as well as others have suggested a long list of

²³ A second possibility is that financing for carry trade activity may have moved to other low-rate jurisdictions.

reasons why central banks might choose to limit that support going forward. Asian central banks, or others such as oil producers, may judge their share of dollar-denominated assets as being excessive. Public sector “rebalancing” could in itself have effects on G-3 exchange rates. Were private sector investors, currently also with long dollar investment positions, also to rebalance in response, then the implications for exchange rate movements could be greater still. The bottom line is that changes in investor preferences are not inconceivable, and this could catalyse an unwinding of external balances as well.

If one accepts the concept of internal and external imbalances, and agrees that currently observed deviations from historical norms are significant, the next question is how a reduction of these imbalances might affect global real growth and price levels in various countries. As noted above, given the complicated nature of the problem, point predictions have little value. On the one hand, a general easing of domestic demand pressures in low-saving countries, allied with the opposite trend in high-saving countries with excess capacity, might redress many of the imbalance problems without doing great harm either to global growth or to the maintenance of generally low inflation everywhere. A lower dollar would probably be the product of such trends, which would also have the advantage of mitigating disinflationary pressures in the United States (arising from the assumption of more saving) and inflationary pressures elsewhere (arising from less saving). On the other hand, were continued rapid consumption growth in the United States to spark an eventual flight from dollar-denominated assets, the feedback effect on policy rates and asset prices might in turn have unwelcome effects on the global economy. A similar conclusion might follow from a “hard landing” in China.²⁴

If the precise nature of the outturn is unclear, the policies needed to shift the balance in favour of a more benign outturn are somewhat more evident.²⁵ Higher saving rates in deficit countries, like the United States, would be encouraged by higher policy rates. Indeed, presenting both an opportunity and a challenge, tightening monetary policy in the United States might eventually lead to stronger effects than in the past because of the interaction between debt service requirements and asset

²⁴ For a fuller analysis of whether current external imbalances constitute a “problem”, see White (2005).

²⁵ A fuller description of current policy options is provided in BIS (2005), Conclusions.

prices. Fiscal tightening in the United States would also be very welcome. Both steps would contribute to re-establishing both internal and external balance, hopefully in the context of a gradual decline in the real effective value of the US dollar. In China, steps to slow an overextended investment sector have already been taken, though it is not yet evident whether they have been successful in restoring internal balance. As for external balance, it seems clear that Asian countries in general should have higher real exchange rates, though the particularities of how this might be achieved are less clear. Evidently, if policy is to be directed to slowing domestic demand in what are currently the two main drivers of global growth, the United States and China, complementary steps must also be taken to speed up growth elsewhere. In particular, continental Europe, Japan and emerging Asia (ex China) must again become sources of demand growth. In all these areas, and in China as well, structural reforms to encourage growth in the non-tradables sectors are required for both internal and external reasons.

As evident as these policy prescriptions might appear to some, there is a reasonable likelihood that they might not be implemented. Fiscal tightening in the United States is by no means assured. Complementary easing in Europe and Japan is constrained by the legacy of already high government debts and other commitments. Structural reforms will take time and will encounter resistance from entrenched interests; look at the difficulties being encountered in implementing the EU Services Directive. Moreover, export-oriented growth strategies in Asia will probably contribute to there being less upward movement in Asian nominal exchange rates than there should be. These impediments to desired policies could result in a further build-up of the internal and external imbalances just identified. These imbalances in turn would pose a greater potential threat to global output and employment going forward.

3 Towards a Domestic Macrofinancial Stabilisation Framework?

The three structural/regime changes identified in Section 1.2 clearly have delivered many economic benefits. Nevertheless, it is hypothesised that they also have certain harmful side effects – in particular credit, asset price and fixed investment cycles – that can eventually feed back negatively on both growth and employment. The policy challenge is to reconcile the secular gains in “efficiency” with the periodic costs of disruptions arising from a kind of financial overreach. There would be

two key elements in making a domestic macrofinancial framework operational. First, there must be a convincing assessment that systemic imbalances are emerging that have the capacity to impose economic costs. Second, given such an assessment, incentives must be in place to ensure that policies will be implemented to offset such risks in as market-friendly a way as possible.²⁶

3.1 Key Elements of a New Domestic Framework

How can we best *evaluate whether systemic imbalances are building up* that require a policy response? In principle, one wishes to gauge changes in the expected losses, measured as the product of the probability of financial stress (PFS) and the economic losses given stress (ELGS). Unfortunately, neither is easy to calculate with accuracy. The underlying analytical problem is the complexity associated with real-financial linkages (going in both directions), the interactions of heterogeneous participants in real and financial markets, the likelihood of responses to shocks that are likely to change over time, and the non-linearities imposed by bankruptcy considerations and regulatory constraints. Moreover, making efforts to predict expected losses even more difficult, both PFS and ELGS could well be evolving in response to structural developments, but with even the direction of the effects being subject to dispute. For example, some contend that PFS might be raised by new kinds of risk-taking made possible by new technology. Others argue that it seems more likely to be reduced given the new culture of risk management engendered by the Basel II process. ELGS might also be rising in the light of the continuous monetary stimulation given to the system, and the rising risk of bankruptcies due to higher debt levels. But, it could also be argued that ELGS might have been reduced by the progressive implementation of codes and standards that improve the functioning of financial institutions, markets and payment systems under stressful conditions. Perhaps the only thing that is clear, as surveyed in a recent paper by Sorge (2004), is the substantial increase in analytical work being carried out on these difficult questions.

Regardless of the difficulties faced by more academic researchers, many official agencies are paying increasing attention to data that indicate future financial vulnerabilities. Their ultimate motivation has been the recognition that the economic costs associated with recent

²⁶ Much of this is drawn from White (2004b) and Borio (2003).

financial crises have commonly amounted to many percentage points of GDP. The IMF, for example, has suggested a list of Financial Soundness Indicators for individual countries and now uses them actively in conducting Financial Sector Assessment Programs. While a major step forward, this work suffers from the same problems just noted. Generally, being micro data aggregated up to macro dimensions, they can provide only limited information about the distribution of risks within the system or the interplay between market participants that can cause one kind of risk (say, market risk) to be transformed into another (say, credit risk or liquidity risk). A parallel can be drawn with the stress tests now being regularly conducted by major financial institutions. They rarely, if ever, consider the possibility of other major players being similarly affected by shocks and reacting in the same way.

Some researchers at the BIS have recently tried to address a number of these issues. Borio and Lowe (2002) look at factors driving PFS and demonstrate that financial crises in industrial and emerging market countries have generally been preceded by a combination of above trend growth in credit and asset prices. In another paper, they apply their methodology and find that overvalued real exchange rates also play an explanatory role in the case of emerging market economies. Goldstein and Turner (2004) rather emphasise how the ELGS in emerging market countries can be affected by currency mismatch problems. All of this work has been promising enough to indicate that further work might well prove very useful.²⁷

What would be the core elements of a macrofinancial stabilisation framework, one that would *ensure an appropriate response* when financial vulnerabilities were identified? The first point to note is that it would preserve the traditional microprudential standards that are designed to improve the soundness of financial institutions, financial markets and the underlying legal and payments infrastructure. This would contribute to reducing PFS and ELGS, as noted above. Yet, a macrofinancial stabilisation framework would also imply an additional set of concerns directed to ensuring the stability of the financial system as a whole.

²⁷ A notable aspect of the Borio-Lowe work is that their asset price data could not include house prices since such historical data were simply unavailable at the time. A recent joint conference by the BIS and IMF was directed towards resolving this critical data problem. More recently, Fitch Ratings have used the same methodology, extended to include real estate prices, to assess the financial strength of banking systems.

Perhaps the most important change would be an enhanced need for supervisors to recognise that they might sometimes face a “fallacy of composition” problem. That is, recommending what seemed right for a single institution might well exacerbate system-wide problems were other institutions to do the same thing. A good example might be recommending the sale of risky assets in stressful situations. Clearly, if broader-based selling reduced market prices, and thus the value of remaining assets, everyone might wind up weaker. Further, given a macrofinancial focus, the monitoring of the component bits of the financial system would also have to change to ensure a greater focus on weaknesses likely to have knock-on effects elsewhere. One implication is that banks, as providers of liquidity, should rightly receive more attention, and that bigger institutions need closer monitoring than smaller ones. Indeed, to reflect these externalities, capital requirements might even be calculated differently. Finally, given the growing importance of markets, both to provide financing and to transfer risks, market monitoring and the evaluation of structural developments affecting markets (for example credit derivatives) would have to be further enhanced. This conclusion is supported if we note that the financial institutions themselves are now crucially dependent on market-based services of various kinds. In fact, a number of steps in this direction have already been taken.

A first guiding principle for a macrofinancial framework would be that both regulatory and monetary policies should be applied more symmetrically over the cycle. This suggestion has parallels in prescriptions for fiscal policy that emphasise running surpluses in upswings to “preserve some room for manoeuvre”. In the case of regulatory policy, more symmetry would imply that more capital should be built up in good times. Not only would this help restrain credit excesses, but it would also allow capital to be run down in bad times²⁸ to cushion the economy from associated credit constraints. Tightening monetary policy in the face of excessive credit growth would also attenuate the worst excesses and could also obviate the need for radical easing later that might trigger the zero lower bound problem. This would not be an inconsequential advantage should an unwelcome degree of disinflation emerge in such an environment.

²⁸ The reference in the text to “fallacy of composition” problems might seem almost like an invitation to forbearance should bad times put pressure on capital ratios. The way to reconcile a macro perspective with avoiding forbearance is to ensure that levels of capital rise earlier in the upswing.

The practical implementation of a more symmetrical regulatory policy might be carried out in various ways. Were the regulators to be quite confident in their predictions that systemic risks were rising to dangerous levels, they could have recourse to discretionary action. Cash reserve ratios, liquidity ratios, loan-to-value ratios, risk weights for regulatory capital, collateral requirements, margin requirements and repayment periods could all be tightened. In contrast, were the authorities to be more doubtful about their capacity to predict stressful events, they might rely more on some simple rule to enforce more prudent behaviour. Goodhart and Danielsson (2001) suggest relating prudential norms to the rate of growth of loans or asset prices. These prudential norms could affect the pricing of risk, provisions for losses (for expected losses) or the accumulation of capital (for unexpected losses). In Spain, a system of “dynamic provisioning for losses” has already been brought in. Provisions must now rise with loan levels on the assumption that losses in the future will be similar to those experienced in the past, but measured over the full economic cycle.²⁹

As for a more symmetrical monetary policy, this too might rely on either discretion or a rule. Examples of the former might be seen in the recent behaviour of a number of central banks. In recent years, both the Bank of England and the Reserve Bank of Australia have raised policy rates in the face of rising house prices and debt, even though projected inflation was not obviously inconsistent with target ranges. The Sveriges Riksbank, for similar reasons, did not initially lower interest rates as much as might have been expected given the extent to which they were actually undershooting their inflation target in 2005. As for more rule-based behaviour, the two-pillar approach of the ECB could also be noted, even if a great deal of discretion has been maintained in reacting to deviations from the monetary reference value. Moreover the suggestion here would be to use the monetary pillar to resist financial excesses in general rather than inflationary pressures in particular.³⁰

The above comments refer to substantial issues in formulating policy, but, in the real world, processes and institutional arrangements are also important. A second guiding principle for a macrofinancial framework

²⁹ Most provisioning to date assumes that loan losses over the next year will be similar to last year. Such simple extrapolation lies at the heart of pro-cyclical risk assessment.

³⁰ In fact, this seems increasingly to be the way the ECB views the “monetary pillar” of its approach. See Issing (2005).

would therefore be the need for closer cooperation on financial stability issues between the various interested agencies in the official sector. As to policy processes, an important first step would be agreement among involved agencies that an imbalances problem was emerging. This might be followed by orchestrated statements of concern.³¹ This alone might prompt both creditors and debtors to rethink their investment strategies.

As to institutional arrangements, the most important problem to avoid is macrofinancial stability issues falling between the cracks. That is, the agencies involved see problems building up, but assume that somebody else will do whatever needs to be done. One practical way to avoid this would be to set up a committee of senior representatives of central banks, regulatory agencies and treasuries to monitor events and identify problems. Interestingly, such a committee exists at the international level – the Financial Stability Forum, whose secretariat resides in Basel – but there is no domestic counterpart in many countries. In countries where committees having similar representation have been set up to facilitate crisis management and resolution, the simplest approach would be to widen the mandate to encompass crisis prevention as well.

3.2 Impediments to a New Framework and How They Might Be Removed

There are many *practical impediments* to the implementation of a domestic macrofinancial stability framework. Some are of a general nature, while others apply more specifically to prudential authorities and still others to monetary authorities. As will be discussed further below, how strongly one feels that these impediments should be removed depends critically on how strongly one believes that there is a systemic problem to be dealt with in the first place.

Impediments

As to the general problems, the existence of normal institutional inertia and preference for the status quo needs no further comment. But, in addition, it must be admitted that there remains considerable uncertainty as to whether the massive structural changes seen recently in the financial area are likely to be the source of significant systemic problems

³¹ This recommendation for statements of concern, followed by action if need be, parallels much of the literature on the efficacy of foreign exchange intervention.

or not. Orthodox and less orthodox views diverge. Arguments can be put forward that recent trends towards marketisation, globalisation and consolidation all increase the risk of systemic problems. Yet, reasonable arguments can also be posited in the opposite direction, with the overall resilience of the financial system to numerous recent shocks being cited as the final proof that all is well. The expression “so far, so good” has always had a particular resonance.

Moreover, it is not only the official community that would need to be convinced of the desirability of a new framework. Periods of financial excess in the private sector are also periods of profit increases for many who will resist giving them up. Intellectually, the idea that the public sector knows better than the collective wisdom of the market will be strongly disputed. Practically, a whole host of lobbyists and enlisted media will be engaged to argue the case that “this time is different”. And to this must be added another cause for hesitancy, linked, paradoxically, to an eventual acceptance that a problem could be developing. It is a fact that such an intellectual turning point is only likely when the imbalances are already very well developed. Thus, steps to mitigate the imbalances are feared because they might catalyse the very crisis everyone wishes to avoid.

There are further, specific impediments to prudential authorities conforming to the general suggestions made above. The first is that they do not have a long tradition of concern about issues having to do with macroeconomic stability. Thinking systematically about the health of the financial system as a whole, rather than individual institutions, is already a big leap. Extending this further to recommend changing the setting of regulatory instruments, when the financial system seems in good health but corporate and household lending looks excessive, could easily be a leap too far. Second, in practice, most prudential authorities do not have the powers ascribed to them above, and obtaining such powers would not be easy. Consider, for example, the traditional opposition of both the accounting profession and the tax authorities to forward-looking provisioning for expected losses. And finally, there is again the “fallacy of composition” problem. How could the prudential authorities convince individuals to act in ways that seemed to conflict with their own best interests? And even if some could be convinced, how could they be assured that others would not free-ride on their decision? One implication of this is that the prudential net would have to be cast very wide. Another is that the use of monetary policy might also have to be contemplated in the face of growing financial imbalances.

