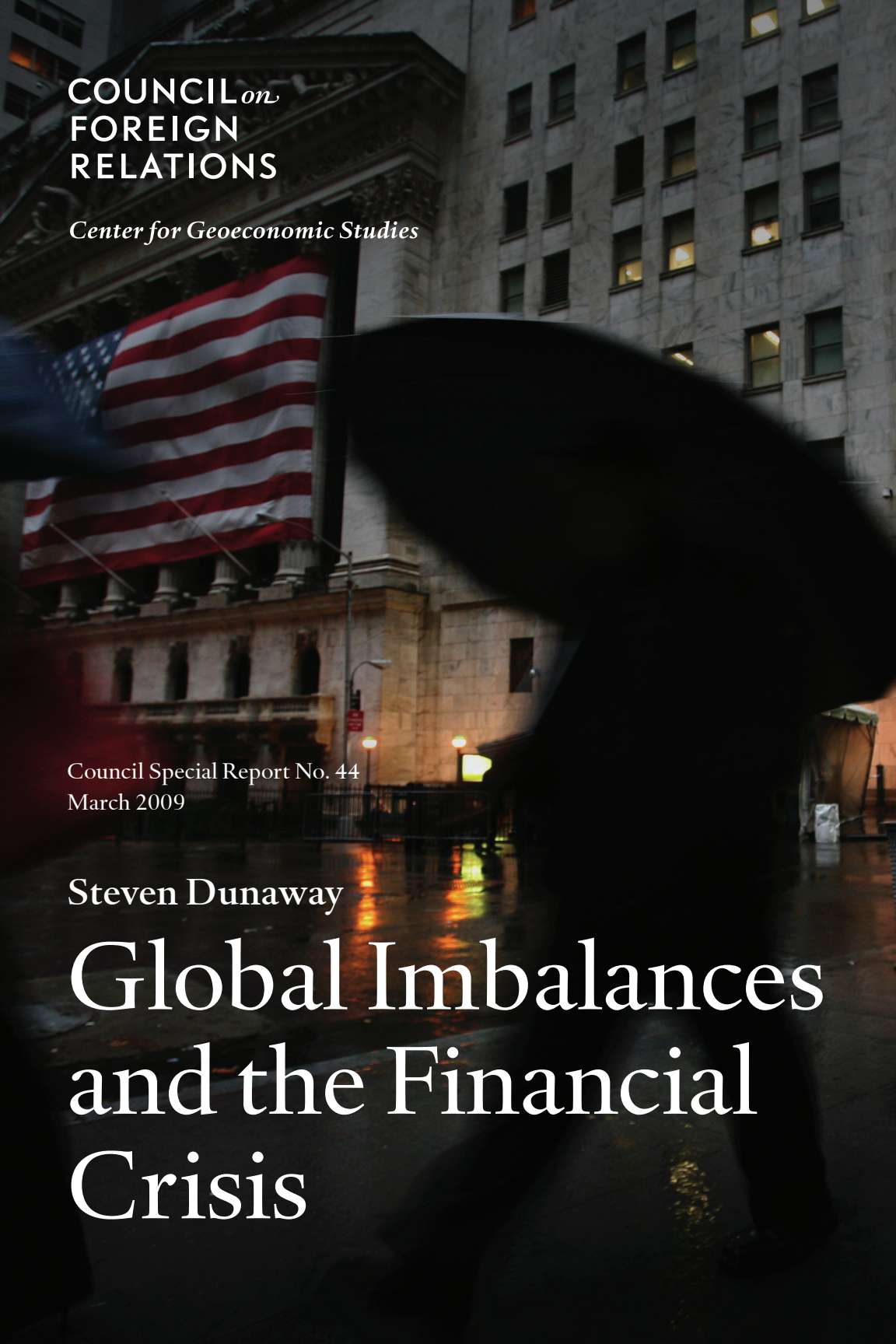

COUNCIL *on* FOREIGN RELATIONS

Center for Geoeconomic Studies

Council Special Report No. 44
March 2009

Steven Dunaway

Global Imbalances and the Financial Crisis

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Cover Photo: People on the way to work in a rain storm pass the New York Stock Exchange on September 26, 2008 (AP Photo/Mark Lennihan).

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Foreword

As the economic crisis has spread from financial markets to real economies in countries around the world, governments have understandably focused on short-term measures to contain the damage. Crafting stimulus packages and financial bailouts to address immediate problems has for many reasons been a priority for policymakers.

In this Council Special Report, however, Steven Dunaway argues that policymakers must go beyond these steps and tackle one of the root causes of today's crisis: imbalances between savings and investment in major countries. The report analyzes the nature of these imbalances, which occur when some countries, such as the United States, run large current account (essentially trade) deficits while others, such as China, maintain large surpluses. Dunaway identifies three features of the international financial system that have allowed the imbalances to persist, features that involve both floating and managed exchange rates as well as the issuance of reserve assets. In particular, he notes that the United States' status as an issuer of such assets has enabled it to finance a current account deficit. The report then prescribes a variety of steps to address global imbalances. Beyond stimulus packages around the world, it urges measures to raise savings (principally government savings) in the United States, reform labor and product markets in Europe and Japan to increase competition and flexibility, and boost domestic consumption in China. Finally, the report advocates improving International Monetary Fund (IMF) surveillance of member states' economic policies by reducing the role of the Fund's executive board and depoliticizing the selection of its senior management.

Global Imbalances and the Financial Crisis is a timely work that offers thoughtful analysis and recommendations. It makes an important and sober case that without action to deal with global imbalances, these imbalances will balloon again and imperil future economic growth.

And while such institutions as the IMF and the Group of 20 (G20) have significant roles to play, Dunaway contends that the ultimate responsibility for tackling imbalances rests with national governments. The central question is whether governments are up to this challenge.

Richard N. Haass
President
Council on Foreign Relations
March 2009

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Steven Dunaway

Council Special Report

Introduction

The current economic and financial crisis has brought about a significant change in global economic governance as the international forum for discussions on the crisis has shifted from the small group of advanced countries in the Group of Seven (G7) to the Group of Twenty (G20), a broader group including important emerging market countries. The G20 summit held in Washington, DC, on November 15, 2008, dealt with the immediate concerns fostered by the crisis and focused on both macroeconomic policy actions needed to support global growth and ideas for implementing financial market reforms. Follow-up G20 summits are expected, starting with a gathering in the United Kingdom in April 2009. However, for these discussions to have a substantial impact, the agenda will have to be broadened beyond economic stimulus and financial market regulation. If not, global policymakers will miss a critical chance to make the world economy and financial markets more stable, as then U.S. treasury secretary Henry M. Paulson Jr. pointed out:

> If we only address particular regulatory issues—as critical as they are—without addressing the global imbalances that fueled recent excesses, we will have missed an opportunity to dramatically improve the foundation for global markets and economic vitality going forward. The pressure from global imbalances will simply build up again until it finds another outlet.[1]

Accurate though his comments were, Secretary Paulson did not go far enough. Global imbalances—meaning imbalances between savings and investment in the major world economies reflected in large and growing current account imbalances—did indeed play a major role in creating the current crisis. But missing in the public debate thus far is a

discussion about the basic features of the international financial system that facilitated the growth of these imbalances and allowed countries to delay dealing with them. Without efforts to mitigate the potential effects of these features, it will be difficult to deal with the imbalances. As Paulson correctly observed, the imbalances and their attendant risks will emerge again once the current crisis is resolved.

Since the Bretton Woods system was established after World War II, three of its features have worked at times to delay adjustment in current account imbalances. One is that a country that issues reserve assets can finance current account deficits for an extended period. The second is that a country facing upward pressure on the value of its currency can manage its exchange rate to resist such pressure and delay adjustment in its balance of payments for an extended period. A third feature that can provide incentives to delay adjustment emerged as a consequence of the shift to flexible exchange rates that began in the 1970s. For countries with floating exchange rates, a depreciating currency can provide a sheltering effect that can diminish pressures for structural adjustment. Rather than simply cushioning one-off shocks, as proponents of floating rates envisage, currency depreciation can also enable policymakers to ignore enduring structural challenges.

The United States has taken advantage of its position as the primary issuer of reserve assets to finance a growing current account deficit during the 2000s. East Asian emerging market economies in general, and China in particular, have taken advantage of the second feature of the system. They have resisted upward pressure on their currencies and run large current account surpluses. Japan and Europe have made use of the third feature. Weaknesses in the value of the yen and the euro in the late 1990s and early 2000s contributed to the slow pace and inadequacy of structural reforms in labor and product markets, slowing economic growth and contributing to global imbalances.

Rather than focus narrowly on economic stimulus and financial regulation, the heads of state involved in the G20 process must confront global imbalances. They need to start by stressing that actions taken now to cushion the global recession should be designed with an eye toward the imperative of unwinding the imbalances. The crisis should not be used as an excuse to pursue policies that will add to imbalances over time or to delay needed policy actions—including structural reforms—that can begin to reduce imbalances. Already the policies that

some countries are putting in place show worrisome tendencies and some policy changes are being ignored.

This Council Special Report does not pretend that tackling imbalances is easy. Moreover, it does not suggest any major overhaul of the world's financial system because, despite its faults, the current system is far more conducive to sound and stable growth than any of its predecessors. The issuer of a reserve currency, for example, can finance a current account deficit by taking advantage of other countries' willingness to hold its assets, but the global system would not function any better without reserve currencies. Floating exchange rates can at times shelter an economy from the need to reform product and labor markets, but they also make countries and the world economy more resilient to shocks. The system's ability to deliver sound and stable growth, however, depends on the willingness of countries to play by the rules. The system functions well when all countries pursue sustainable macroeconomic policies. The trouble comes when the system's flaws disguise the costs of bad policies and cloud judgment as to which policies are sustainable.

The International Monetary Fund (IMF) was established to oversee the world's financial system and, through its surveillance of member countries' economic policies, has an important role to play in mitigating the system's flaws. The IMF cannot compel member countries to change their economic policies, however; it can only persuade. To be effective in this task, IMF surveillance has to provide countries with candid assessments of their policies and clear advice on needed change. The surveillance process also has to bring international pressure to bear when countries persist with policies that are in neither their best interests nor those of the world. The IMF's track record in this regard has not been good in recent years. To improve surveillance, this report suggests eliminating the IMF executive board's direct role in the process and enhancing the effectiveness of IMF management by selecting the institution's top executives solely on the basis of merit.

In the end, a solution to the problem of global imbalances rests with the major economies. Governments must demonstrate the political will to choose policies that may entail risks in the short run but that are in the medium run best for their own countries, as well as for the rest of the world. The imbalances cannot last indefinitely. If the major economies fail to adopt appropriate policies, then adjustment will be

forced on them, and everyone will have to settle for slower growth and a less stable world economy. It is sometimes argued that stricter financial regulation and tighter monetary policy might over time contain the financial excesses that global imbalances help produce. But these are second-best policies and would achieve this objective only by slowing world economic growth.

Three Pitfalls in the International Financial System

The problem of global current account imbalances has been discussed at length for a number of years.[2] Recognition of the problem is widespread even among the authorities of the major countries contributing to it. There is even agreement on the policy changes each country needs to make to deal with the problem and acknowledgment that these changes are in each country's and in the world's best interests. However, little progress has been made in dealing with the situation.[3] In the United States, politicians have found it difficult to raise national savings in a responsible manner, particularly through tax and expenditure policy changes. In Europe and Japan, politicians have been reluctant to tackle the thorny issues of structural changes in product and labor markets. In China, the leadership's attachment to the status quo in economic policy is quite strong; current policies have been successful in delivering rapid growth and development, so China's government is reluctant to make anything more than gradual changes. With these attitudes among the leaders of the major economies, it is not surprising that global imbalances have emerged. What is not readily apparent is why it was possible for global imbalances to grow unchecked for so long without triggering a correction. In large part, the answer lies in three features of the international financial system that allowed countries to delay adjustment.

Normally, a current account imbalance triggers forces that encourage adjustment and maintain the imbalance at a sustainable level. Countries with deficits face increasing pressures in obtaining financing. This fosters adjustment through upward pressure on domestic interest rates, downward pressure on the real exchange rate, and slowing domestic economic activity. Surplus countries face similar pressures in the opposite direction, with rising economic activity and appreciation of the real exchange rate the main forces that prompt balance-of-payments adjustment. That global imbalances have grown and remain unchecked points

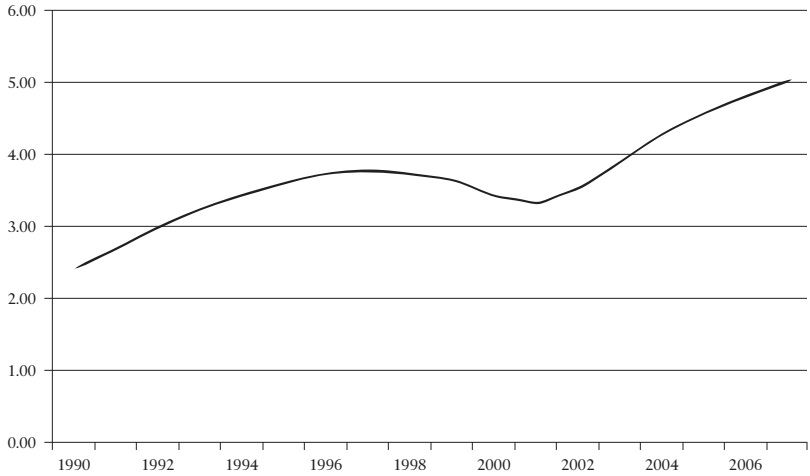
to features of the international financial system that have worked to delay adjustment.

One such feature, which has existed since the Bretton Woods system was established, is the role played by countries that provide reserve assets. This is an important feature that gives needed scope for reserve assets in the system to expand as the world economy and international trade grow. But it can also enable a country that provides reserve assets to delay adjustment when its external position becomes unsustainable because of macroeconomic policies or economic shocks. Such a country can finance a deficit in its external position rather easily for some time by issuing assets in its domestic currency.