What impediments could prevent central banks from operating as the new framework would suggest? The most obvious problem is that the objective of monetary policy in many countries has been identified as low inflation, generally narrowly defined as some version of the consumer price index (CPI). Thus, if inflation were under control and the new framework suggested that policy rates had to rise, there would be a chance that over the forecasting horizon the policy target would be undershot. Some worry that this would undermine the credibility of the whole regime.³² At the very least, there would have to be a public explanation of what would look like an inconsistency. A second problem, already observed, would be securing an intellectual acceptance of the need to focus on the simultaneous observation of a number of indicators before changing policy rates. To date, there has been some tendency for policymakers to equate the proposed macrofinancial stability framework with “targeting asset prices”. Since there are many well known objections to this latter proposal,³³ acceptance of the former framework clearly suffers from this association.

Removing Impediments

Given enough conviction that a macrofinancial framework was needed, it might be *possible to remove these impediments* to action. Consider the assertion above that policymakers would be biased towards inaction by uncertainty as to whether systemic problems were truly building up. In effect, they would tend to balance off the known costs, in terms of output losses associated with tighter policy, against the uncertain losses associated with future systemic problems. This argument might easily be turned on its head given acceptance of a minimax optimising strategy that put greater weight on avoiding “truly bad outcomes”. Moreover, the bias to inaction could be further reduced by more research indicating the extent to which internal governance and market forces had historically contributed to pro-cyclical financial behaviour. Another promising research approach would be to further improve the

³² In the limit, some might contend that the authorities were no longer interested in keeping down inflation. However, it is hard to see how this could be concluded from policy actions that were even tighter than those needed to control inflation.

³³ Which asset price to target? At what level? Would bursting the bubble in one sector cause major damage elsewhere in the economy? How to sell the policy to the public?

financial vulnerability indicators suggested by Borio and Lowe, among others.

As for getting the private sector to support the idea of a new framework, a process of public education would be useful. It is worth recalling that during the 1960s and much of the 1970s there was little public support for fighting inflation, but now the desirability of such policies is commonly acknowledged. The fact that so many central banks already publish a financial stability review indicates that this process of education is already under way. Moreover, a clear commitment to leaning against financial excesses might also change people's behaviour, inducing more prudent recourse to credit and speculative behaviour. Further progress in providing better official measures of "imbalances" would of course be crucially important in this regard.

Turning to the particular impediments to action facing prudential regulators, the current "culture" of microprudential surveillance could be supplemented with macroprudential concerns focused on systemic exposures. More regular contacts between central banks and regulators, together with Treasury counterparts, would help to build a common culture based on shared objectives, mutual trust and a similar understanding of emerging problems and possible solutions. Kapstein (1992) describes just such a process as being responsible for the continuing success of the Basel Committee. If this could work at the international level, where initial suspicions are evidently greater, it could surely also work at the national level. All this said, the capacity of participants in a liberalised financial system to evade regulatory actions cannot be underestimated. This forces one back to a consideration of the role of monetary policy.

The principal impediment to using monetary policy to resist financial excesses is that it can be seen to conflict with the desire to stabilise inflation at a low positive level. Perhaps the first heretical point to raise is whether this should always be the objective of policy, given the reality of ongoing positive supply side shocks. There was a lively debate about such issues prior to the First World War,³⁴ and the issue needs to be addressed again.³⁵ As noted above, resisting a "good deflation" (supply-driven) could over time rather result in fostering conditions that might

³⁴ For an overview, see Selgin (1997).

³⁵ A historical overview indicates that periods of falling prices were not generally characterised by depressed output and growth. In this regard, the early years of the Great Depression, 1930-33, were truly outliers. See BIS (1999), pp. 78-80. See also Borio and Filardo (2004).

lead to a “bad deflation” (demand-driven). Nonetheless, presuming maintenance of this objective for the time being, perhaps a regime of “augmented inflation targeting” might be suggested. This would still allow concerns about financial excesses to be expressed in terms of price objectives, albeit over a rather longer policy horizon. In effect, leaning against emerging imbalances might cause an undershoot of near-term inflation objectives. This would be judged acceptable since not doing so would risk a boom-bust cycle that could result in an even bigger undershoot of prices.

As a practical matter, a central bank would normally continue to focus on controlling inflation over traditional horizons. However, it would also make it clear, through its public monitoring of financial vulnerability indicators, that policy would occasionally have to be conducted in a way that reflected these longer-term concerns about prices. Evidently, this would imply some convergence in the subject matter of a central bank’s inflation review and its financial stability review³⁶ and perhaps even some organisational changes as well. Given the real-financial interactions that lie at the heart of the analysis in this chapter, it is by no means clear that such changes would be undesirable.

4 Towards an International Macrofinancial Stabilisation Framework

In a sense, it is odd that domestic financial imbalances are not ranked higher on policymakers’ list of priorities, since international imbalances have been a source of concern for centuries. Indeed, earlier versions of the international monetary system were all designed to prevent such imbalances from getting dangerously out of hand. Against the backdrop of the so-called “impossible trinity”, the gold standard incorporated a process (not always smooth) of automatic adjustment of trade imbalances. It retained a fixed exchange rate and free capital flows while giving up monetary independence. Under the Bretton Woods system, countries kept fixed exchange rates and independent monetary policies but gave up free capital flows. The IMF essentially played the role of policeman, disciplining in particular countries running large external deficits. Subsequently, after increasingly free capital flows brought an end to the

³⁶ Sveriges Riksbank has already begun inserting boxes on financial vulnerability indicators into its regular inflation review.

Bretton Woods system, floating exchange rates were assumed to be the mechanism through which trade imbalances would be reduced before they attained disorderly proportions. Given the size of recent current account imbalances, this last supposition is being increasingly challenged. Principal worries are that a sharp decline in the demand for dollar-denominated assets might generate instability in global financial markets, or that protectionist pressures might rise sharply.

The underlying problem is that we no longer have a coherent system that somehow forces countries to alter their relative degrees of domestic absorption, and associated exchange rates, so as to reduce external imbalances in an orderly way. A number of important creditor countries, particularly in Asia, have taken significant steps to hold down the value of their currencies against the dollar, thus impeding the needed downward adjustment of the dollar on an effective basis. In sum, we do not really have a freely floating rate system. Moreover, the IMF has never had much influence over creditor countries, and currently has little influence over the biggest debtor country, the United States. Thus, we are not back in the land of Bretton Woods either. While it is logically possible that policy measures consistent with resolving domestic imbalances might resolve external imbalances as well, this should not be assumed. In any event, it is not likely to happen. This leads on to the question of whether there are institutional changes that might be recommended to strengthen the international adjustment process. Three possibilities might be considered.

First, consideration could be given to going back to a more rule-based system. A number of academics and others have suggested reverting to the gold standard or establishing a single international currency. More realistically, one might recommend a small number of more formally based currency blocks (say, based on the dollar, euro and renminbi/yen), but clearly they would have to float more freely against each other. Nor would such a system avoid the possibility of excessive capital flows, based on misguided optimism about one currency block or another, leading to disruptive exchange rate changes and associated international resource misallocations.

Second, consideration could be given to a system more like that of Bretton Woods, but with the IMF accorded substantially more power to force both creditors and debtors to play their appropriate role in the international adjustment process. An associated requirement might be augmented resources for the Fund, to avoid countries feeling that they had to build up their own foreign exchange reserves to very high levels

as a form of “self-insurance”. By way of opening a discussion of such issues, Mervyn King recently said, “I am not convinced that the future of the Fund is primarily as an occasional lender of last resort for middle-income countries suffering financial crises.” (King, 2005, p. 4). Of course, convincing countries to voluntarily give up sovereignty in this fashion would not be an easy sell.

Third, consideration could be given to informal cooperative solutions, based on the mutual recognition of interdependencies and the need to avoid circumstances that could lead to systemic disruptions. At the very least, this would require representatives of large creditor countries to share views with debtors as to whether problems were emerging and, if so, what policies might help resolve them. This is probably the most plausible way forward in current circumstances. However, similar to the difficulties that arise in dealing with domestic imbalances, the impediments to cooperative action arising from different perceptions of systemic risk, different cultures and analytical models, and simple national interest should not be underestimated.

5 Conclusion

All policy choices involve trade-offs and judgment, and policy in the area of macrofinancial stability is no exception. It is hard, on the one hand, to question the benefits of the more stable macroeconomic environment we have experienced over the last 20 years and the policy framework that has produced it. On the other hand, evidence of emerging strains is not difficult to find and future problems cannot be ruled out. What is being suggested here is that financial imbalances, both domestic and international, need more systematic attention, and that this might be accomplished through an evolutionary adaptation of the current policy framework. While there are clearly impediments to this happening, none would seem insuperable, at least to those who believe that there is a problem that needs fixing.

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7

Global Imbalances and the Role of the IMF

Ariel Buira and Martín Abeles

The world economy has become dependent on the United States as a “consumer of last resort”, fueled by US government deficit-spending and US household debt financed consumption. Aided by the willingness of surplus-country residents to acquire dollar-denominated assets, the United States has been able to pull approximately 70 percent of global capital flows in order to finance its current account deficits (Rajan, 2006). These deficits are not being financed mostly by other developed economies; Japan and Germany, the two largest industrial surplus countries explain only 30 percent of aggregate current account surpluses. Developing and transition economies have become crucial sources of finance of the United States’ current account deficits. Developing countries moved from a collective deficit of \$90 billion in 1996 to a surplus of almost \$600 billion in 2006, while the United States moved from a deficit of \$125 billion in 1996 to a deficit of \$857 billion in 2006.¹ Poor countries finance rich countries and not the other way around.

The build-up of global macroeconomic imbalances poses a serious threat for the global economy. In the United States, the current account deficit widened to around 6.5 percent of GDP in 2006. On present policies, the US current account deficit would approach 10 percent of GDP in five years, and consequently the debt of the United States would rise to 60 percent of GDP by 2010, and to more than 100 percent by

¹ IMF, World Economic Outlook Database, 2006 and Bureau of Economic Analysis, US Department of Commerce, online database 2007.

2015.² On the other hand, in 2005 and 2006, the current account surplus remained at a peak level of almost 4 percent in Japan and to over 7 percent in China, while emerging Asia also continued to run large current account surpluses.

Current account surpluses also increased in the Middle East and Russia due to high oil prices; these surpluses are currently roughly equal to those in emerging Asia and Japan (IMF, 2005). As a result, net international assets of emerging Asia, Japan, the Middle East, and Russia continued to rise in 2005 and 2006.

The trend shown by these variables poses considerable risks for international financial stability and worldwide economic activity. To be sure, the growing US current account deficit is not on a sustainable path. At some point it will cause disruption. The only question is “when” and “how much”.

A sudden reallocation of portfolios away from dollar-denominated assets, or even just a gradual decline in the demand of US dollars as a reserve currency due to diversification, would entail large costs as the value of these assets falls and dollar interest rates rise, leading to a slowdown of the US economy and (given the structure of global demand) to a decline in worldwide economic activity. A fall in worldwide economic activity could in turn trigger pervasive “beggar-thy-neighbour” policy responses, including protectionism and extensive competitive devaluations. Such a scenario would affect economies across the globe, but would be particularly harmful to developing economies. Rising interest rates, coupled with the likely fall in commodity prices and exports of manufactures, would force severe macroeconomic adjustments.

The magnitude of this menace calls for an assessment of the Fund’s potential role in dealing with an orderly adjustment of global imbalances. And it calls for an assessment of how to reform the global monetary and financial system to prevent global imbalances from developing – if possible. The International Monetary Fund is charged, under Article I of its Articles of Agreement, with the responsibility of promoting international financial stability. Among other responsibilities, it is supposed to “oversee the international monetary system in order to ensure its

² See Eichengreen and Park (2006); Yoshitomi *et al.* (2005) show that even under favourable assumptions in 10 years time the US debt/GDP ratio would reach 150 percent of GDP, equal to 40 percent of the net wealth of the rest of the world.

effective operation, and oversee the compliance of each member with its obligations". The Fund's current failure to conduct effective multi-lateral surveillance, as well as its limited effectiveness in fostering coordination among systemically important economies, poses a serious matter of concern.

The chapter is organised as follows. Section 1 describes the most salient trends of recent international financial flows, examines the main risks posed by global imbalances, and discusses the Fund's likely response to a dollar crisis in connection with developing countries. Section 2 analyses the Fund's potential role in dealing with global imbalances and reviews some relevant historical precedents where the Fund played an effective counter-cyclical role. Section 3 proposes measures to prevent a global downturn and a facility to assist developing countries in the event of a dollar crisis. Section 4 concludes.

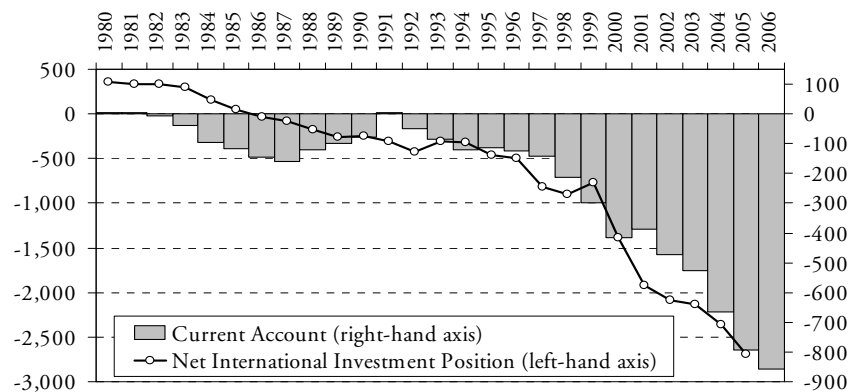
1 The Risk Posed by Global Macroeconomic Imbalances

Since the mid-1970s, the United States has experienced increasing deficits in its balance of trade in goods with pervasive effects for global financial arrangements. This trend, endorsed by international investors' appetite for US dollar-denominated liabilities, has exacerbated in recent years raising concerns about its sustainability in the international community.³ As recently pointed out by the International Monetary Fund's *World Economic Outlook*, an abrupt decline in capital inflows to the US "could engender a rapid dollar depreciation and a sharp increase in US interest rates, with potentially serious adverse consequences for global growth and international financial markets" (IMF, 2005).

As a consequence of large capital inflows in the 1990s, the US currently bears the world's largest net international debtor position. By the end of 2005 the rest of the world owned \$12.7 trillion of US assets, while US-owned assets in the rest of the world reached \$10 trillion; i.e. a net international investment position of minus \$2.7 trillion. As pointed out by Buira (2005a), the shift in the United States net international investment position (a shift that mirrors the United States' switch from trade surpluses to deficits over the last three decades) entails one of the most important changes in the world economy since 1944, when the IMF was created: "The United States, which was the only large capital

³ See Blecker (1998) for an early warning.

Figure 1 US Current Account and Net International Investment Position
(in billions of dollars)



Source: IMF, World Economic Outlook Database, September 2006.

surplus country up to the 1960s and thus the main provider of resources for the IMF and World Bank, has become a net debtor as its external liabilities have exceeded its assets abroad. Today, it is the largest debtor country.”