Accordingly, the United States, which is the primary provider of reserve assets to the system, has been able to finance current account deficits for long periods. After 2001, rising U.S. current account deficits largely reflected expansionary fiscal policy in the United States and booming consumption growth.[4] Financing was in large part provided by foreign governments. The cost to the United States for this financing was relatively low because of the premium foreign governments were willing to pay to obtain presumably risk-free U.S. government securities. One distinct advantage the United States has is the breadth and liquidity of its government securities markets. This is a particularly important consideration for investments by countries in official reserve assets. The definition of a reserve asset stresses that such an asset should be highly liquid and that the volatility of its value should be low.[5] However, ultimately there is a limit to the willingness of other countries to hold U.S. assets. This limit depends on how close other potential reserve assets are to being substitutes for U.S. dollar assets.[6] But until the limit is reached, the availability of cheap foreign financing allows the United States to put off painful measures to boost national savings. As Figures 1 and 2 show, between 1990 and the onset of the financial crisis in 2007, the United States was able to double its national debt in dollar terms without being penalized by a diminishing appetite for the debt. On the contrary, investors accepted lower yields on U.S. government securities.

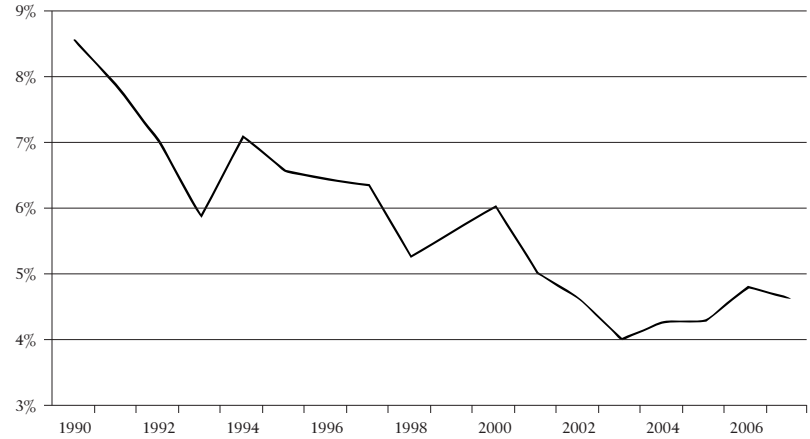
Recall that the second feature of the international system is that countries with balance-of-payments surpluses that manage their exchange rates can resist upward pressure on their currencies for an extended period. Similarly, deficit countries facing downward pressure on their exchange rates can defend the rate and finance their deficits only as long

FIGURE 1. U.S. GOVERNMENT DEBT ($ TRILLIONS)



Source: Council of Economic Advisers, *Economic Report of the President*, 2008.

FIGURE 2. YIELDS ON TEN-YEAR U.S. TREASURY BONDS (PERCENT)



Source: Council of Economic Advisers, *Economic Report of the President*, 2008.

as they have official reserves or are willing to use their reserve assets.[7] Countries facing upward pressure on their rates, however, have no such reserve constraint, given that the rest of the world is demanding their currencies. They can hold their exchange rates by intervening in the market and selling their own currencies. They can then attempt to "sterilize" this exchange market intervention through domestic monetary policy actions. The intention is to avoid a rise in inflation that would otherwise induce a real appreciation of their currencies.

There are limits, however, to how long sterilized intervention will work. In particular, the cost of such intervention in terms of higher domestic interest rates will eventually take its toll on the finances of the central bank and have consequences for the real economy, but these adverse effects may go unnoticed for quite some time. To diminish some of these consequences, sterilized intervention can be supported by capital controls and administrative controls over domestic financial markets (e.g., moral suasion or window guidance to control credit growth).[8] Although the effectiveness of capital and administrative controls will diminish over time, such measures can succeed for a while.[9]

Imposing capital and administrative controls is not without cost, given the distortions they create and the repression of the financial system that tends to occur. Moreover, maintaining an undervalued exchange rate imposes large costs on the real economy. The distortion in the value of the exchange rate will create serious misallocations of resources in the export- and import-substituting sectors of the economy. The longer an undervaluation of the currency is maintained, the greater the misallocations created and the more difficult the readjustment the economy must undergo to unwind the distortion.

Among the emerging economies in East Asia, China most exploited this flaw in the international financial system during the 2000s. To maintain an increasingly undervalued exchange rate, particularly because productivity growth in China exceeded that in the rest of the world, China had to amass a stunning amount of official reserves, with nearly $1.5 trillion of these reserves accumulating in the three and a half years after the country's exchange rate regime was changed in July 2005. China's exchange rate policy also influenced those of other East Asian countries in that they sought to limit appreciation of their currencies in response to competitive pressure from China, and these countries probably built official reserves to levels higher than they ever intended.

China's investment-driven growth model, with its heavy reliance on exports, has delivered rapid growth and development. As a result, the government is reluctant to do more than make gradual changes to it. But maintaining an undervalued exchange rate imposes growing costs on the economy. In particular, it creates serious overallocations of resources to export- and import-substituting industries. This will have to be sorted out; the more the adjustment is delayed, the greater the distortion becomes and the more costly the process. Moreover, when the inevitable currency appreciation comes, the country will encounter a substantial loss on the foreign exchange reserves it has accumulated while trying to keep its currency cheap. The longer the country accumulates excess reserves, the more costly these portfolio losses are.

Maintaining an undervalued exchange rate also stunts the development of China's financial sector. Efforts to get its banking system to operate on a sound commercial basis are undermined by the government's heavy reliance on window guidance to control credit expansion and establish lending priorities. Window guidance has been an important part of China's sterilization efforts in response to concerns that upward pressure on domestic interest rates would induce increasing inflows of foreign money as capital controls have become more porous. In addition, currency undervaluation makes foreign financing look more attractive than domestic financing. The resulting spur to foreign borrowing further stunts the domestic financial sector. The buildup in foreign liabilities by Chinese enterprises may go unreported as companies seek to avoid capital controls, but it could eventually make the country vulnerable to a financial shock. However, these problems do not occur immediately or are not apparent, so it is easy for policymakers to discount them.

Another feature of the international financial system that may encourage delay in external adjustment arises as an inadvertent consequence of the shift to floating exchange rates. A depreciating currency can, as mentioned earlier, provide a sheltering effect and thus slow adjustment to adverse economic shocks arising from structural changes.[10] Specifically, currency depreciation can reduce pressure on a country's external position, providing an opportunity to more gradually make policy changes—especially reforms in the structure of a country's economy—that may be needed to deal with the consequences of such a shock. Because currency depreciation initially has a positive effect on economic growth, the tendency is to overlook the longer-term negative

consequences. Moreover, slower initial adjustment can also contribute to depreciation pressures on a country's exchange rate that can persist for some time, providing additional incentive to delay adjustment.

Liberalization of trade during the 1990s and the rise of newly industrializing countries, particularly China, was a major competitive shock to advanced economies. It had especially strong effects on European economies, with their rigid product and labor markets, though Japan was also affected. Depreciating currencies in the late 1990s took the pressure off Europe and Japan to push structural reforms. In Europe in particular, labor market reforms were badly needed but politically difficult to implement. However, by delaying reform, European countries set themselves up for a sharp slowdown in growth when the euro began to appreciate in the 2000s. The impact of that appreciation was initially offset because strong demand from the Middle East and China boosted exports of the major European economies, principally Germany and France, but this demand evaporated when the Middle East and China slowed. Now facing a major recession, European countries are suffering the consequence of their earlier decision to delay needed reforms. Economic recovery in the euro area may well be slow.

Global Imbalances and the Crisis

Most explanations of the current economic and financial crisis focus on financial causes. The standard account runs along the following lines: relatively low interest rates worldwide for much of the 2000s drove investors to seek higher yields, and relative stability in financial markets, reflecting the low cost of funds and solid economic growth, led to significant underpricing of risk. Lending standards were weakened and leverage increased. The rise in leverage sharpened the exposure to liquidity risk for financial institutions as they depended increasingly on wholesale markets for funding and these funds became increasingly short term. New, complex financial products obfuscated risks and contributed to serious mispricing. Risk controls failed and good old-fashioned fraud also created significant losses. All of this combined to precipitate unprecedented turmoil in global financial markets beginning in mid-2007.

But missing is a discussion of how the seeds of the crisis were sown by the economic policies in those major countries that fostered global imbalances and by the features of the international financial system that facilitated the growth of those imbalances. Substantial imbalances in savings and investment emerged after 2000, and were reflected in growing current account imbalances within major world economies. Rising U.S. deficits and increasing surpluses in emerging East Asian economies (especially China) and oil-exporting countries in the Middle East developed. In turn, the savings and investment imbalances gave rise to the so-called savings glut in developing countries and spawned sizable net flows of capital from developing to advanced countries, with the United States being the primary recipient of these flows. The savings glut helped to reduce world interest rates.[11] At the same time, the substantial rise in demand, especially by East Asian and Middle Eastern economies, for official reserve assets crowded out private demand for such high-quality, low-risk assets. Consequently, a scramble by private

investors for other higher-yielding but relatively low-risk assets contributed to the financial excesses that finally culminated in the present turmoil in world financial markets.

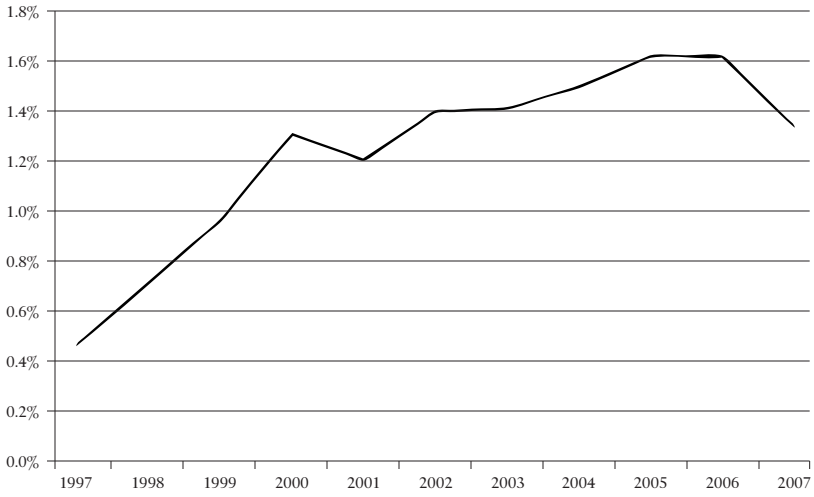
The statement of the November 2008 G20 summit hints at the role that imbalances played: "Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruptions."[12] The term "unsustainable global macroeconomic outcomes" appears to be a rather oblique reference to global imbalances.[13]

The rise in global imbalances during the 2000s was driven by a combination of factors with mutually reinforcing effects. Significant changes took place in savings and investment behavior in major countries. In the United States, national savings declined as the fiscal position shifted from a surplus to a substantial deficit and as household savings fell, resulting in a dramatic rise in the current account deficit (Figure 3). The decline in household savings in part reflected relatively low interest rates and increased availability of financing related to housing that sparked a boom in consumption and residential investment.

Consumption-fueled growth in the United States fostered economic recoveries in Japan and Europe on the back of higher exports. Particularly in Europe, corporate profits rose. But problems in the structures of these countries' economies—especially rigidities in product and labor markets—limited investment opportunities. The combination of high corporate savings and sluggish investment led to rising national savings and external surpluses (Figure 4).

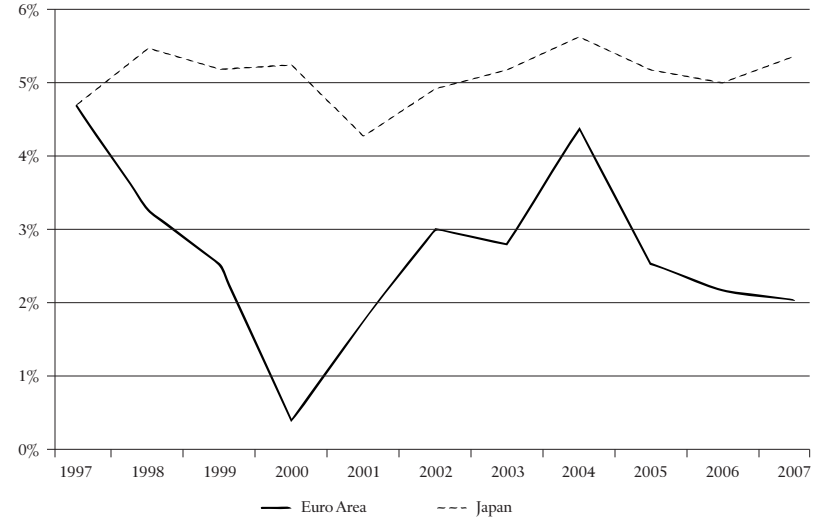
Savings and investment imbalances and current account surpluses of developing countries also rose sharply (Figure 4). In emerging economies in East Asia other than China, savings increased. More important, the increases in the external surpluses of these countries reflected a decline relative to GDP in investment—especially in structures—following the excesses in such investment that occurred in the buildup to the Asian financial crisis of 1997–98. External surpluses also reflected policy decisions in many of these countries to rebuild official reserves, which had been decimated during the financial crisis. The years after 2000 also showed a dramatic rise in the savings and

FIGURE 3. U.S. CURRENT ACCOUNT DEFICIT (PERCENTAGE OF WORLD GDP)



Source: International Monetary Fund, 2008.

FIGURE 4. EURO AREA AND JAPAN CURRENT ACCOUNT SURPLUSES (PERCENTAGE OF WORLD GDP)



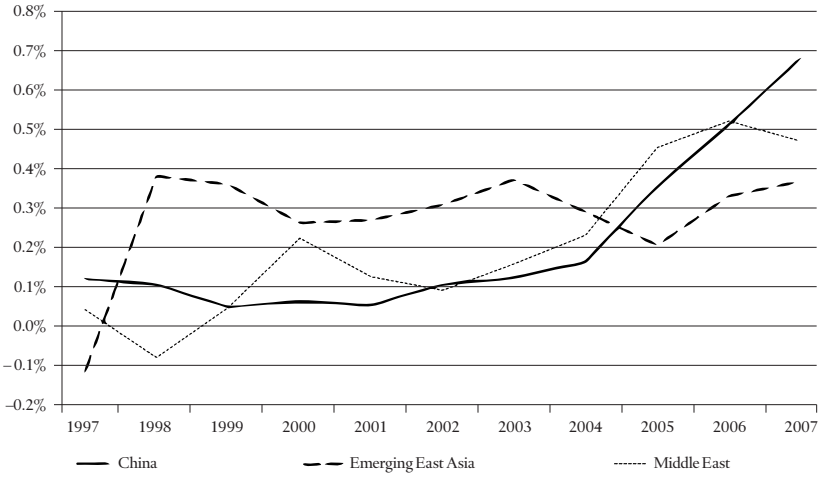
Source: International Monetary Fund, 2008.

investment imbalance in China. Despite a very strong investment performance, Chinese savings rose even more dramatically. The fiscal position (government savings) improved and corporate savings posted a sharp rise. In East Asia generally, external surpluses put upward pressure on exchange rates, but this pressure was mitigated by substantial sterilized currency intervention, delaying adjustment. After 2002, current account surpluses of Middle East oil-exporting countries began to rise as strong global demand and concerns about the security of oil supplies drove up prices.