As indicated above, the US ran a current account deficit of 6.5 percent of its GDP in 2006, equivalent to over 1.5 percent of world GDP. As shown in Figure 1, the historical trend is disturbing, as current account deficits – which have to be financed by foreign capital inflows – have widened significantly over the past decade, facing policymakers across the globe with the prospect of a possible decline or collapse in the demand of the US dollar as a reserve currency. Until now, the unrelenting demand for US-dollar assets has financed the increase in US current account deficits allowing the US to sustain rising levels of domestic absorption despite its diminishing international competitiveness.⁴ In

⁴ Poole (2005) argues that US’s lower competitiveness is the result of international investors’ confidence in US dollar-denominated assets: “[I]nstead of thinking that capital flows are financing the current account deficit, it may well be that the trade deficit is driven by – is financing, so to speak – capital flows determined by investors seeking the best combination of risk and return in the international capital market. The mechanism creating this outcome is that capital inflows keep the dollar stronger than it otherwise would be, tending to boost imports and suppress exports, thus leading to a current account deficit.”

fact, after the slowdown of 2001, when GDP's annual growth rate fell below 1 percent, GDP growth rates in the US have risen to over 3 percent in 2004, 2005 and 2006. It is widely accepted that this growth in output has been sustained by deficit-financed spending of the US government⁵ and by debt-financed consumption of US households.⁶

In spite of the growing concern regarding the possibility of a decline in the demand for US dollars, capital has not ceased to flow into the US.⁷ Such an appetite for US dollar-denominated liabilities has contributed to finance the swelling US current account deficits at appreciably low interest rates.⁸ Resulting low US dollar interest rates have contributed to finance the housing boom in the US, which in turn allowed for increased debt-financed spending by US households due to the resulting wealth effects. A similar process, albeit less significant for the global economy, can be traced for the United Kingdom.

In 2005, despite the large US current account and budget deficits, the US dollar strengthened and remained at fairly high levels. However, the present strength of the US dollar seems to result from a combination of temporary factors, namely:

- A relatively aggressive interest rate policy by the Fed, coupled with a passive interest rate policy by other central banks giving rise to an interest rate differential in favour of dollar assets;
- Higher growth rates in the US than in other industrial economies,

⁵ After four consecutive years of fiscal surplus (1998-2001), following the recession of 2001 the United States' federal budget deficit rose to and resulted in five consecutive years with deficits of over 3 percent of GDP (2002-2006).

⁶ Debt-financed spending by United States households also contributed to keep domestic demand on the rise, encouraged by a combination of low long-term interest rates and the associated wealth effect resulting from the housing boom and swelling real state prices (which are in turn fed by low long-term interest rates). According to Zamparelli *et al.* (2005), personal net borrowing comprises the main domestic counterpart of foreign net lending in the US.

⁷ It should be noted, as pointed out by D'Arista (2005), that "for all the attention paid to foreign central banks purchasing US Treasuries in order to curb the appreciation of their currencies, this sector's net acquisition of US assets amounted to only 27.4 percent of the total net inflow [in 2004]. The remaining 72.6 percent (\$1.05 trillion) consisted of private investment that was mostly channelled into purchases of corporate and other bonds (\$309.3 billion) and banks' liabilities (\$322.6 billion)".

⁸ Long-term interest rates have remained fairly low despite the Fed's 1½-year drive to increase short-term rates (the so-called "Greenspan's conundrum").

particularly Japan and Germany, which gave rise to higher returns on investments in the US;

- The demand for dollars resulting from the repatriation of profits fostered by the Homeland Investment Act;
- The dismal political performance of the EU, viz. the rejection of the European Constitution by France and The Netherlands and the protracted difficulties for the approval of the EU budget – all factors that have undermined investor's confidence and discouraged US dollar denominated investments from moving into the euro.

As pointed out by numerous financial analysts, current low interest rates are also unlikely to persist in the medium term. For sure, interest rates will rise if foreign investors fear the possibility of US dollar devaluation and respond by reducing the rate of accumulation of dollar-denominated assets; or (even worse) if they react by cutting back their holdings of dollar-denominated assets. A dollar devaluation would itself entail domestic price increases in the US, as the rise in the price of tradable goods impinges on domestic prices. The increase in domestic prices could in turn trigger a contractionary response by the Federal Reserve, which may decide to raise short-term interest rates.⁹ A rise in interest rates due to either of these causes (or most likely due to a combination of both) could prick the housing bubble reducing household consumption further thus worsening the contractionary impact of rising interest rates.

Consumption growth in the US may also prove to be unsustainable at the current rate, for the following reasons:

- It is based on borrowing by households, whose debt has risen markedly to 126 percent of disposable income (more than 7 percent of GDP), and whose debt service has increased to 14 percent of disposable income despite prevailing low interest rates (Wolf, 2006). As consumption has been fueled by the wealth effect of rising house prices, a softening or a decline in the housing market – as noted above, the effect of higher interest rates – would lead to a fall in consumer purchases and an economic slowdown. If the rise in interest rates in the US continues, the US could suffer a recession or a slowdown in 2007, with a good chance that the global economy would also slow down (more on this below);
- The differential in returns between dollar and other bonds is very narrow, (1 percent on euro bonds and about 3 percent on yen in 10-

⁹ The increase of oil prices and the ultimate pass-through of general inflation into core-inflation would most likely move the Fed in the same direction.

year bonds) and not enough to compensate for the fall in the dollar that is likely to occur over the next few years. As pointed at by Martin Feldstein (2006), “the dollar must fall faster than these small interest differentials to prevent the current account deficit from increasing faster than GDP.” This means that investors in dollar bonds will eventually have lower returns, potentially much lower returns than investors in bonds denominated in other currencies. At some point that will trigger a shift away from the dollar into other currencies to avoid the loss of value of their dollar bonds (*ibid.*).

It should be noted that a sudden loss of appeal of US-dollar denominated assets is not necessary for the dollar to weaken. All that is necessary is that the willingness of others to continue to purchase US-dollar denominated assets lags behind the insatiable US demand for borrowing to finance its deficits. There are several reasons why this second scenario is likely to materialise.

First, surplus savers in rest of the world may seek to *diversify* their portfolios. We have been given notice by the Chinese authorities that while they are unlikely to sell off a large part of their dollar holdings, they will use some proportion of their fast growing reserves to purchase other assets and diversify their portfolio.¹⁰ Similarly, the BIS has noted that bank deposits held by OPEC are sensitive to interest rate differentials as well as a longer term tendency for OPEC to diversify out of US assets. Some of the OPEC funds are temporarily held in US paper until they are invested.¹¹

Second, while it is expected that the US will continue to grow faster than Europe and Japan, the growth rate differential with these countries will probably narrow in 2007. This means that the attractiveness of dollar assets declines, while the investment needs and opportunities in these countries, which could absorb a greater share of their savings, rise. The interest rate differential in favour of the dollar may decline, as the Fed adopts a neutral stance and interest rates stop rising in the US in the second semester while they may be expected to rise in other industrial countries.

¹⁰ “We won’t sell off our dollar-denominated assets,” said Tang Xu, head of the research bureau at the People’s Bank of China. But buying other assets with growing inflows is likely, he stated, adding that China does not exclude buying oil for petroleum reserves (IMF Morning Press, January 10, 2006).

¹¹ The sharp increase in the price of gold, to around \$540-\$550 per troy ounce must be seen as a sign of diversification by some surplus savers.

1.1 From Global Excess Liquidity to Higher Interest Rates

The risks posed by the growing US current account deficits have attracted substantial attention in international policy circles. However, international financial markets appear to be complacent regarding present interest rate and trade risks. Indeed, the future path of interest rates and spreads, which have been at historically low levels for an extended period of time, comprises another important source of uncertainty in international financial markets. However, no financial authority or institution seems to be making contingency plans in connection with a potential dollar crisis.

The prolonged low interest rate environment has considerably increased global liquidity and seems to have led financial market participants to become excessively leveraged, leaving them vulnerable to a sharp increase in interest rates.¹² In this context, the growing US current account deficit not only poses a clear danger to foreign exchange markets, but also threatens the stability of the global financial system more broadly. As the cycle matures, macroeconomic imbalances could unwind abruptly and bring about unanticipated interest rate spikes.

Concerns not only relate to interest rate levels, but also to historically low interest rate spreads. The long-standing low level of interest rates has encouraged financial market participants to channel funds into riskier financial assets in search for higher returns, as perceived in the growing interest in longer-term financial assets, which tend to carry more risk. As funds have been channelled into long-term debt, yields have fallen contributing to historically low real government bond yields.

This phenomenon has not only affected advanced countries, but also developing countries. Indeed, low yields have encouraged the purchase of long-term debt that offers a premium over the return provided by government debt in industrialised countries. As a result, considerable funds have been directed towards corporate and emerging market debt, causing a significant narrowing in their interest rate spreads vis-à-vis

¹² Many analysts point to the prolonged “hyper-stimulative stance” of monetary policy in many countries as the source of recent financial excesses. In the United States the real Fed funds rate was negative from October 2001 to November 2004, significantly below the positive 1.98 percent average of the ten years prior to the 2001 downturn (see Bank Financial Group, 2005). Similarly, in inflation-adjusted terms the European Central Bank has averaged roughly 0.5 percent over the past three years, also low compared to an average of about 2 percent over the preceding decade (*ibid.*).

government debt. The underlying strategy of borrowing at short-term rates to invest in long-term assets introduces considerable interest rate risk, and entails increased vulnerability to a sudden rise in interest rates. As a result, global financial markets appear more vulnerable today to unexpected shocks than they have been in the past.

Although over the past two years emerging market economies have reduced their public debt levels, debt-related vulnerabilities are still important. According to the *World Economic Outlook*, by the end of 2005 public debt ratios in emerging markets had fallen by approximately 8 percentage points of GDP since 2002, to an average of 60 percent of GDP.¹³ Despite this relative improvement, a rise in US interest rates would still pose a menace to public finances in many developing countries. Furthermore, the impact of such a rise in US interest rates would be compounded in the developing world by the likely concurrent increase in interest rate spreads.¹⁴

Higher interest rates and higher spreads would affect public finances in developing countries in two ways: by increasing the cost of servicing existing variable-rate debt and by increasing interest rates on new debt commitments. Naturally, the fiscal impact of the second effect is bound to increase over time as old debt at lower rates is replaced with new debt at higher rates. An IMF Working Paper estimates the impact on emerging market fiscal performance in 2006-07 of an increase in global interest rates by 100 to 300 basis points relative to the end-2004 level, finding a substantial negative fiscal impact of future higher interest rates on many emerging markets' future fiscal performance (Hauner and Kumar, 2005). In the most highly indebted developing economies the fiscal impact of a 300 basis points rise in industrial country base interest rates would amount to approximately 1½ percent of GDP in 2006-07, their impact rising as maturing debt at lower rates is replaced with new debt at higher rates (*ibid.*).

¹³ Public debt ratios have fallen most significantly in Latin America (an average decline of 13 percent of GDP, to approximately 52 percent of GDP by end-2005), followed by the Middle East and Africa (by 11 percent of GDP, to about 77 percent of GDP), and Asia (by 5 percent of GDP, to 58 percent of GDP). Only in the central and eastern European countries have public debt ratios increased about 1 percent of GDP, to around 53 percent of GDP (IMF, 2005).

¹⁴ The extent to which rising interest rates in advanced countries would entail a widening of spreads on emerging market debt is uncertain, although historical experience seems to indicate that this is likely to be the case. Indeed, if interest rates rise in the US, investors would be less pressed to look for high yield elsewhere and the pursuit of risk could diminish.

Similarly, according to the World Bank's (2005) *Global Development Finance*, an increase in US short- and long-term interest rates of 200 basis points would reduce economic growth in emerging economies by 1 percent in 2005 and 2006. Furthermore, if such increases in US interest rates were associated with widening interest rate spreads, the slowdown would be much more pronounced, by more than 2 additional percentage points in 2005 and by around 4.5 additional percentage points in 2006.

Note that in the event of a steep rise in global interest rates and the widening of interest rate spreads the fiscal strain on developing countries would stem from an exogenous event. Furthermore, the weakening of public finances resulting from rising debt obligations would come about despite the recent decline in public debt to GDP ratios in the developing world (IMF, 2005). The potential increase in developing countries' risk premiums due to a fall in the US dollar would be unrelated to domestic policies, a crucial aspect to be considered from a multilateral perspective. Under such circumstances, further fiscal adjustment – a likely IMF recommendation – would only make things worse. Furthermore, in the context of global contraction, fiscal adjustment would not affect individual debtor economies – it would also contribute to exacerbate the slowdown of global economic activity.¹⁵

1.2 Trade and Interdependence

The risks for developing countries not only stem from the possible reversal in the low interest rate environment, but also from the associated slowdown of US (and global) economic activity and the likely fall in commodity prices. Given the structure of global macro-economic imbalances, a recession in the US would unavoidably affect surplus countries, i.e. those economies whose thriving exports are directly or indirectly linked to high US growth rates.

¹⁵ The cited IMF Working Paper suggests that developing countries should increase their already contractionary stance: “[T]he fiscal risks for emerging markets stemming from a reversal in the benign global financial environment are substantial, even more so as a deterioration in global financial conditions could be accompanied by a slowing pace of global activity and lower commodity prices. This increases the onus on emerging markets to aim for a consolidation of their underlying fiscal position, and to press ahead with fiscal reforms to preserve benign financial conditions for their countries, even if the global financial environment should deteriorate.” (Hauner and Kumar, 2005).

The most obvious example at hand points to Canada and Mexico, two sizeable economies closely linked to the US, who would suffer enormously from a slowdown of economic activity in the US. In both cases, exports to the US represent more than 80 percent of their total exports.¹⁶ A slowdown in Canada and Mexico, induced by a downturn in the US, would in turn affect third parties involved, particularly among developing countries, as Canada and Mexico tend to increasingly import goods and services from the developing world.

Given the Chinese and (to a lesser extent) Indian growing dependence on US demand, as well as their growing influence on third parties, the impact of a downturn in the US on China and India would give rise to a most preoccupying situation. To illustrate, more than 20 percent of China's exports go to the US, whereas more than 50 percent of China's imports come from the developing world. Although less significantly, India has also become increasingly dependent on US economic growth, and its imports from developing countries are also significant.

As suggested above, a reduction in China's exports brought about by a reduction in US demand for Chinese goods would, in the absence of counteracting factors, e.g. sharp growth of domestic absorption in China and other Asian economies (China by itself is too small to offset a decline in US consumption), immediately affect other economies in the developing world. Consider the case of Africa. While Africa's overall exports have doubled between 1998 and 2004, from \$92 billion to \$190 billion, Africa's exports to China alone have grown more than tenfold, from less than \$1 billion to more than \$11 billion. As a result, between 1998 and 2004 the share of China as a destination for African exports increased from less than 1 percent to more than 6 percent.¹⁷ In short, China's significance for Africa has grown in recent years, especially after 2000. While 30 percent of Africa's total exports currently go to developing

¹⁶ In the 1990s, Mexico displaced Japan as the second-largest US trading partner. Since 2003, however, Mexico was displaced by China as the second largest supplier of US imports (after Canada, which remains the largest US trading partner regarding both exports and imports).

¹⁷ It should be noted that African exports to the US more than doubled in the same period, from around \$13 billion to \$30.5 billion. While the increase in African exports to China in the period 1998 and 2004 explains approximately 10 percent of the overall increase, the increase in African exports to the US explains close to 18 percent of the overall increase between 1998 and 2004. Hence, a slowdown in the US GDP growth would affect Africa directly, not just indirectly due to its impact in Chinese growth.

countries, of which around half go to Asian countries, almost 50 percent of Africa's exports to Asia go to China alone. Consequently, a slowdown in China would seriously affect Africa's exports.