The substantial savings by East Asian emerging economies and Middle East oil-exporting countries were reflected in large net capital outflows, which made their way to the United States.[14] With the desired level of savings in the world exceeding desired investment at the interest rates prevailing at the time, the glut of global savings drove down real rates of interest and set off a boom in asset prices.

At this point, the cycle began to feed on itself. With expanded availability of credit and lower interest rates, U.S. households used debt to sustain consumption and fuel a housing boom. Rising U.S. demand stimulated additional growth in the rest of the world, adding to current account surpluses, especially in East Asian emerging market economies.

FIGURE 5. CHINA, EMERGING EAST ASIA, AND MIDDLE EAST CURRENT ACCOUNT SURPLUSES (PERCENTAGE OF WORLD GDP)

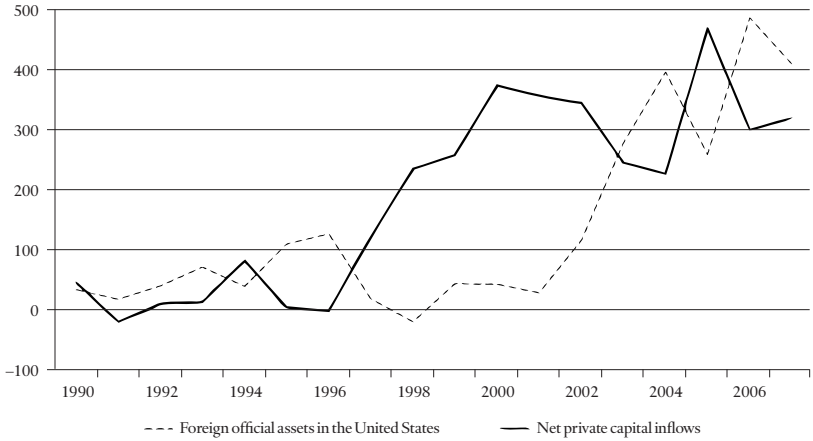


Source: International Monetary Fund, 2008.

Among these countries, China's current account surplus skyrocketed and official reserves rose to record levels. Competitive pressures from China also created pressure on other East Asian countries to limit the appreciation of their currencies against the U.S. dollar, boosting external surpluses and reserve accumulation in these countries. The current account surpluses of oil-exporting countries in the Middle East also rose because increasing worldwide demand continued to push up oil prices. In turn, through net capital flows, developing countries' external surpluses were funneled back to the United States. This financing then helped fund a continuation of the consumption and housing boom and a steady rise in asset prices.

To a significant extent, the strong preference for U.S. dollar assets that emerged reflected the pivotal role the dollar plays as a reserve currency in the international financial system. Consequently, the United States was able to finance its growing external deficits relatively easily and delay needed adjustments in domestic savings and in its balance of payments (reflecting the first feature of the international financial system). However, there was also a net flow of private capital into the United States, as shown in Figure 6. This reflected the sense that U.S. markets were better regulated, had better governance, and were more secure than markets in emerging economies. Moreover, in the first

FIGURE 6. NET CAPITAL INFLOWS TO THE UNITED STATES (U.S. $ BILLIONS)



Source: Bureau of Economic Analysis, 2008.

part of the 2000s economic growth was faster in the United States and returns on financial assets were perceived as being higher than in other advanced countries. As a result, a self-reinforcing effect set in. As capital inflows to the United States boosted asset prices and returns, additional flows of capital were stimulated.

Few analysts dispute the existence of the imbalances or their contribution to asset price inflation. But with the benefit of hindsight, many commentators have argued that the United States should have used monetary policy to blunt the effects of capital inflows, thereby averting the crisis. It is asserted that the Federal Reserve permitted loose monetary conditions to prevail for too long, allowing the buildup of too much liquidity in the financial system. The Fed is a convenient scapegoat, but what these commentaries suggest is that it could have used monetary policy alone to deal with global imbalances. They fail to recognize that monetary policy is a blunt instrument. With the inflows of capital, the yield curve in the United States was relatively flat through much of the 2000s, suggesting that a decision to hike short-term policy rates might not have fully fed through into long-term rates. Indeed, senior Fed officials had commented on the unusual difficulties being encountered in trying to use monetary policy to influence long-term interest rates. Then chairman Alan Greenspan often spoke of an interest rate conundrum,[15] and then deputy chairman Ben Bernanke offered the savings glut as an explanation for the low level of long-term interest rates that appeared hard for the Fed to control.

To be sure, the flat yield curve did not imply that the Fed could not bring about an increase in long-term interest rates. Monetary policy certainly could have been used to limit the effect of the inflows of capital to the United States and prevented some of the excesses that occurred. However, to be successful, there would have had to be a substantial tightening of monetary policy. Such aggressive use of monetary policy to deal with this problem would have inflicted a high cost on the U.S. economy and, in turn, the rest of the world. Granted, the costs inflicted by the current economic and financial crisis are quite high, but the relevant question is whether other policy alternatives would have been better placed than monetary policy in dealing with the situation at a much lower cost. Obviously, dealing more aggressively with global imbalances would have been the best policy response.

The False Hope of Decoupling

In the past couple of years, a view has emerged that the problem of global imbalances would diminish over time as growth in the rest of the world—particularly in Europe and East Asia—was seen to decouple from growth in the United States. In conjunction, it was also argued that other countries—especially China—were stepping up to become engines to sustain world growth. It was therefore argued that global imbalances could be self-correcting and that there was time for more gradual changes in economic policies in the major countries. That the recession in the United States has had a more severe than expected impact on the rest of the world has exposed these propositions as myths and dashed hopes that a permanent correction in global imbalances could be achieved without a severe disruption in world growth. Now there is a clear need for policy actions to deal with the problem, and global imbalances should no longer be considered a medium-term problem that can be dealt with gradually.

The decoupling and new-engines-of-growth myths stemmed from a simplistic analysis of national accounts data. The data for Europe and East Asian countries indicated that domestic demand, not net exports, was increasingly the major contributor to economic growth, hence the view that growth in these economies had decoupled from growth elsewhere. The new engines myth was derived from an analysis of world GDP data, which showed that other countries' contributions to world GDP growth were rising relative to the contribution of the United States. Indeed, China's contribution to world growth exceeded that of the United States in 2007.

The basic problem with the analysis underlying the decoupling myth was that it focused solely on the proximate sources of growth. No attempt was made to try to determine whether domestic demand growth was self-sustaining or whether it was generated as the knock-on (or multiplier) effect arising from the income derived from exports.

Similarly, in the new-engines-of-growth myth, the suggestion that China was becoming a growth engine for the world economy did not factor in whether China was actually generating demand for the rest of the world. China certainly was, to some extent, doing so for the rest of Asia. However, the engine ultimately driving China's import demand was China's exports.[16] That the two propositions were in the end just myths became abundantly clear as the United States slipped into recession. The financial turmoil may have added to the slowdown in the rest of the world, but it is the loss of stimulus derived from U.S. demand that has been the major factor in slowing economic growth, particularly in East Asia.

In one common view, current economic difficulties make it hard in the near term to deal with global imbalances, owing to concerns about negative short-run effects on growth and employment. But ignoring imbalances and falling back on old policies to crank up growth will serve only to exacerbate the imbalances when the world economy recovers, making them an even bigger problem and creating an economic environment that ultimately may be less stable. The challenge for heads of state is to formulate policies that both cushion the economic downturn in the near term and address global imbalances at a reasonable pace.

The United States finds itself in a somewhat ironic position. For years, economists have called for actions to boost national savings in order to reduce the current account deficit. Now, substantial fiscal stimulus is needed to save the U.S. economy from a sharp downward spiral. But it has to be implemented with an eye to the need to consolidate the U.S. fiscal position over the medium term. To maximize its effect, a premium should be placed on spending that provides a direct stimulus to the economy without permanently raising expenditures.

Beyond the questions of stimulus design, the United States will have to increase national savings in the medium term, and the most efficient way to do so is to raise government savings. Efforts will have to include reforming the tax system. Reforms of spending programs can provide some savings, but given large and growing demands, spending constraints will not achieve the needed increase in government savings. In the end, there will have to be tax increases. One option is to restore the top marginal income tax rates of the 1990s when the cuts enacted during the Bush administration expire in 2010. A substantial amount of revenue could thus be raised without creating significant disincentives for work and investment, judging by the high rates of growth

during the 1990s. Simplifying both the personal and corporate income tax code could also boost efficiency, improve equity, and at the same time raise revenue.[17]

In Europe and Japan, medium- and longer-term demands on government resources present challenges but should not block near-term fiscal action. The short-term to medium-term trade-off in these countries is similar to that in the United States. Significant fiscal stimulus now could prevent an economic recession from turning into a depression. Accordingly, for the European countries, substantial flexibility should be used in adherence to the objectives in the Stability and Growth Pact. It is also important for the euro-area countries that looser monetary policy supports fiscal stimulus.

Stimulus in the short term will help soften the downturns in Europe and Japan, but structural reforms in labor and product markets are needed to reinforce these efforts and lay the basis for more balanced and sustainable growth over the medium term. To break out of the cycle of relatively slow growth and heavy dependence on exports, Europe and Japan must boost competition in product markets by removing barriers to entry and by improving business opportunities. Labor market reform is particularly critical in Europe. It must enhance competitiveness by increasing labor flexibility and mobility, reducing employment protection, and better aligning wages with labor market supply and demand. In both Europe and Japan, it is also essential to boost labor force participation to offset the effects of aging.

Europe and Japan will be tempted to put off structural reforms out of concerns to preserve employment. But both have delayed structural reform for too long. Each time these economies face shocks, they put off adjustment. The tendency to delay reforms out of concern for short-term employment is becoming self-reinforcing and, in particular, is condemning Europe to slower and slower growth. Near-term losses in employment resulting from labor and product market reforms are likely to be more than made up because such reforms will foster more rapid growth when economic recovery takes hold.

East Asian emerging economies also have room to provide fiscal stimulus to help offset the impact of the global slowdown, and they should move ahead quickly. How China responds is particularly important to the world economy. China has already announced a large fiscal package and has taken steps to ease monetary and credit conditions. However, some of China's actions may serve simply to reinforce the

country's dependence on investment-driven growth and exports. The government has taken steps to sustain export growth, including increasing value-added tax (VAT) rebates for many categories of exports and by effectively repegging China's renminbi to the U.S. dollar.[18] Such efforts to sustain export growth are likely to cause difficulties in other East Asian economies and could provoke protectionist responses in advanced countries.

The Chinese authorities must deliver a stimulus that promotes domestic consumption. The government needs to continue improving critical social services, especially education, health care, and pensions. Reducing the uncertainties surrounding the provision of these services will substantially diminish households' strong precautionary savings motive and give households the confidence to raise consumption. These are areas where significant short-term stimulus could be provided. Nevertheless, although the Chinese authorities have acknowledged the need to bolster social services, economic stimulus plans thus far appear to be predominantly oriented toward sustaining investment and export growth.

The Chinese authorities are aware that significant changes in policies are imperative to sustaining rapid growth over the medium term. They have publicly stated that the economy needs to be rebalanced away from its heavy dependence on investment and exports toward consumption.[19] To do so requires removing price distortions and other policy changes to eliminate inefficiencies and incentives favoring investment over consumption. Distortions exist in such areas as energy, other utilities, and land, but a major problem is the low cost of capital. Capital costs need to be raised significantly, and that cannot be done without permitting more flexibility and a more rapid rate of appreciation of the exchange rate. The ceiling imposed on interest rates paid on savings deposits is a major factor behind the low cost of capital, keeping the bank lending rate low and holding down the opportunity cost for enterprises' use of their retained earnings for investment. This ceiling needs to be lifted. In turn, a higher cost of capital and a stronger currency will help curb investment in the export- and import-substituting sectors. Real household incomes would be boosted by a rise in both the exchange rate and bank deposit rates. Consumption would rise, particularly because, with a strong precautionary motive for savings, a greater proportion of an increase in household interest income from a rise in deposit rates is more likely to be spent than saved.

Financial market reform is also needed to improve the intermediation of savings in China. Lifting the cap on deposit rates would not only help push up the cost of capital, it would also increase competition in the banking sector and provide incentives for banks to expand credit to new customers. Greater access to credit would reduce the incentives of both firms and households to hold large savings. Bond and equity markets must be developed to provide alternative sources of financing for firms and a much broader array of assets for households to invest in. Small- and medium-sized firms have had to rely largely on retained earnings or the assets of their owners to finance investment. Consumers also have had limited access to credit. Better credit access and higher-yielding assets to invest in would reduce household savings and raise household incomes over time, boosting consumption.

Better IMF Surveillance

An important part of dealing with global imbalances (and trying to diminish the prospect of a similar situation arising again) entails finding ways to mitigate the potential effects of the features in the international financial system that can permit countries to delay adjustment to external imbalances. There are no easy or hard-and-fast solutions to these problems.