In the case of Latin America and the Caribbean, China has become an increasingly relevant market. While overall exports of Latin America and the Caribbean increased by 70 percent between 1998 and 2004, (from \$284 billion to \$484 billion), the region's exports to China have grown more than sixfold (from less than \$2.5 billion to more than \$15 billion). As a result, between 1998 and 2004 the share of China as a destination for Latin America and Caribbean exports rose from less than 1 percent to more than 3 percent.¹⁸

One of the most important impacts of China and India's outstanding growth performance is associated with the recent rise in commodity prices. China and India's extraordinary growth rates (their combined contribution to global economic growth has been estimated to be of approximately 30 percent) have helped keep global output growth rates and prices above trend, a critical factor in improving the terms of trade of primary commodity producers.¹⁹

The recovering Japanese economy also seems to rely increasingly on China as a market for its exports. Note that between 1998 and 2004 the increase of 8 percentage points in Japanese exports to China matches the decrease in its exports to the US. While in 1998 China represented only 11 percent of Japanese exports to the developing world, in 2004 China absorbs 23 percent of Japanese exports to developing countries, which have themselves increased as a proportion of total Japanese exports.

To be sure, no economy in the world would remain unaffected in the event of a US dollar depreciation-cum-recession. While many Asian economies, including India and China would be directly affected by

¹⁸ In the case of Latin America and the Caribbean the growth of exports to the US is also very significant in absolute terms. The region's exports to the US increased by 74 percent between 1998 and 2004, from around \$146 billion to approximately \$254 billion. This increase of more than \$100 billion represents more than 50% of the overall increase of exports originated in Latin America and the Caribbean during this period. Here again a slowdown in the US GDP growth would affect Latin America and the Caribbean directly, not just via its impact in Chinese growth.

¹⁹ According to Chen *et al.* (2005): "If world industrial growth exceeds 4 percent, the barter terms of trade of primary commodity to finished goods prices rise. High global growth thus counteracts the Prebisch-Singer hypothesis that technological progress has led to a secular decline for raw commodity prices since World War II".

the fall in US demand, many countries in Latin America and Africa, who depend on growing Asian demand of primary goods, would also face a fall in their exports and be forced to adjust downwards. A likely fall in commodity prices would only contribute to make things worse.

1.3 The Fund's Likely Response to a Systemic Crisis

If the international community does not intervene, the likelihood of a disorderly adjustment that would result in global contraction increases, with unpredictable downward dynamics. While the burden of US dollar depreciation would mostly fall on countries with floating-exchange rate regimes, mostly in the European Union,²⁰ Latin America and Africa, the rise in dollar interest rates and the slowdown in US economic growth would directly affect Asian countries, even if their currencies remain pegged to the US dollar, as their exports largely depend on US demand. The slowdown in Asian economies would hit Latin American and African countries yet again, as the demand for their primary goods exports falls, and their terms of trade decline. Such a generalised deteriorating situation is likely to trigger defensive responses and “beggar-thy-neighbour” dynamics.

Such is precisely the type of development (e.g. growing restrictions on trade, a chain reaction of competitive devaluations, etc.) that the Fund’s “founding fathers” had intended to avert. Indeed, according to Article I of its Articles of Agreement the Fund should:

- Promote international monetary cooperation providing the machinery for consultation and collaboration on international monetary problems;
- Facilitate the expansion and balanced growth of international trade, and contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy;
- Give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national and international prosperity;
- In accordance with the above, shorten duration and lessen the degree of disequilibrium in international balances of payments of members.

²⁰ To the extent that in this process the euro strengthens vis-à-vis the US dollar, the African countries which peg their currencies to the euro would suffer as well.

Developing countries' prevalent export-led development strategy, which sustains existing global imbalances, seems to be related to the Fund's response to recent financial and currency crises. In fact, the so-called "savings glut", a term popularised by Ben Bernanke, chairman of the US Federal Reserve System, which points to the excess of savings vis-à-vis investment in developing countries (particularly in Asia) as the main culprit for global imbalances, results to a great extent from developing economies' ubiquitous export-led growth strategies, which necessitate competitive exchange rates and tend to limit domestic absorption.²¹

While in the cases of India and China current account surpluses seem to be related to domestic expansion strategies, other developing countries' current account surpluses appear to be a defensive response to inadequate Fund intervention in the past, particularly after the 1997 Asian financial crisis, where Fund conditionality was considered to be inappropriate, turning a liquidity crisis into a solvency crisis (Taylor, 1998). In order to avoid resorting to Fund assistance-cum-conditionality in the future, Asian countries have decided to build up international reserves and to develop regional monetary arrangements as a form of self-insurance.²² The development of alternative regional monetary cooperation arrangements and the accumulation of high levels of international reserves seem to comprise costly forms of insurance, not just for the Asian economies, but given its contractionary bias also for the global economy as a whole.²³ Such a contractionary bias is apparent in global

²¹ While at the individual country level an export oriented strategy may give rise to a short-term expansionary thrust, as in the case of Japan in the 1960s-70s, the Four Tigers (Hong Kong, Singapore, South Korea, and Taiwan) in the 1970s-80s, and more recently other countries (including Thailand, Malaysia, and Vietnam), at the global level such a strategy tends to create a contractionary bias (see Blecker and Razmi, 2005).

²² The Chiang Mai initiative was established to provide liquidity support to its members facing contagion and/or speculative attacks against their currencies. In the words of Masahiro Kawai, a former high official of the Japanese finance ministry who will head the new regional financial integration office at the ADB, "The Chiang Mai initiative has the potential to become an Asian Monetary Fund" (Financial Times, May 6, 2005).

²³ Baker and Walentin (2001) estimate that "the increase in the ratio of reserve holdings to GDP over the last four decades has imposed costs that exceed 1 percent of GDP, and possibly 2 percent of GDP, for many developing countries" and point out to increasing international financial instability as the main explanation of the over-accumulation of reserves, especially after the 1997 East Asian crisis.

investment figures (see Figure 2).

In the *World Economic Outlook*, the Fund's staff reject the idea that current global imbalances result from a "savings glut", a supply-sided approach, and appear to believe that the problem lies on the demand side.²⁴ Indeed, the staff's judgement points to the need to boost investment demand worldwide (with the exception of China), especially in surplus countries, as a means to balance global real and financial flows.

However, the staff lay excessive emphasis on medium-term reforms to promote supply-side responses, including financial sector reforms in emerging Asia and structural reforms in Europe and Japan. Irrespective of the merits of such reforms, it seems unlikely they would be suitable to cope with the macroeconomic disequilibria faced today in the short and medium term.²⁵ Indeed, the effect of structural reforms in terms of reverting current account imbalances seems to be small, at least in the short and medium run. There seems to be a disconnect between the Fund's demand-side assessment of global macroeconomic imbalances, on the one hand, and the medium- and long-term nature of the recommended supply-side policy response, on the other.

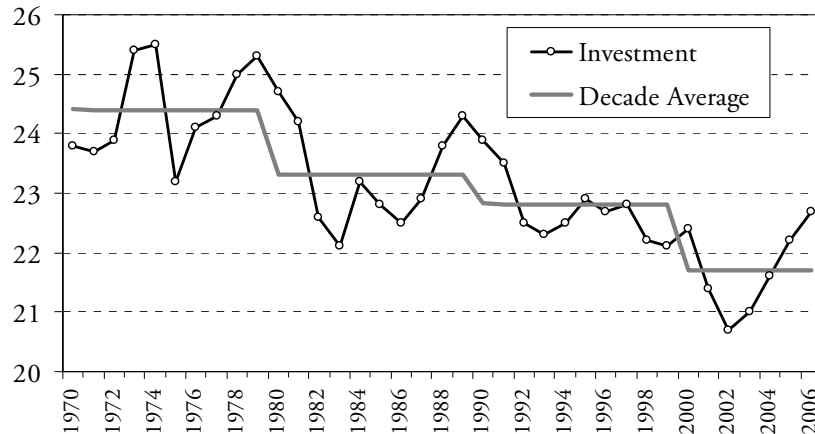
For instance, as regards Europe (a surplus region), the emphasis seems to be on labour market reforms, a policy which can only be expected to be practicable if applied in stages and which can at best bring forth significant effects over the long run. Similarly, with reference to developing countries in Asia, including China, besides sensible demands for some exchange rate realignment, the Fund seems to be excessively concerned with long-term financial system reform (IMF, 2005). Finally, as regards Latin American countries, the emphasis seems to be on further fiscal adjustment, a policy that, if not cyclically adjusted, would be entirely inappropriate.

²⁴ In a recent lecture about global imbalances the director of the IMF's Research Department asserted: "Unlike those who view the imbalances as mirroring a savings glut, I see the problem as the world is investing too little" (Rajan, 2005).

²⁵ The diagnosis in terms of demand side constraints followed by supply-sided policy recommendations is clear in the following passage by the director of the IMF's Research Department: "[W]e need more investment, especially in low-income countries, emerging markets, and oil producers. China is an exception in needing less, not more, investment. The easy way to get more investment is a low-quality investment binge led by the government or fueled by easy credit [...]. The harder, and correct, way is through product, labour, and especially financial market reforms, which will ensure that high-quality investment emerges" (Rajan, 2005).

Figure 2 Global Investment Rate

(as percentage of GDP)



Source: IMF, World Economic Outlook Database, September 2006.

As pointed out by Blecker (2005) in a slightly different (albeit related) context, when stressing the convenience of yuan revaluation, long-term structural reforms, whether appropriate or not, are certainly incapable of coping with short term disequilibria: “There is no reason to wait for long-run policy reforms [viz. liberalisation of Chinese financial markets] that could take decades to enact before making a relatively simple adjustment that is vitally necessary for rectifying the current asymmetries in the global trading system” (Blecker, 2005).

Recent documents and historical evidence suggest that, as regards global macroeconomic disequilibria, the IMF seems inclined to push for further structural market reform and short-term contractionary adjustment – the very conditions that have led many developing countries to run substantial current account surpluses (so that they do not have to turn to the Fund again), bringing down global aggregate demand. Such a policy stance, if not modified, would reduce both the pace and the amount of financial resources that many developing would require in order to cope with a downfall in foreign demand and/or a rise in their foreign debt obligations. As we argue below, what developing countries would need in the current juncture is the very opposite approach – the provision of timely and sufficient financial support subject to appropriate conditionality.

2 The Fund's Potential Role in Dealing With Global Imbalances

Current global imbalances call for a strong involvement of the Fund under its monetary cooperation and multilateral surveillance functions. International financial stability is the Fund's primary responsibility. In the present context, a first concern arises from the fact that the risks posed to the international economy by global imbalances are not being addressed. Currently, each systemically significant country pursues its own policies in accordance with its individual, often short-term interests, with little or no regard for their international consequences. There is no effective IMF oversight and no overall policy coordination to ensure that the outcome of these policies is consistent with international financial stability and sustained worldwide economic growth. Thus, while the risks posed by global imbalances increase unabated there can be no assurance that they will not lead to a crisis and a major global recession.

In order to prevent a disorderly adjustment and help sustain economic activity worldwide the IMF should adopt a pre-emptive stance and encourage a coordinated approach to the resolution of global imbalances.²⁶ Acting along these lines, the IMF should assume a central role in the resolution of global imbalances by promoting a coordinated shift of aggregate demand from countries running current payments deficits to countries running current surpluses.²⁷ This would require a more pro-active and assertive implementation of Fund surveillance, making explicit the risks inherent in the continuation of current trends, and exploring the policy options available for the solution of the problem. These policy options should be put on the table for discussion by the international community, with a view to influencing the policy stance of major countries and inducing them to adopt concerted actions.

The impact of a disorderly adjustment on developing countries, whose access to international financial markets tends to fade precisely when it is most needed, gives rise to another concern. In the absence of sufficient financial assistance on appropriate terms, a financial crisis could result in a severe recession or even a protracted adjustment process, reminiscent of Latin America's "lost decade". Therefore, the Fund should stand ready to provide financial support on terms that do not deepen the

²⁶ In contrast to its now customary policy of lending only after a crisis has developed.

²⁷ This is similar to what has been recommended by Bergsten, Cline, Goldstein, Truman, Mussa and Williamson.

contraction in economic activity. This would be in keeping with one of the Fund's purposes, i.e. "to provide its member countries with the opportunity to correct external imbalances without resorting to measures destructive of national and international prosperity." (Article 1, Section 5; italics added).

In addition, we also recommend the establishment of a counter-cyclical facility to help developing countries sustain aggregate demand in the event of a major exogenous shock arising from a disorderly correction of international financial imbalances; a facility meant to cover export income loss and increased external debt service due to a sharp rise in dollar interest rates in the event of an exogenous fall in external demand, due to an abrupt exchange rate re-alignment and likely slowdown in US and world economic activity.

Most developing countries have been unable to carry out counter-cyclical macroeconomic policies in the recent past. This is partly related to the pro-cyclical bias built into the working of international financial markets, and partly to the limited availability of financing and excess conditionality attached to IMF facilities. In recent times, the Fund has often failed to provide timely and sufficient financial assistance to stressed economies; assistance has been provided only after a financial crisis had detonated. By so doing, the Fund appeared incapable of preventing the typical sequel of currency devaluation, interest rate spikes, extended private sector bankruptcy, financial sector rescue, and increasing unemployment – an outcome that is totally at variance with the Fund's mandate of providing member countries with the opportunity to correct macroeconomic imbalances "without resorting to measures destructive of national and international prosperity". A different approach, one more consistent with the Fund's mandate, would allow for multilateral precautionary intervention, with sufficient financial support provided in a timely manner, i.e. before existing disequilibria unwind into a market-driven debt-deflation.

The same lack of precautionary concern seems to underlie the Fund's current stance regarding global imbalances. As argued above, present global macroeconomic imbalances call for pre-emptive intervention. Indeed, the world economy needs a degree of management and coordination among major economies to reduce the probability of a crisis. In the event of a crisis, developing countries will need counter-cyclical programmes with adequate financial support. Before elaborating on the convenience of developing a counter-cyclical facility, it may be worth recalling the Fund's response to somewhat comparable

global imbalances in the past: i.e. the establishment of an Oil Facility in the mid-1970s, and the discussion regarding the establishment of a “substitution account” in the late 1970s.

2.1 Oil Facility (1974-75)

The Fund’s belated reaction in the face of financial crises in the past decade differs significantly from the pre-emptive policy it adopted in the mid-1970s, a period of profound global imbalances. As pointed out by Buira (2005a), “with the world economy emerging from three years (1969 to 1971) of a combination of recession and high rates of inflation, the sharp increase in oil prices in 1973 and 1974, which deepened the recession and fueled inflation, posed for the Fund what was perhaps its greatest challenge to that date”. The Fund recognised that many developing countries would find it difficult to borrow from international capital markets in order to pay for the increased cost of oil. Furthermore, there was a growing uncertainty regarding the ability of international banks to recycle the sizeable flows involved.

Facing these unprecedented circumstances, in 1974 Johannes Witteveen, the Fund’s Managing Director, proposed the establishment of an Oil Facility to help recycle the surplus from oil-exporting to oil-importing countries. This facility would help oil-importing developing countries finance the external imbalances resulting from increased oil prices, thus reducing their adverse impact on economic activity, allowing for a longer-term process of adjustment to the change in oil prices, including the adoption of energy-saving technologies. Despite initial resistance by the United States, the initiative was brought into being in 1974 with strong support of European and developing countries, including the oil-exporting countries that would finance the facility. The Oil Facility proved to be effective and was renewed in 1975.