The U.S. dollar's status as a reserve currency is not likely to change in the near future. Even in the midst of the current financial crisis, money is pouring into the United States, which is seen as a safe haven despite the fact that the crisis originated in U.S. financial markets. U.S. Treasury securities remain the world's premier risk-free asset. Accordingly, the United States is likely to remain the dominant provider of reserve assets, and when the global economy recovers from the current downturn, a steady underlying demand for foreign official holdings of U.S. dollar assets will continue. And just as the United States will be able to use this advantage to put off adjustment, so countries facing upward pressure on their currencies will be able to delay adjustments in their external surpluses. Likewise, it is not feasible to diminish the sheltering effect that exchange rate depreciation may have and how it may delay adjustment to structural shocks in countries with floating exchange rates. Nor would it be desirable, because floating rates undoubtedly make countries more resilient to temporary shocks and serve to stabilize the system overall.

Bilateral pressure has not been effective in inducing countries—especially the major countries—to make necessary policy adjustments. Such pressure is often seen as being motivated by self-interest and therefore biased. Ad hoc groups of countries have been no more successful. The same question concerning motives can apply, and there are usually members of the group that are reluctant to firmly judge the behavior of one country, lest their own policies attract scrutiny.

The designers of the international financial system recognized the need for an impartial body to enforce the rules of the system, to flexibly respond to its potential flaws, and to change the system as the global economy evolves. This is a primary goal of the International Monetary Fund. In particular, the IMF's articles of agreement require the organization to promote the smooth functioning of the international financial system by conducting surveillance of the economic policies of member countries. As mentioned earlier, however, the IMF cannot compel member countries to change their economic policies; it can only urge them to make needed changes. The persistence of global imbalances suggests that the IMF has failed in the execution of its surveillance mandate, especially with regard to its larger, systemically important members, which have been the main players in the global imbalances saga.[20]

One approach advocated to improve IMF performance is to make the rules governing surveillance more specific, particularly with regard to exchange rate policy. The articles of agreement establish the obligations of IMF member countries and the general principles on which the institution's surveillance function is based. Rules for applying these principles are specified in decisions by the IMF's executive board, and the application of these decisions is laid out in guidance notes from IMF management to the institution's staff. It is argued that these decisions and guidance notes should be more specific in identifying policy actions, the value and behavior of exchange rates, the size of external imbalances, and other relevant variables that would make it more straightforward and automatic to determine whether member countries are violating their obligations.

Although in principle this approach may sound good, in practice it is difficult to implement. Countries' economic situations are not always black and white, and their policy actions may not be easily judged as conforming to, or violating, their IMF obligations beyond a reasonable doubt. Moreover, possible indicators of inappropriate policy actions may be subject to considerable variance in interpretation, and their measurement may also be imprecise. It is difficult, for example, to measure the value of a country's equilibrium real effective exchange rate to determine whether its currency is significantly over- or undervalued. Attempts to apply specific rules will likely result in numerous exceptions being made to ensure that countries are not unfairly held for violating IMF obligations. The larger the number of exceptional cases (and the number will be large as countries strongly argue why they should be

exceptions), the more questionable it will be that anything is gained by embracing more specific rules for surveillance.

There is more to be gained from steps to strengthen the way the IMF operates under its current guidelines. The surveillance process at the IMF involves the staff, management, and the executive board. The staff conducts the IMF's surveillance, but the framework for surveillance is proposed by management and approved by the executive board. The IMF's managing director and the deputy managing directors provide guidance on the conduct of surveillance to staff, both formally and informally. The executive board ultimately determines the results of the surveillance process. The board is considered to be the IMF, and it alone can speak officially for the institution. Accordingly, all Article IV consultation reports must be reviewed by the executive board, and the board makes a formal, public statement on the IMF's assessment of each member country's economic policies at the conclusion of the surveillance process.

The failure of the IMF to exercise firm surveillance reflects to an important extent the influence of the executive board and management. The board is a relatively large body with a disproportionate representation of advanced countries. It strives for consensus, and so does not generally take strong positions in its assessments of countries' economic policies. In particular, this tends to be the case in dealings with the IMF's major member countries, which are well represented on the board. Consequently, public messages resulting from IMF surveillance tend to be muted and unclear, and opportunities to exert pressure in favor of needed policy changes are lost.

IMF management has been characterized by rapid turnover in recent years, especially at the top. This has not been conducive to the IMF being able to articulate strong, coherent assessments of major countries' policies. Moreover, management-led reforms to the surveillance process (partly aimed at establishing more specific rules) and debate over the guidance for the implementation of these reforms have served more as a distraction over the past few years than as an enhancement to IMF surveillance.

Significant improvements in the IMF's surveillance could be achieved by limiting the executive board's role in the surveillance process and by making IMF management more effective. The board should no longer be involved directly in surveillance reviews. Its responsibility should be limited to approving the overall framework for surveillance (consistent

with the articles of agreement) and holding IMF management responsible for the effective execution of surveillance. To carry out its responsibilities effectively, IMF management, including the managing director and the deputy managing directors, needs to be selected in an open process solely on the basis of the candidates' qualifications and competence. The current selection process is relatively closed and tends to be dominated by political considerations.[21]

A question naturally arises as to whether earlier adoption of these reforms in IMF governance would have changed the course of events that led to the current crisis. It is difficult to argue convincingly that the crisis would have been averted, but improving the IMF's surveillance efforts could have made a material difference to its severity and duration. Although governments are not in the habit of publicly recognizing the salutary effect of IMF pressure, there have been many occasions when IMF surveillance has helped change countries' economic policies for the better. The Canadian authorities have acknowledged the important role IMF surveillance played in policy decisions of the mid-1990s that resulted in the elimination of fiscal deficits, as have the U.S. authorities in regard to support for its fiscal consolidation in the second half of the 1990s and the Chinese in regard to the restructuring and recapitalization of China's largest state-owned banks since 2003.

Given this track record, tougher surveillance of the major countries could have fostered policy changes that would have slowed the growth in global imbalances. The United States could have been pressed more forcefully on the need to increase national savings and reduce its cyclically adjusted fiscal deficit. This could have strengthened the hand of those arguing for policy changes. For Europe, greater emphasis could have been placed on the significant losses in competitiveness that euro-area economies experienced during the 2000s as the euro appreciated, which would have reinforced the argument for liberalization of labor and product markets. Such changes could have been easier to achieve in more prosperous times. Similarly, prosperous times could have provided a better opportunity for changes in economic policies in China. In particular, earlier and stronger pressure might have helped build a consensus for a significantly faster change in China's exchange rate and had a measurable impact on China's external imbalance. That the annual IMF surveillance consultation with China has not in fact taken place since 2006 points to missed opportunities to influence the country's economic policies.

In the end, whether IMF surveillance would have materially altered the current crisis depends on how the surveillance would have been conducted had the reforms suggested here been adopted. This is a matter of speculation. But improving surveillance is at least an important first step toward strengthening the global system. There is no reason not to attempt it.

Conclusion

The G20 has emerged as the main group for discussions on the global economy and reforms of the international financial system. The group's November 2008 summit made a reasonable start, despite its hasty organization. Understandably, the summit focused on actions to arrest the slide in economic activity and get growth restarted. It also seized on the proximate cause of the economic and financial crisis—significant failures in the supervision and regulation of the financial sector in advanced countries—and proposed a credible action plan to begin to address these failures. But the problem of global imbalances was largely ignored.