With this policy, the Fund helped recycle the surplus of oil-exporting to oil-importing countries, which could therefore avoid a disproportionate reduction of domestic absorption, what would have compounded the problems already being faced by the international economy.

It should be stressed that the 1974 Oil Facility involved minimum conditionality. The only requirement for access to the Oil Facility by oil-importing countries was the existence of a balance of payments problem. There was virtually no other conditionality than for borrowing countries to desist from imposing restrictions on trade and payments

without the Fund's consent. Under the 1975 Oil Facility the Fund imposed somewhat stricter conditions. Still, conditionality was minimal if compared with more recent IMF programmes.²⁸

The Fund's foresight during the mid-1970s, which led to the development of the counter-cyclical Oil Facilities of 1974-75, should serve as an example of the Fund's potential role in preventing the acceleration of global recessionary forces.

2.2 Substitution Account

There is another interesting historical precedent in which the Fund sought (though finally failed) to adopt a pre-emptive policy stance meant to counterbalance a loss of confidence in the reserve currency at a time of mounting international payments disequilibria.

In the early 1970s, the recognition that SDRs, whose original purpose was to serve as a supplement of the US dollar as a reserve asset, could serve as a substitute of a portion of the US-dollar assets held in central banks' portfolios led the Fund to devote substantial effort to the development of a practical approach for promoting large-scale reserve diversification into SDRs: "By acquiring SDRs through allocations by the Fund or in exchange for dollars through transactions with other central banks, a country could gain a single asset with a more stable exchange value than the dollar" (Boughton, 2001, p. 937).

The idea of a "substitution account"²⁹ (as it was then called) did not make much progress until the end of 1977, when the dollar became increasingly exposed to selling pressures.³⁰ In the first half of 1979 the Fund's staff put forth a proposal whereby the Fund would establish and administer an account in which central banks would voluntarily deposit dollars (typically, short-term US treasury bills). In exchange, they would receive SDR-denominated claims, which they could use in the same limited manner as any other SDR. The account would

²⁸ Under the auspices of the 1975 Oil Facility borrowing member countries were required to discuss and get the Fund's approval of the policies designed to solve their balance of payments problem, including measures to reduce oil imports and/or develop alternative energy sources.

²⁹ For a detailed description of the discussions behind the substitution account, see Boughton (2001).

³⁰ Support for the substitution account included some US officials who esteemed the possibility of promoting the role of SDRs as a means to diminishing speculative pressure against the US dollar (Boughton, 2001).

convert its assets into longer-term dollar-denominated claims on the US Treasury, which would pay a suitable long-term interest rate on them. Interest would be paid to depositors at the official SDR interest rate (which at the same time was maintained below the market rate). The intention was that the account's exchange risk would be covered by the difference between the long-term US bond rate and the official SDR interest rate (Boughton, 2001, p. 939).

The project, driven by the hope to overcome the weakness of the US dollar in exchange markets, could lead to the realisation of the amended Article VIII (Articles of Agreement), which sought to make SDR the main reserve asset of the international monetary system. Most importantly, the establishment of such a substitution account would have implied a radical blow to the US dollar as an international reserve currency; namely the "substitution" of the dollar for SDR as the ultimate reserve asset in the international monetary system.

The project, put forth by the Fund's Managing Director, Jacques de Larosière, together with the Fund's Chief Economist, Jacques Polak, proved in the end to be politically unacceptable. Apparently, none of the parties involved was prepared to bear the underlying currency risk involved in the substitution of US-dollar denominated assets for SDRs (Boughton, 2001). By 1980, the tightening of US monetary policy (that had begun in late 1979) eased fears concerning the dollar collapse, contributing to dispel the imbalances that had motivated the initiation of the project.³¹ Most fundamentally, it seems, the implications of a strengthened SDR reducing the role of the US dollar proved unpalatable for US authorities.

Despite the failure to establish the substitution account, some of its attributes are worthy of consideration. The precautionary nature of the substitution account, meant to prevent a systemic crisis (rather than dealing with mounting disequilibria *ex post facto*), is worth emphasising. It would certainly be beneficial for the entire world economy if the International Monetary Fund regained such a pre-emptive concern, both as regards counter-cyclical financial intervention and the reconsideration of some of the (acknowledged) risks introduced by full-fledged capital deregulation over the past two decades (Prasad, Rogoff *et al.*, 2003).

³¹ The decline in oil-exporters surpluses also contributed to moderate the concerns about the fall of the US dollar.

3 A G-20 Accord and the Need for a Counter-Cyclical Facility

Following the precedents of the Smithsonian and the Plaza Accords, signed in 1973 and 1985, which successfully achieved the realignment of the US dollar, a concerted approach to the correction of global imbalances would involve the members of the G-20. While the US would pledge to tighten its fiscal policy and Japan and China and other countries in large surplus were to revalue and increase private demand all countries would contribute to a non-recessionary adjustment of global imbalances and carry out exchange rate interventions to depreciate the US dollar in an orderly fashion.

As argued recently by various analysts (Buirra, 2005; Williamson, 2005; Cline, 2005), presently there seems to be a need for an initiative comparable to the 1985 Plaza Agreement, though in this case to be agreed upon by a larger group, say the G-20, of major industrial and emerging-market economies, rather than just by the G-5. In this Accord, countries that have pegged their currencies to the dollar and intervened in exchange rate markets to prevent their currencies from appreciating against the US dollar would desist from such a course of action.

Central banks could in turn agree to sell US dollar reserves. And the US could similarly agree to purchase euros, yens and other currencies. All surplus countries would be required to persist in this policy until their exchange rate against the US dollar had been sufficiently realigned.

In support of this exercise, the IMF could suggest an approximate range of exchange rates for the G-20 currencies that would be consistent with external balance at high levels of employment in all participating countries. According to Cline's (2005) own estimations, the entire adjustment process could be expected to last no less than three years.

A concerted approach as described above should involve a shift in global demand from deficit to surplus countries. This is a key component of any workable solution to global imbalances: In the absence of a boost in the demand by the surplus economies, a US fiscal correction and the decline in the US dollar would undoubtedly bring about a worldwide recession. For a such an approach to succeed other countries would have to adopt domestic expansionary measures in order to make up for the reduction in global demand resulting from the lower net exports related to US external adjustment. Hence, to be successful the shift in demand from deficit to surplus countries should involve the entire G-20.

Obviously, the Chinese economy (which amounts to 20 percent of the US economy) alone cannot by itself offset the fall in global demand resulting from a slowdown of the US economy.

There are several benefits of a concerted action agreement vis-à-vis a market-based solution. First and foremost, such an agreement is capable of minimising the recessionary bias of alternative adjustment processes, such as the abrupt fall in the rate of consumption growth in the US, or the sudden adjustment of international portfolio away from US-dollar assets. Second, it would resolve the collective action problem faced by many developing countries that have pegged their currencies to the US dollar and are unwilling to appreciate their currencies for fear of a loss of competitiveness if acting in isolation (Cline, 2005).

Third, it would provide a framework for coordinated intervention in exchange rate markets (*ibid.*). And lastly, by including US fiscal adjustment, a concerted action accord would assure the rest of the countries involved that the US would also make the necessary corrections.

For the above reasons the best solution would come about as part of an agreement, with the consequent checks and balances. Still, in the context of a G-20 Plaza-type accord the benefits of the IMF assuming a leading role in the pre-emptive resolution of global imbalances are vast. First, the Fund could provide technical support regarding the realignment of the exchange rates involved (Williamson, 2005). Second, as the adjustment process is unlikely to proceed as smoothly as portrayed above, even under the assumption that such an Accord is agreed upon, the Fund should expand the array of financial facilities to sustain demand in developing countries in the event of contractionary shocks.

The mechanics of such a facility, which would also serve in the event of profoundly disruptive adjustment, is described below.

3.1 The Mechanics of a Facility

As indicated above, disorderly adjustment of global imbalances would result in the fall of the US dollar and the increase in the level of US dollar interest rates, and most likely of interest spreads worldwide. An increase in US dollar interest rates would in turn induce a sharp slowdown in the level of economic activity (or even a recession) in the US, bringing other major economies down with it, with the consequent decline in their demand for imported goods and services from third countries, and so forth. The threat such a situation poses for developing

countries' balance of payments should be apparent, given developing countries' (direct or indirect) reliance on US demand.

For this reason, we suggest the creation of a counter-cyclical facility to sustain demand in developing countries and prevent a downfall of the US dollar from triggering a downward spiral of competitive devaluations. It should be noted that, as opposed to relatively more commonplace balance of payments distress triggered by exchange rate misalignment and/or excessive domestic absorption, the type of crisis under consideration would be caused by exogenous factors beyond developing countries control.³² Under such circumstances efforts to reduce domestic absorption, as typically put forward by the Fund, would be unsuitable and exacerbate rather than contribute to solve the effect of the initial exogenous shock.

The proposed credit line would resemble the existing Extended Fund Facility (EFF), in that the EFF consists of longer-term assistance and allows for longer-term repayment terms.³³

Access to Fund Resources

Under the proposed facility, countries facing an exogenous sharp fall in the demand for their exports and/or an exogenous marked rise in interest rates on their outstanding foreign debt would qualify for financial support in amounts linked to the decline in export demand and/or to the rise in their debt service obligations. Given the exogenous nature of the shock, access would be determined as a function of the decline in GDP of the US or other major trading partners, and the rise in dollar interest rates, rather than in proportion to the countries'

³² Towards the end of 2005, the Fund's Executive Board approved an Exogenous Shocks Facility (ESF) to provide financial support for low-income countries facing shocks, such as commodity price shocks, or abrupt changes in their terms of trade. However, the ESF is subject to upper credit tranche conditionality and only available to countries eligible for the Poverty Reduction Growth Facility (PRGF); access limits are very restrictive, as annual access is set at 25 percent of the member's quota subject to a cumulative access limit of 50 percent of quota.

³³ In actual fact, the purpose of the EFF is to provide longer-term assistance to support structural reforms to address balance of payments problems of a longer-term character. Recipient countries, which can borrow up to 300 percent of their quotas, are to adopt 3-year programmes of structural reform, and the repayment period can be extended up to 10 years.

quotas (i.e. the 300 percent access limit would not apply).³⁴ For instance, if the growth of exports can be estimated as a proportion of US GDP growth, the fall in GDP can be used to make a preliminary estimate of the export shortfall.

Similarly, the rise in US interest rates may be applied to floating rate debt to estimate the increase in total debt service payments. Both effects would be added in order to determine access to the Fund facility, which could fully cover the shortfall or could be established as a proportion (of say 90 percent) of the estimated total foreign currency losses to the country.³⁵

Conditionality

Since, as indicated above, the export income loss and the increased debt service burden would be the result of causes beyond the control of the borrowing countries, it would not be appropriate to impose any conditionality on countries whose fiscal accounts were in approximate (inter-temporal) balance when cyclically adjusted. The logic of this facility is that it would not be desirable to raise taxes at a time of economic recession. Tax or other revenue-related measures could be required to become effective only when the economic upturn materialised. In addition, consistent with the purposes of the facility and of the Fund, borrowers would commit not to impose new restrictions on trade and current payments.

In order to foster recovery Fund disbursements would have to be made without delay so as to sustain a rising tide of international demand from which all countries' exports and worldwide economic activity would benefit. Indeed, there should be virtually no need to negotiate an elaborate programme with the borrower; drawings should be automatic and expeditious, and could be approved on a quarterly or six monthly basis, following the estimated impact of the crisis, i.e. the sum of export shortfall and increase in debt service.

Since access to such a facility should not give rise to unwarranted government expenditure, in order to prevent an increase in govern-

³⁴ To prevent the risk of "moral hazard", loans could be made at progressively rising rates for larger amounts.

³⁵ In order to reflect the evolution of the exogenous variables on which drawings under the facility are based, drawings could be established and made quarterly.

ments' current expenditures, the Fund could require that recipient countries allocate a certain proportion of the resources thus obtained to public investment. Conditionality would therefore apply mainly to the level and type of public expenditure.

Cost of Borrowing and Repayments

Since the crisis would result from factors beyond the control of the borrower, i.e. with no "moral hazard" risk, loans would be made at the normal Fund basic lending rate, even if the rate is below the rate at which the country was able to borrow in financial markets before the crisis. Nonetheless, a rising interest rate scale could be established to discourage access beyond certain threshold, as suggested above.

While repayments could be linked to the recovery in the borrower's rate of growth, which by itself would reflect the growth of exports and the reduction in interest rates, they could also be linked to the same exogenous factors that gave rise to the drawing, i.e. the growth performance of the US economy and the level of US interest rates. The second option would be beyond authorities' control and might provide more suitable incentives for them to remain competitive.

Subject to the reversal of the exogenous conditions that triggered the initial need for Fund's assistance, repayment terms of the counter-cyclical facility could coincide with those of existing Extended Fund Facilities (EFF), i.e. 4½-10 years for obligations and 4½-7 years for expectations, with an increasing interest rate scale to provide sufficient incentives for timely (or even early) repayment.

Source of Funding

At current levels, Fund resources and access policies would not be sufficient to cover the potential requirements of this facility. Total Fund resources stood at only 3.2 percent of current payments in 2003 and may be presumed to be smaller now.

Quotas averaged 0.9 of 1 percent of member's GDP on that date.³⁶ With access limits of 100 percent of quota in one year and in exceptional circumstances 300 percent of quota over three years, those levels of Fund support would be clearly insufficient.

³⁶ This is not to ignore that in a few cases access to Fund resources has been substantially larger, but these cases are not predictable.

One first option is that Fund resources be increased through a quota review. But experience suggests that a quota review process would probably take several years to complete, while its outcome would be uncertain.

A second option is that the Fund borrows from surplus countries to recycle funds to deficit countries – a procedure that would resemble that followed under the Oil Facility of the mid-1970s (Section 2.1). This may be a suitable option at the present time of excess global liquidity.³⁷

A third option for increasing Fund resources rapidly could involve a special allocation of SDRs. This alternative is perfectly consistent with the Fund's Articles of Agreement.³⁸ Since SDRs have to be allocated to members in proportion to their quota, recipient countries would commit to lend or donate the SDRs received to the Fund to increase its resources. The possibility of combining new allocations of SDRs with a mechanism similar to that of the substitution account discussed in the late 1970s (when there were also fears of a dollar sudden collapse) should not be disregarded.

For a counter-cyclical policy to be effective, how large should the increase in Fund resources (or an SDR allocation) be? Estimates of the size of the expected contraction should be made. As an initial rough conjecture, the additional resources should not be less than the contraction in international aggregate demand estimated as a proportion of the GDP of developing countries. The US current account deficit at 1.5 percent of world GDP provides an outside limit.

4 Conclusions

The build-up of global imbalances poses a serious menace for global financial stability and worldwide economic activity. As expressed throughout this chapter, the adverse impact of a global contraction on

³⁷ The Fund could also activate the GAB (General Arrangements to Borrow) and the NAB (New Arrangements to Borrow).

³⁸ In fact, the Fund is in a position to either expand or reduce SDR allocations at its own will: "In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such a manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world" (Articles of Agreement; Article XVIII, Section 1).

developing countries, in the absence of adequate multilateral financial support could be very severe.

Moreover, the IMF, whose *raison d'être* is to maintain global financial stability and facilitate the expansion of world trade in the context of sustained economic growth, is increasingly being questioned as it appears unable to discharge its surveillance duties effectively.

Industrial countries have the ability to pursue counter-cyclical policies and foster economic growth; this might explain some of the passivity mentioned above. In contrast, in a world of increasingly integrated capital markets, most developing countries have been unable to carry out similar counter-cyclical policies. Given the pro-cyclical bias evidenced by international financial flows, frequently exacerbated by IMF conditionality, developing and low-income countries have had little choice but to adopt contractionary measures to protect their balance of payments and avoid crises of confidence and massive capital outflows. One of the effects of this defensive response to growing capital account volatility has been the tendency shown by developing countries to maintain competitive exchange rates, run current account surpluses and build up international reserves as a form of self-insurance.

As pointed out above, from the standpoint of the world economy this ubiquitous strategy entails a deflationary bias. Thus far, such contractionary forces have been offset by mounting US current account deficits, which have allowed the world economy to sustain high rates of economic growth. However, for the reasons indicated above (Section 2), the strong US dollar will eventually decline; interest rates will increase; and consequently the high consumption levels in the US will fall. Indeed, an expansion based on the accumulation of consumer debt cannot be sustained indefinitely. Eventually, consumption has to give way to higher levels of saving and investment in the US, whereas global demand has to shift from deficit nations, like the US and UK, to nations running surpluses, like China and other Asian economies. The question is whether the required adjustment will take place gradually and with minimal disruption or abruptly and causing a serious recession in the international economy and major damage to most of the developing world.

So long as the global economic cycle remains in the current expansionary phase, the risks described above may be small. But as the housing market cools down in the US and capital gains diminish or disappear, consumers may be inclined or compelled to increase their savings; consumption would thus stall, removing the driving force behind current worldwide economic growth, and leading to downward adjust-

ment across the globe. Furthermore, in this context the global labour arbitrage that has been squeezing employment and real wages in developed countries may well give rise to a strong protectionist backlash as economic activity decelerates.

This chapter is the result of concern about the Fund's role in the event of a scenario of disorderly adjustment of global imbalances – the “hard landing” scenario – in which a faulty Fund response would exacerbate, rather than counter, contractionary forces. To deal with this situation we have proposed two different policies:

First, we argue that in order to reduce the risk of a disorderly adjustment-cum-global recession it is necessary to seek increased policy coordination among the entire G-20; this would call for the realignment of exchange rates accompanied by fiscal measures to gradually shift demand from deficit to surplus countries. In order to bring about such a coordinated outcome, the Fund would have to adopt a proactive, pre-emptive policy stance, going beyond the policy of identifying sources of imbalances, monitoring the performance of countries and acting only after a crisis has developed.

Second, in the event of disorderly adjustment-cum-global recession, we propose the establishment of a counter-cyclical Fund facility that sustains the aggregate demand in developing and emerging countries directly or indirectly affected by the slowdown in world economic activity (lower exports) and/or the increase in their foreign debt obligations (higher interest rates). The facility would cover export revenue loss and increased foreign debt service due to an exogenous rise in interest rates.

The policy instruments proposed in this chapter are meant to stimulate a necessary discussion and are not intended as an exhaustive list of possible solutions.

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8

Global Imbalances and the Role of the IMF: A Comment on Ariel Buira and Martín Abeles

Mark Allen

Ariel Buira and Martín Abeles have written a thought-provoking piece on the risks of global imbalances and the possible ramifications for developing and emerging market economies. As far as the role of the IMF is concerned, their article begs two questions: What can and is the IMF doing about fostering an orderly resolution to global imbalances? And what can and is the IMF doing about protecting developing and emerging market countries from the possible fallout of an unwinding of global imbalances? Let me address each in turn.

At the outset, let me state that the IMF is a dynamic institution that is continuing to reshape its surveillance to remain effective in an increasingly integrated world characterised by significant cross-country spillovers. We have been working on modernising the *framework* for surveillance by reviewing its legal foundations and reassessing its effectiveness. This has included an increased focus on financial sector and capital markets, drawing on the enhanced expertise of the new Monetary and Capital Markets Department. In parallel, we are continuing to improve our analytical toolkit for exchange rate analysis and for modeling cross-country interactions.

The *implementation* of surveillance is also being strengthened at the multilateral, regional, and bilateral levels. In line with the authors' suggestion to "adopt a pre-emptive stance and encourage a coordinated approach to the resolution of global imbalances" the IMF's first *multilateral* consultation – a new instrument adopted last year – has been

focused on exactly this issue. It has provided a forum for systemically important members and groups of members – China, the euro area, Japan, Saudi Arabia and the United States – to discuss jointly what should be done to address global imbalances. To date, the discussions have been candid and instructive and have contributed to a better understanding of the issues and each country's position, while policies have been moving in directions advocated by the IMF to address global imbalances: strengthened public savings in the United States, structural reforms in the euro area and Japan, greater exchange rate flexibility in China, and increased investment in Saudi Arabia. Given the importance of regional spillovers, *regional* surveillance has also been expanded, through consultations with regional institutions as well as through publication of *Regional Economic Outlooks* (REOs). Finally, at the *bilateral* level, surveillance is becoming more selective, identifying the most important risks and focusing on topics at the heart of the IMF's surveillance mandate.

Helping Developing Countries

Let me turn now to what the IMF can – and is – doing to help protect developing and emerging market countries from the possible fallout of an unwinding of global imbalances, or external turbulence more generally. The first line of defense, of course, is the country's own policies; a strong macroeconomic framework and rigorous institutions can go a long way to insulating countries from market vagaries while allowing scope for appropriately counter-cyclical policies. The IMF plays its part through surveillance activities and provision of technical assistance and capacity building. With the encouragement of the IMF, many emerging market countries have used this period of a benign external environment to address balance sheet vulnerabilities – especially foreign currency and maturity mismatches – and to strengthen their fiscal and external positions. The IMF has also been exploring ways in which it can support regional reserve pooling and similar financial arrangements. In low-income countries, sizeable debt relief under the HIPC and Multilateral Debt Relief Initiatives have provided much-needed policy space. Here the challenge will be to use this space sensibly to foster growth and poverty reduction without re-accumulation of unsustainable debts. The newly refined debt sustainability framework for low-income countries, developed jointly by the IMF and the World Bank, helps countries design effective borrowing strategies tailored to their circumstances.

But the IMF also has a vital role to play through its lending activities. Indeed, as Buira and Abeles remind us, the Articles of Agreement mandate the IMF to help members address “maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.” To this end, the IMF has also been using this period of relative calm to enhance its own toolkit. Beyond our traditional financing instruments – the Poverty Reduction and Growth Facility (PRGF) for low-income countries and the stand-by arrangement (SBA) for middle-income countries – we have been at work on two new instruments. The authors note the Exogenous Shocks Facility, intended to provide financial support to low-income countries experiencing a sudden and exogenous shock that requires adjustment and temporary external financing. In addition, the Policy Support Instrument (PSI) for mature stabilisers among low-income countries, and the precautionary SBA for market-access countries, are also available to support and signal sound policies and allow quick financial support in the event of a shock. For market access countries, work is also underway on designing a possible new liquidity enhancement instrument. Such an instrument could play a key role in crisis prevention both by allowing a country to draw on immediate and sizeable IMF resources to augment its own reserves, and by enhancing the credibility of policies with the IMF’s “seal of approval.” Again, this instrument – if it is established – would go a long way to providing the type of support that Buira and Abeles consider necessary to help protect emerging market countries from a possible adverse “unwinding” scenario.

In this connection, there is one point of Buira and Abeles with which I would take exception. They view member countries as turning away from the IMF because of onerous conditionality. In my view, this is perhaps part of the story, but the evolution of conditionality in IMF-supported programmes is much more complex. For instance, early adjustment programmes focused only on stemming aggregate demand rather than on increasing also aggregate supply, and this was viewed by many as a major shortcoming of IMF-supported programmes. It was in large part to address these concerns that the IMF became involved in structural reforms to help elicit a positive supply response rather than relying solely on demand management for external adjustment. But by the late 1990s, the increase in the number of conditions and apparent lack of programme focus raised questions regarding the effectiveness of conditionality. Many argued that conditionality was too intrusive and not tailored to country circumstances. Against this background, in 2002 the

IMF Board approved new conditionality guidelines – the first revision since 1978 – that highlight the importance of country ownership of programmes and parsimony of conditionality. Specifically, the member has primary responsibility for the selection, design, and implementation of an IMF-supported programme, and conditionality should be applied only to measures that are critical to achieve the programme goals – but to all such measures.

I believe that the new conditionality guidelines achieve an appropriate balance between minimising interference in national policymaking and providing assurances to the member country of the circumstances under which it will receive financial support (and assurances to the IMF that it will be repaid). Indeed, some interesting research suggests that IMF resources have a beneficial effect on crisis prevention even *controlling* for the country's gross foreign exchange reserves.¹ In other words, IMF support has a benefit beyond just the liquidity enhancement effect of its resources. Why would this be? It is because of the credibility that conditionality associated with IMF lending brings to the authorities' policies.

To summarise, Buira and Abeles have written a timely and thought-provoking paper. Many of their concerns are at the core of the IMF's current agenda of strengthening the effectiveness of its surveillance and programme support in an increasingly integrated global economy. These efforts are directed both at achieving an orderly unwinding of global macroeconomic imbalances and at boosting the resilience of developing and emerging market countries to a disorderly resolution should it occur.

¹See "Fund-Supported Programs and Crisis Prevention," available at www.imf.org/external/np/pp/eng/2006/032306.pdf

9

The Future of the International Monetary System

John Williamson

Avinash Persaud (2005) has argued that the world never has room for more than one key currency at a time. I find his argument convincing as regards some international roles of a currency, but not all. I doubt if we shall ever witness a world in which more than one currency is widely used for intervention in exchange markets, in setting the prices of commodities, or in complex transactions. On the other hand, I would expect to see continued use of a range of currencies for denominating the prices of manufactured exports, and for holding reserves. There are after all significant benefits from holding a well-diversified portfolio, and in an age when transactions costs are rapidly diminishing I would be surprised if central banks were not prepared to incur these when they need to mobilise some of their reserves for use in intervention, even if the intervention itself is always in the dominant international money.

Thus, my expectation is that we shall continue to see a single currency dominating the international system, alongside several other currencies being used internationally for specific purposes. In considering the first question we have been asked to consider, “Will the US Dollar Remain the Key Currency of the System?”, the first step is to ask what the contenders for role of the key currency may be. For the next 25 years, which I take it is the sort of time horizon in which we are interested, the only two alternatives to the dollar worth considering seem to me to be the SDR and the euro. The RMB or even the rupee may be candidates one day, but not for the next 25 years.

I devoted two of the best years of my life, 1972-74, to an attempt to build a more symmetrical international monetary system based on the

SDR. I was then the most junior IMF employee whose duties were principally regular participation in the work of the Committee of Twenty. I wrote up my experiences in a book whose title I invented during the second meeting of the Committee, *The Failure of World Monetary Reform* (Williamson, 1977). I concluded that the attempt to build a symmetrical SDR-based monetary system had failed for a very basic reason, namely because most countries were so attached to that quaint social institution we call national sovereignty. Jane D'Arista has proposed an alternative design for a symmetrical system,¹ which has zero chance of adoption, for the same reason: that it would require countries to give up too much of their sovereignty. None of these grand designs for an SDR-based or more symmetrical system has the slightest chance of going anywhere unless and until there is a sea-change in popular attitudes on this question.

It follows that only a real currency can hope to challenge the US dollar, and the euro is the only plausible candidate. As stated above, I think it quite likely that the euro will play a larger role in some of the functions of an international currency. For example, I would expect most manufactured exports from the euro area, and from other countries closely associated with the euro area such as those in Eastern Europe, to be denominated in euros. I expect many bond issues to continue to be denominated in euros. And I expect the proportion of international reserves to be held in euros to increase somewhat, especially as expectations of a further depreciation of the dollar in terms of the euro gain ground. What I find most unlikely is that the euro will displace the dollar in intervention, in denominating the price of homogeneous commodities, or in regular international transactions. In other words, I do not expect the US dollar to be displaced from its role as the key international currency in the next quarter century, even if and when it ultimately undergoes another bout of severe depreciation.

Does that also imply that I see no possibility of building a more balanced international monetary system? No. What it does suggest is that a new system would have to be based on increasing the effectiveness of the IMF while respecting the bases of national sovereignty, which I take as implying floating exchange rates and inflation targeting,² rather than on

¹ See the next chapter in this volume.

² Or internal balance, which those of a Keynesian disposition may find a more comfortable formulation, though personally I doubt if there would be large practical difference.

a change in the international monetary unit. I think it is clear that a precondition for increasing the effectiveness of the IMF is a change in IMF governance, with the effect of increasing both the voting power (quota shares) and representation (chairs in the IMF Board) of Asia at the expense of Europe. Admittedly, the reluctance of the US Congress to increase the US quota stands in the way of consummating this change quickly, but the world's reaction to George W. Bush's attempt to veto Kyoto has already shown that the United States no longer runs the world. It is a change that is rapidly becoming inevitable, and the biggest question is whether Europe will take the lead in pressing for this change and thus strengthen its role in the IMF, or will put up a hopeless defensive resistance that will merely erode its global monetary standing.

There still seems to be an unwillingness to take actions to adjust the current global imbalances, despite their evident unsustainability. The likely result of this sort of obstinacy is a global recession. We do not know what will precipitate the end of the capital inflow to the United States, for shocks are typically unforeseen, but let me sketch one possible scenario. Suppose that the US were to elect a president who recognised that its current account deficit was a problem that needed to be fixed, and who therefore proposed a US contribution that started by raising taxes by 2 percent of GDP levied on those who could afford to pay them. It is not beyond the realm of possibility that those who would be affected would retaliate by shifting some of their money abroad (capital flight), perhaps aiming to put some of it where the taxman would be unlikely to find it. Once such a run started, it might well continue until the dollar had depreciated another 20 percent or 30 percent against most currencies. Such a dollar depreciation would be inflationary in the United States, but at least any demand loss engendered by the collapse of confidence would be offset by the expansionary expenditure-switching effect of the dollar's depreciation. In the rest of the world both income and substitution effects would decrease demand, so a recession would be all too likely, especially if so many countries are still pretending that they are powerless to increase demand.

I do not believe that it had to be like this. The IMF needs a rulebook that commits it to active surveillance of the macroeconomic policies of its systemically important members, based on regular calculation of a set of mutually consistent reference exchange rates believed to be compatible with a generally acceptable set of current account balances (see Williamson, 2006). Application of such a rulebook would have preempted the emergence of the large US fiscal deficits and substantially

undervalued Asian currencies that together generate the present global imbalances. Even now it would be easy enough to design a set of policies that would promise to reduce the imbalances to less threatening levels, but at this stage, and without any international obligations to seek balance, there seems no hope of inducing the major countries to take any note. Certainly, I would have expected China to respect any well-specified international obligations that it had incurred on entering the Fund, although I accept that it is a different matter to expect it to agree to institute now changes that would unquestionably have the effect of requiring it to revalue.

Does this imply that there is no hope of the world moving to a system of surveillance based on reference exchange rates such as I have sketched above? That is slightly too pessimistic. One can distinguish three circumstances under which such a change might occur:

First, this change might occur in the same sort of situation as that in which past major changes in international monetary arrangements have been effected, namely in the wake of a crisis. So if and when the doomsday scenario described above materialises, I hope that a system along these lines may emerge from the rubble.