If the G20 is to prevent similar crises in the future, it will have to reckon with global imbalances and the features in the international financial system that facilitated their growth. If nothing is done, the imbalances will simply build up again as the world economy recovers, and in time they will become a major contributing factor to the next global crisis. Diplomacy through the G20 process is an important opportunity to make the world economy more sound. The reforms of the IMF proposed in this report would help strengthen surveillance and encourage the policy adjustments needed to unwind imbalances.

Yet in the end it must be recognized that solutions lie not with any international gathering but with governments. The international system has allowed governments to build up huge balance-of-payments imbalances; the international system will continue to allow them to do so. But the past year or so of crisis demonstrates the difference between doing what may be politically expedient and doing what is sound economic policy. If country authorities do not learn their lessons from the current economic and financial crisis, they will find themselves reliving it.

Endnotes

1. That global imbalances were only indirectly referred to and not explicitly mentioned in the G20 summit's statement does not bode well for getting the necessary international cooperation to finally deal with this problem. "Remarks by Secretary Henry M. Paulson, Jr., on the Financial Rescue Package and Economic Update," U.S. Treasury press release, November 12, 2008.
2. The International Monetary Fund has written at length about the problem of global imbalances since the early 2000s. See *World Economic Outlook*, International Monetary Fund, various issues.
3. In the report on the multilateral consultation with major members held by the IMF in late 2006 and early 2007, the view of the participating countries was that "the [global] imbalances were seen as a fundamentally medium-term problem that required medium-term solutions. There was general agreement that a correction in global imbalances would eventually be necessary, but with the U.S. current account deficit still being relatively easily financed, most saw the immediate risks as low; the greatest concern was that imbalances could add to protectionist pressures, on both the current and capital account. Thus the policy strategy should be gradualist in nature, consistent with and supportive of the necessary adjustment in the private sector, and aiming to build confidence that a credible and consistent strategy to reduce imbalances was being pursued." *Staff Report on the Multilateral Consultation on Global Imbalances with China, the Euro Area, Japan, Saudi Arabia, and the United States*, International Monetary Fund, June 2007.
4. The factors driving the rise in deficits after 2001 were sharply different from those that had contributed to sizable U.S. current account deficits in the second half of the 1990s. At that time, changes in information technology and their application in productive processes raised returns on investment in the United States and prompted substantial inflows of private capital.
5. *Balance of Payments Manual*, 5th ed. (rev.), International Monetary Fund.
6. In the Bretton Woods system, gold was a substitute for the U.S. dollar as a reserve asset. The system basically collapsed when demands for gold in exchange for dollars rose sharply, especially because the French government was less willing to hold dollar assets and the United States was reluctant to continue selling its gold stock at the price at which the dollar was pegged to gold.
7. Using foreign exchange controls can extend the period, but the resulting impact on the real economy can be rather harsh, and such actions directed at current account transactions can invite retaliation by other countries.
8. The so-called iron trinity argument suggests that by instituting capital controls, a country trying to peg its exchange rate is able to pursue an independent monetary policy.
9. Capital controls can be seen as being equivalent to a tax on international capital movements. When potential returns are high enough, investors will be willing to incur

additional costs to evade the controls; the higher the potential return, the greater the incentive for investors to evade.

10. See, for example, Richard G. Harris, *The New Economy and the Exchange Rate Regime*, Center for International Economic Studies, Adelaide University, March 2001.
11. Ben S. Bernanke, "The Global Savings Glut and the U.S. Current Account Deficit," Homer Jones Lecture, April 14, 2005, and "Global Imbalances: Recent Developments and Prospects," Bundesbank Lecture, September 11, 2007.
12. "Statement from the G-20 Summit on Financial Markets and the World Economy," November 15, 2008.
13. It is not readily apparent why global imbalances were not directly cited as a root cause of the current crisis. The strange phrasing, along with what appears to be a typographical error in the list of underlying factors and a missing reference to the role played by exchange rate policies, would suggest that there was opposition from the Chinese authorities to the inclusion of a reference to global imbalances in the communiqué.
14. See Brad W. Setser, *Sovereign Wealth and Sovereign Power: The Strategic Consequences of American Indebtedness*, Council Special Report No. 37 (New York: Council on Foreign Relations Press, 2008).
15. See "Testimony of Chairman Alan Greenspan," *The Federal Reserve Board's Semiannual Monetary Policy Report to the Congress,* delivered before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 16, 2005.
16. In fact, the slowing in China's export growth has been accompanied by an even greater slowdown in the growth of China's imports. As a result, China's net exports are likely to rise in 2008 and probably again in 2009.
17. As an example of improving equity while raising revenue, the elimination of the inheritance tax could be made permanent, but equity in the tax system would be improved and revenue would be raised if the markup basis for pricing of inherited equities were changed. Currently, inherited stock is valued at the price when inherited instead of at the original purchase price. Hence, capital gains taxes on these securities can be avoided by people who inherit stocks but not by those who purchase and later sell stock for a gain. Eliminating the markup and valuing inherited stock at the original purchase price would put all stock transactions on the same basis for tax purposes.
18. Since mid-July 2008, the value of the Chinese renminbi against the U.S. dollar has been largely unchanged, after the currency appreciated roughly 7 percent in the first half of the year.
19. Chinese premier Wen Jiabao in his address to the National People's Congress in March 2007 said that "the biggest problem in China's economy is that growth is unstable, unbalanced, uncoordinated, and unsustainable."
20. Speakers at the October 2008 Per Jacobsson Roundtable on the Role and Governance of the IMF were particularly vocal on the failures in surveillance. Former IMF chief economist Raghuram Rajan summed up the panel's assessment with the statement: "What I think we are missing in these moments is the presence of a strong international, independent voice which stands for the world economy and fights for the world economy. And it is a loss that the Fund is not performing that role."
21. Similar recommendations are made in a report on governance of the IMF issued by the IMF's Independent Evaluation Office (*Governance of the International Monetary Fund: An Evaluation*, Report of the Independent Evaluation Office of the IMF, 2008). In response to that report, the IMF's managing director appointed a committee of eminent persons to review IMF governance and make recommendation for changes. The committee's report is expected to be delivered in spring 2009.

About the Author

Steven Dunaway is an adjunct senior fellow for international economics at the Council on Foreign Relations. Previously, he was a deputy director of the Asia and Pacific department at the International Monetary Fund. From November 2001 until December 2008, he was primarily responsible for directing the IMF's country work on China and headed the IMF's consultation missions with the Chinese government. This was Dr. Dunaway's second assignment on China while with the IMF; in the late 1980s, he was desk officer for China. Before his assignment in the Asia and Pacific department, Dunaway was head of the North American division in the IMF's Western Hemisphere department. In that capacity, he directed the IMF's consultations missions with the United States and Canada.

During his twenty-five-year career at the IMF, Dunaway had a wide variety of other country assignments ranging from such countries as Australia and New Zealand to Indonesia and the Philippines. In addition, during the mid-1990s, he directed the IMF's research on private capital flows to developing countries and handled IMF support for Brady debt deals for Ecuador, Panama, and Peru.

Before coming to the IMF, Dunaway worked for ten years at the Bureau of Economic Analysis in the U.S. Department of Commerce, doing analysis and forecasting of U.S. international transactions. He holds undergraduate and graduate degrees in economics from the Universities of Louisville and Cincinnati, and received his PhD in economics from George Washington University.

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