Second, it is conceivable that the world might change in such a way that the major players who would currently see their interests threatened by adoption of such a system would no longer feel themselves threatened. For example, China may suffer an inflation sufficient to eliminate its current undervaluation, and the United States may get a president with the guts to raise taxes (without that provoking capital flight).

Third, in principle there is the possibility that the major powers might decide to adopt such a system of surveillance (and the consequential policy changes) with the intention of heading off the crisis that is otherwise likely. I regret to say that this conference has reinforced my prior suspicions that this is extremely improbable.

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10

A More Balanced International Monetary System

Jane D'Arista

As US gold holdings eroded in the 1960s, Robert Triffin argued for a transformation of the Bretton Woods monetary agreement into a multilateral system. In his view, "...the alternative to the gold standard is not a dollar standard unilaterally run and managed by the United States alone, but a true international standard, calling for concerted decisions and management by all participating countries" (Triffin, 1968, p. 187). Subsequently, he warned that the dollar standard that emerged after 1971 was not only unsustainable but "scandalous" – that, "Ironically, the richest and the most capitalised country in the world is actually being financed by the poor countries through the creation of international monetary reserves" (Teunissen, 1987, p. 376). Triffin had promoted European monetary union throughout his career and, in an interview in 1987, noted it would help Europe delink from the dollar. But he did not consider the EMS the final solution to the problem. Meaningful reform would need to include the United States (*ibid.*).

After Triffin's further criticisms in the early 1990s, there was relatively little discussion of this most basic element of the global system: the choice of the means of payment in cross-border transactions. Triffin's warning that the monetary system itself would create mounting global imbalances was ignored in favour of a more narrow focus on US fiscal deficits and more recently, undervalued Asian currencies. Nevertheless, there is renewed awareness that, as Triffin argued, the international reserve function of the dollar-based key currency system creates a uniquely ironic imbalance in the global economy as the current account surpluses of emerging economies are loaned to the US to

finance the public and private borrowing that supports its growth.

For example, Mervyn King, Governor of the Bank of England, points out that capital has flowed “uphill” from poor to rich countries (King, 2006, p. 8) and Lawrence Summers agrees, noting that “the majority of the world’s poorest people now live in countries with vast international financial reserves” (Summers, 2006, p. 8). Meanwhile, the spillover effects of the investment of emerging economies’ current account surpluses in US and other major financial markets assure that some portion is recycled back to the emerging economies in the form of private foreign acquisition and ownership of their financial assets and productive facilities.

From this perspective, one of the more pressing issues in dealing with global imbalances is to find ways to recycle these countries’ savings back into their own economies in support of development strategies that increase demand and income more equitably across their household and business sectors and reduce dependence on exports for growth. So far, however, most prescriptions for dealing with imbalances shun what King calls “more idealistic aspirations” (King, 2006, p. 8) in favour of changing IMF governance and strengthening its role in surveillance (Williamson, 2007). Summers, on the other hand, argues that it is time for some form of scrutiny of international investment – time for the IMF and World Bank to think about ways to contribute to deploying the funds of emerging market countries rather than lending to them. He proposes a more ambitious undertaking “than simply providing surveillance and monitoring”; one that would support emerging markets’ investments by creating “an international facility in which countries could invest their excess reserves without taking domestic political responsibility for the process of investment decision and ultimate result.” (Summers, 2006, p. 8)¹

Shortly before Summers presented his proposal in March, I presented a revised version of an earlier proposal (D’Arista, 1999) for redirecting the flow of capital back into developing economies at the FONDAD conference. In the following pages, I present a further revised version of the proposal. It describes the kind of institutional framework that might be used to create a global development facility.

¹ Assuming that this would provide more income than current investments in US Treasury securities, Summers advocates charging emerging economies a 100 basis point fee for the service and using the proceeds for global public goods, multilateral grant assistance or debt relief.

1 Creating a Public International Investment Fund for Emerging Economies

With the phenomenal growth of institutional investors' assets over the last two decades, foreign portfolio capital has become an important component of inflows into the evolving securities markets of emerging economies. In most cases, however, these inflows tend to change prices and exacerbate volatility in secondary markets rather than provide long-term financing for economic expansion, while outflows often trigger or intensify currency crises. Moreover, many developing countries that need long-term financing for infrastructure and other basic components of development strategies do not have markets that can absorb foreign portfolio investment flows nor the credit standing to attract them. What is needed is a new channel for portfolio investment to provide flows that are stable, in amounts appropriate to the size of a country's economy and directed toward the goals of development rather than solely toward the short-term profits of investors.

Such a channel could be constructed by creating one or more closed-end funds for emerging market investment as a separate institution under the Bretton Woods umbrella.² These funds would issue their own liabilities and use the proceeds to buy stocks and bonds of private enterprises and public agencies in a wide spectrum of developing countries. They would be marketed both to institutional investors in advanced economies and official investors from emerging economies and their liabilities would also qualify as international reserves, guaranteed by a multinational agency and its member countries. Investing the reserves

² Unlike open-end mutual funds that must buy back an unlimited number of shares in response to investors' demand, closed-end investment pools issue a finite number of shares that trade on stock exchanges or in over-the-counter markets and are only redeemed at the initiative of the fund itself. This structure would allow the prices of shares to fluctuate without triggering destabilising purchases and sales of the underlying investments. The structure could be made more suitable for long-term investors such as pension funds by requiring that 10 to 20 percent of the value of shares sold to investors be used to purchase and hold government securities of major industrial countries in amounts roughly proportional to the holdings of the funds' shares by residents of those countries. This would give investors a partial guaranteed return, denominated in their own currencies, and capital backing in addition to the guarantee of the multilateral agency and its member countries. Moreover, the introduction of these securities would benefit both private and official investors by adding more low-risk instruments with long maturities to the menu of assets in international financial markets.

of developing countries in these funds would redirect external savings back into the economies of the countries that own them rather than into the financial markets of strong currency countries.

International closed-in funds would provide additional benefits as well. They would encourage the development of securities markets denominated in local currencies in poor and middle-income developing countries, would reduce the need for capital controls if countries chose to accept foreign portfolio investment only through this channel, and would help pension plans in developing countries diversify their portfolios while minimising country risk and transactions costs.

A more important contribution of these funds, however, would be their inauguration of a meaningful shift into a non-national reserve asset and the phasing out of a system in which the choice of financial assets as reserve holdings centres on a few countries whose wealth supports the strength of their currencies.³ Encouraging developing countries to hold these securities as reserves would provide them with a *multilateral* guarantee from industrial countries and, in time, from wealthier emerging economies.⁴

Given the focus on development, a major function of the funds should be to finance infrastructure that is both commercially and socially useful. Both criteria would be met by projects that build and improve roads, construct or renew sewers and extend electrical grids and communications systems. But these projects must be initiated in remote areas as well as cities and towns. Other areas qualifying for financing should include systems to provide health care and clean water, projects for cleaning up polluted areas and restoring and preserving forests; investments in renewable energy and transportation and in local institutions that will provide funding for communities to design and build their own affordable housing.

These and many other similar investment areas are among those that fail to attract financing in the marketplace in both developing and

³ Wealthy countries, too, could hold these securities as reserves and avoid the credit-generating effects their reserve investments impose on other advanced economies. The credit-generating capacity of reserve assets could then be utilised multilaterally to benefit a wider group of countries – developed and developing – and moderate the constraint on demand that imbalances in external savings have created.

⁴ The institutional guarantee would be the same as the existing guarantee for World Bank liabilities, but the capital investment in the government securities of advanced economies would enhance that guarantee and provide a partial hedge against exchange rate risk.

advanced economies. For example, the US found it necessary to undertake a wide range of public-purpose market innovations in the 1930s – most notably the Reconstruction Finance Corporation and the Tennessee Valley Authority – and continued adding new strategies into the 1970s, including the development of the secondary mortgage market. These and numerous other examples from other countries underscore the need for governments to take the lead in laying the institutional groundwork for financing productive economic and social investments. Another indication of that need is the fact that, even in many advanced economies, investments in renewable energy, infrastructure, the environment, transportation and affordable housing are seriously underfinanced.

Structuring a channel to attract portfolio investment for such purposes need not reinvent the wheel. Mechanisms and potential assets already exist in the marketplace and the authority to manage these funds is wholly consistent with the World Bank's original mandate to facilitate private investment in developing countries. Moreover, the Bank's experience in issuing its own liabilities in international capital markets would expedite the start-up of one or more closed-end funds which could then be transferred to a separate institutional structure created for the purpose.

But, like other Bretton Woods institutions, these public sector funds must be required to operate in a far more open, accountable and responsive fashion than is the current norm. Properly structured to include collaborative decisionmaking by both the managers of the funds and the countries in which investments are made, they could make a significant down payment against the democratic deficits that characterise private portfolio investment decisions as well as governance and policymaking at the international institutions.

2 Reforming the International Payments System

The above proposal – to use multilateral credit liabilities as reserve assets – is evolutionary in nature and, while it addresses a critical flaw in the current international monetary system, an equally critical one – the means of payment – would still need to be addressed. Permitting the continuation of a key or strong currency regime for cross-border transactions tends to perpetuate the export-led growth paradigm by requiring the majority of countries to shape their economies to ensure

that they can earn – or borrow – key currencies to conduct external trade and investment transactions. It also requires the key currency country to import more than it exports to meet the demand for its currency and to accept the resulting current account deficits and build-up in debt. The global economy can only regain balance if every country is able to use its own currency, backed by the wealth created within its own borders to participate in the global economy.

One way to achieve this objective would be to mine John Maynard Keynes' Bretton Woods proposal to create a new institutional framework. While Keynes' overall proposal was designed for a very different world, the basic structure in his concept – an international clearing agency (ICA) – could be revised to serve as the institutional platform for a new global payments system that would foster egalitarian interactions and more balanced outcomes.

The new ICA would clear transactions denominated in members' own currencies by crediting and debiting their clearing accounts. These clearing accounts would, in fact, constitute the international reserves of the system, held for the member countries by the ICA and valued using a trade-weighted basket of all members' currencies. Thus the clearing process would change the ownership of reserves and reinstate the original intent of the Bretton Woods Agreement to maintain public control of international payments. It would also permit exchange rate adjustments over a set period of time in response to changes in reserve levels, preserving the valid role of market forces in shaping currency values through trade and investment flows while ensuring that speculators would no longer dominate the process.

A revised ICA proposal could also reintroduce former US Undersecretary of the Treasury Harry Dexter White's Bretton Woods proposal to authorise the International Monetary Fund to engage in open market operations. It would do so by permitting the new clearing agency to acquire government securities of its member countries as backing for its reserve holdings.⁵ This would give the ICA means and authority to conduct open market operations at the international level, enabling it to help national authorities correct imbalances and promote stability by altering holdings of international reserves relative to national central

⁵ In the US, the Federal Reserve had developed open market operations as a counter-cyclical policy tool in the 1920s, but it was not widely used by other central banks at the time of the Bretton Woods negotiations and the White proposal was dropped from the agreement.

bank reserves invested in domestic assets. When approved by a super-majority of its member countries, the ICA's money creating powers would also allow it to operate as a true lender-of-last resort – a role the IMF cannot play given its dependence on taxpayer contributions. In this capacity, the ICA could assist a national central bank in supplying liquidity by buying government securities from residents in the national market and augmenting the country's supply of international reserves.

Membership in the ICA would be open to national central banks of all participating countries and branches of the clearing agency would operate in every major financial centre across the globe. The Agency would be governed by a rotating executive committee that would at all times represent half the world's population and half its total output. Its role in clearing members' payments in their own currencies ensures that it would not infringe on their sovereignty as an international central bank that issued a single currency would do.⁶ The conduct of national monetary policy and decisions about preferred exchange rate regimes would remain the prerogative of national authorities. But the ICA's ability to create and extinguish international reserves would give it the power to change the availability of liquidity at the global level. The absence of and need for that power has been increasingly evident throughout the post-Bretton Woods era as crisis after crisis has underscored the inadequacy of the current institutional framework.

This is a brief sketch of a proposal that attempts to incorporate the still-valid objectives of the Bretton Woods Agreement for an open international trading system while reforming the institutional framework to promote stability and more egalitarian participation by all

⁶ In the previous chapter, John Williamson referred to the ICA proposal as “an alternative design for a symmetrical system, which has zero chance of adoption [because]...it would require countries to give up too much of their sovereignty”. This characterisation implies some misunderstanding of the structure and role of the proposed ICA – in particular, that it would not issue the means of payment but only administer the process by which cross-border payments alter the reserve accounts of member countries. Indeed, the proposed ICA was designed to enhance sovereignty by allowing all countries to use their national currencies to make international payments and by reducing the influence of speculative capital flows on policy decisions at the national level. The only choice member countries would lose would be their ability to decide how to invest their international reserves since their reserves would automatically be invested in their own national liabilities.

countries in the global economy (D'Arista, 1999). No doubt other, better systems could and will be designed. But they, too, must incorporate a more egalitarian payments system as well as more democratic governance of its institutional structure.

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11

Reforming the International Monetary System: Comments on Jane D'Arista and John Williamson

Henk Brouwer

In this volume, authors make proposals as to how the international monetary system should be reformed, and what role they see for the IMF in addressing global imbalances in the future. As Mark Allen has already provided comments on Ariel Buira's and Martín Abeles' proposals in his contribution to this volume, I will limit my comments to the proposals put forward by Jane D'Arista and John Williamson.

Jane D'Arista calls for a "true international standard" in the international financial system, pointing out that the current system is not desirable as it is causing capital to flow from poor to rich countries. The source of this problem, she claims, is the US dollar being *the* global currency, as such a system requires emerging economies to hold the dollar and, consequently, finance the US external debt. She proposes new "closed-end funds for emerging market investment," by creating a new institutional framework under the Bretton-Woods umbrella. Such funds would "redirect external savings back into the economies of the countries that own them," to finance their own development strategies that "increase demand and income more equitably," and "reduce dependence on exports for growth."

John Williamson claims that such a system has "zero chance of adoption," because countries would have to give up too much of their national sovereignty. At the same time, he stresses that the current global exchange rate arrangement is unfit to solve the global imbalances problem. He proposes a "more balanced international financial system,"

based on “increasing the effectiveness of the IMF while respecting the bases of national sovereignty,” which specifically implies a combination of exchange rate flexibility and inflation targeting, instead of pegging to the dollar. To achieve this, he claims that the IMF’s surveillance of its systemically important members should be based on regular calculation of a set of mutually consistent reference exchange rates believed to be compatible with a generally acceptable set of current account balances.

Let me discuss Jane D’Arista’s paper first. I welcome her candid proposal to restructure the current international monetary system. However, her proposal is not a new one – a similar proposal for a global currency was made by Keynes at the Bretton Woods conference in 1944, and then followed by similar proposals afterwards. None of them has ever materialised, mainly because the major economies – most notably the US – opposed. This is related to my first comment on her paper – I do not think that her proposal is feasible, as there will be too many political obstacles to be overcome. The reality is that the effectiveness of any international economic institution depends on the participation of major economies, and there is no law-enforcement mechanism in the international community to force any country into participation. The international monetary system needs to be consistent with the main players’ economic and political incentives and, unfortunately, I do not think the proposed system fits the bill.

Second, regarding her point that the dollar’s dominance as a vehicle currency is *the* main source of global imbalance, I see why it can be *a* source (as it allows the US to run sizeable deficits), but I do not think it is the main source. Many developing countries, as well as some developed ones (such as Korea and Japan), are intervening in foreign exchange markets not (just) because the dollar is the world’s vehicle currency, but also because they want to maintain their international price competitiveness by keeping their currency from appreciating. In addition to this, some countries turn to the dollar-peg for a credible nominal anchor – the motivation for so-called “dollarisation” proposed in many Latin American countries is to get inflation-fighting credentials for their monetary policy (Frankel, 1999). My point is that dollar dominance is a reflection of the US economy’s large size, credible US monetary policy, and the dollar’s high liquidity rather than a reflection of an unfair international monetary system.

Third, D’Arista’s claim that capital is unfairly flowing from “poor” economies to “rich” nations is not really correct, for two reasons. First, many developing countries are running current account *deficits* – for

example, sub-Saharan Africa and Central & Eastern Europe are running current account deficits of 1.2 percent and 4.2 percent of GDP, respectively (in 2005), whereas many Asian countries are running substantial surpluses as we all know. The reason why some emerging economies save abroad is largely due to their limited domestic absorption. To put it another way, different degrees of financial market development can be a source of global imbalances (Mendoza *et al.*, 2006). That said, financial development in emerging economies is in rapid progress. If this process continues, the absorption problem should eventually subside. Second, there is no evidence that surplus economies lack sufficient investment to achieve their economic growth. As of 2005, investment as percentage of GDP is around 34 percent in developing Asia, 22 percent for the Middle-East, 19.7 percent for sub-Saharan Africa, and 21 percent for advanced economies. This tells us that investment in developing Asia (in general) is by no means *insufficient*, although it is probably partly *inefficient*. In addition, recent IMF research (Prasad *et al.*, 2006) shows that capital outflow from non-industrial economies does not dampen economic growth in these countries by depriving them of financing for investment.

Let me now turn to John Williamson's paper. I agree with his point that although the dollar is likely to continue to dominate as an international currency for the foreseeable future, the current global exchange rate arrangement cannot really address global imbalances. The current system, under which surplus economies try to stabilise their exchange rate vis-à-vis the dollar, could indeed create serious problems to the euro area as it is difficult to see how the dollar would depreciate without causing a substantial effective appreciation of the euro.

I have two points that I would like to raise. First, Williamson's proposal of setting a "reference exchange rate" would not only require frequent policy negotiations among the major countries including China, it will also be very difficult to reach an agreement on the level of this reference exchange rate, let alone doing so regularly. Moreover, I doubt that the IMF or any other international institution has the ability to facilitate the regular negotiation process. A more realistic approach is one where the exchange rates between the key currencies – the dollar, the yuan, the yen, and the euro – would be, by and large, freely floating. Policy interventions should be an exception rather than the rule (Joshi, 2006). International dialogue should include those economies which are important for the international monetary system – China first and foremost.

Second, even though I am in favour of better policy coordination among the major economies, we should not overestimate the effectiveness of international policy coordination or underestimate what domestic policy can do to address the global imbalances problem. For example, there are various *domestic* distortions – such as a lack of proper insurance and pension systems in China, and public dissaving in the US – that can and should be addressed by domestic monetary and fiscal policies (Blanchard, 2006).

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12

A Response to the Comments of Henk Brouwer

Jane D'Arista

As Director Brouwer points out, I have argued that the international monetary system itself is the main source of global imbalances. Of course there are other contributing factors, but a key currency system creates a framework for global interactions and responses in which, as Triffin pointed out decades ago, the key currency country must run deficits in either the current or capital account even though its deficit position will undermine confidence in the currency over time. As noted in the paper Stephany Griffith-Jones and I presented at the FONDAD Conference,¹ this problem would also occur if the euro, the yen or the yuan were to replace the dollar.

Our joint paper for the conference makes several other points about the problems of emerging economies in confronting the key currency system. Although some developing countries or regions are, as Director Brouwer notes, running current account deficits, IMF data underscore the charge that capital is flowing from the poor to the rich by repeatedly reporting that 70 percent of the annual global current account surplus is invested in the US. And while limited domestic absorption and limited financial markets compared to those in the US can contribute to imbalances, the real problem is the scale of private capital flows to emerging economies and their pro-cyclical nature – in particular, the

¹ See Jane D'Arista and Stephany Griffith-Jones (2006), "The Dilemmas and Dangers of the Build-Up of US Debt: Proposals for Policy Responses", In: Jan Joost Teunissen and Age Akkerman (eds.), *Global Imbalances and the US Debt Problem: Should Developing Countries Support the US Dollar?*, FONDAD, The Hague.

experience of either feast or famine and of abrupt shifts in exchange rates and competitiveness. During the recent, low-interest-rate environment in advanced economies, inflows of foreign portfolio investment reached historically high levels. For emerging economies, the result was a loss of control by monetary authorities over the growth of domestic credit that forced them to intervene in their own markets to mop up the excess liquidity created by foreign institutional investors and re-export this liquidity as investments in international reserves.

It seems to me that Henk Brouwer's observation that there is sufficient investment in emerging economies to achieve economic growth overlooks the growing concern that export-led growth – vigorously promoted over the last two decades – has not fostered a successful development agenda. Measures of the quality of life have failed to advance in many countries and have declined in others. In many emerging and developing countries, growth itself has been inadequate on a per capita basis and, even in countries with high growth rates, inequality appears to be widening as pressures for price competitiveness continue to act as a global constraint on wages.

As for the proposals offered in this short paper, Brouwer argues that they are not feasible – that similar proposals have been offered in the past, that they have been opposed by the major economies and that these reforms are not consistent with the economic and political incentives of those players. To answer these objections, I will paraphrase comments that Kenneth Rogoff, the former chief economist of the IMF and currently a professor of economics at Harvard University, recently published in the *Financial Times* that make points similar to those I would choose to make in reply.²

While Professor Rogoff agrees with Director Brouwer and others that the financial system does not need grand plans, he argues that it does need “fixing”. He notes that grandiose plans have vanished but so has introspection in the policy community – replaced, he says, by the “smug belief” that there is no problem markets cannot solve. He doubts that markets and central banks could handle the fallout from several highly credible economic and geo-political scenarios he outlines. Thus he concludes that the disappearance of grand plans is a loss because they provided a reservoir of ideas to spur major improvements in an international framework growing increasingly irrelevant as private debt and equity markets dwarf official financing.

² “No grand plans, but the financial system needs fixing”, In: *Financial Times*, February 7, 2007.

As I noted in my comments at the FONDAD Conference, I very much agree with Professor Rogoff's assessment of the value of proposals for architectural reforms. In writing about US financial reforms in the 1930s, I found that most were not based on new ideas and some were proposals that had been offered decades before and were pulled off the shelf and modified when the crisis hit. Designing reform proposals seems to me a particularly appropriate role for political economists – not only for the sake of anticipating a breakdown in the system but because any system can benefit from ideas for improvements.

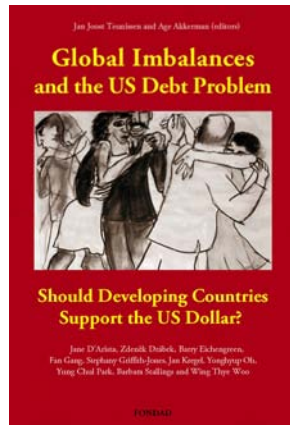
The particular reforms offered in this paper are, as I noted, modifications of earlier plans proposed by Keynes, Triffin, Kaldor and others. Like previous plans, they propose a non-national reserve currency and a larger role for the public sector in managing cross-border payments. But the structure of the International Clearing Agency (ICA) differs from those in earlier proposals in that it would allow each nation to use its own currency in international transactions by creating a system in which an international agency would clear transactions among national central banks in the way that these national institutions clear for their commercial banking systems.

Moreover, unlike the Keynes proposal or the IMF, the ICA could conduct open market operations at an international level and thus undertake counter-cyclical and lender-of-last-resort operations. It has become obvious that the IMF's dependence on contributions from member countries constrains its ability to lend. Moreover, the IMF's framework for issuing a non-national reserve currency does not permit it to interact with private markets. These limitations have marginalised the SDR and the Fund's ability to stabilise imbalances in a world in which trillions of dollars move through global markets on an annual basis.

Many emerging market countries are aware that the IMF has become less relevant as a force either for stabilising the system or for addressing potential crises. They are also aware that their large holdings of dollar reserves augment their role in determining the sustainability of the international monetary system. They may or may not be ready to embark on the kinds of policy coordination so often and so unsuccessfully advocated for the G-7 but, if they do decide to create institutions friendlier to their own needs, a new architectural framework will evolve from that process without the guidance of the major economies. The failure of the major economies to engage in the process may result in reforms that are less consistent with their economic and political interests than those that might be achieved through participation.

Global Imbalances and the US Debt Problem: Should Developing Countries Support the US Dollar?

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FONDAD, The Hague,

December 2006

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197 pages

Price: € 15

Contributing authors say:

“It would be nice if the US would address the domestic roots of its twin deficits. But emerging markets cannot afford to wait for the US to act.”

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“The US dollar is no longer a stable anchor in the global financial system, nor is it likely to become one: thus it is time to look for alternatives.”

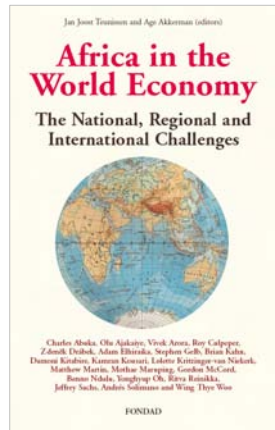
Fan Gang, China Reform Foundation

“A major risk for the world economy – and for developing economies – is an abrupt unwinding of global imbalances. The scale of the US deficit, its rapid growth and that of US net liabilities, make the problem an increasing source of concern.” *Jane D’Arista, Financial Markets Center, and Stephany Griffith-Jones, Institute of Development Studies, Sussex University*

“The widespread international attention on the value of the (Chinese) yuan is possibly the first time in international monetary history that the value of the currency of a developing country has so greatly exercised the finance ministries and central banks of the largest developed countries.” *Wing Thye Woo, University of California, Davis, and Brookings Institution*

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ISBN-13: 978-90-74208-27-7
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“The role of the state in financial sector development in sub-Saharan Africa should go beyond regulation and surveillance of the banking sector to the establishment and deepening of the capital market...” *Olu Ajakaiye, African Economic Research Consortium*

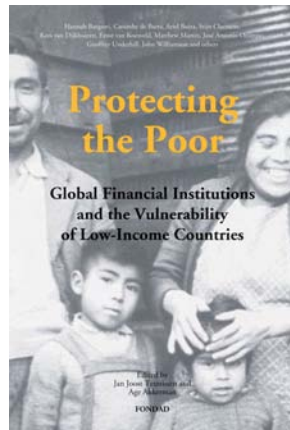
“Aid is of poor quality and low effectiveness, and the global aid architecture is thoroughly inadequate.” *Matthew Martin, Debt Relief International*

“Growth-oriented strategies would require much greater policy space in order for African countries to devise strategic trade and industrial policies adapted to their specific economic and social conditions and based on their endowments.” *Kamran Kousari, UNCTAD*

“Moving towards a regional bond market would help overcome the diversification problem and strengthens the argument for regional capital markets in Africa.” *Brian Kahn, South African Reserve Bank*

Protecting the Poor: Global Financial Institutions and the Vulnerability of Low-Income Countries

Edited by Jan Joost Teunissen and Age Akkerman



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Contributing authors say:

“Developing countries, and particularly low-income countries, are subject to important shocks emanating from exogenous variations in their balance of payments.” *John Williamson, Institute for International Economics*

“Africa is already suffering from large shocks beyond its control ... making it impossible for the continent to reach the MDGs. There is no better use or higher priority for additional aid funds than immediate, low-cost contingency financing.” *Hannah Bargawi and Matthew Martin, Debt Relief International*

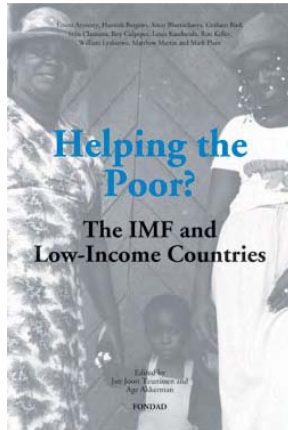
“The serious deficiencies in the governance of the international financial system point to the need for reform.” *Stijn Claessens, World Bank, Geoffrey Underhill, University of Amsterdam*

“Rather than accepting the current rules of the game, developing countries will have to play the game by identifying their collective interests.” *José Antonio Ocampo, Department of Economic and Social Affairs, UN*

“The IMF should adopt a genuinely multilateral attitude and recast itself in the role of partner rather than macroeconomic master.” *Caoimhe de Barra, Trócaire*

Helping the Poor? The IMF and Low-Income Countries

Edited by Jan Joost Teunissen and Age Akkerman



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Contributing authors say:

“Above all, the IMF needs to adapt its conditionality to the needs of low-income countries and their wishes for genuinely country-led strategies.”

Matthew Martin and Hannah Bargawi, Debt Relief International

“The IMF should be more flexible in programme design and react as problems reveal themselves, as opposed to setting unrealistic monetary and inflation targets.” *Louis Kasekende, Bank of Uganda*

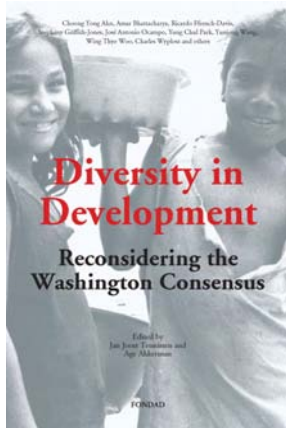
“The recurrent nature of the debt problems, the ongoing debates, and the limited and poor resource transfers are but signs of the need for deeper reforms to the institutional framework for dealing with the financing problems of low-income countries.” *Stijn Claessens, World Bank*

“The Bank’s and the IMF’s future role involves... greater empowerment of the borrowing governments and... a move from stabilisation to more pro-poor macroeconomic frameworks.” *William Lyakurwa, African Economic Research Consortium*

“Given the lack of scientific consensus about the causes of growth, member countries need to be encouraged to formulate their own development strategies that the IMF can then endorse, monitor and support.” *Graham Bird, Surrey Centre for International Economic*

Diversity in Development: Reconsidering the Washington Consensus

Edited by Jan Joost Teunissen and Age Akkerman



FONDAD, The Hague,

December 2004

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ISBN-13: 978-90-74208-24-6

238 pages

Price: € 17.50

Contributing authors say:

“The Washington Consensus is the farce that the development establishment in Washington foisted upon the developing world as universal science...” *Wing Thye Woo, University of California*

“...the international divergence of income levels and high financial volatility in both the developed and the developing world are increasingly seen as inevitable outcomes of the neo-liberal global order.” *José Antonio Ocampo, Department of Economic and Social Affairs, UN*

“There is strong evidence that trade liberalisation has helped growth and has not worsened inequality...” *Anthony Boote, IMF*

“The science of economics, the economics profession and international economic organisations cannot continue to ignore the social, political and cultural effects of globalisation and neo-liberal policies.” *Oswaldo Sunkel, Corporación de Investigaciones del Desarrollo, Chile*

“The core of the East Asian crisis was the failure to appreciate the fatal risks of financial liberalisation and globalisation in the context of weak domestic institutions.” *Yunjong Wang, Korea Institute for International Economic Policy*

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