

MTI-CSC Economics Speaker Series
**“The Global Economy in the Post-Crisis World:
Prospects for the Great Rebalancing”**

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Causes of Current Financial Crisis

Dr Arvind Subramanian began the lecture by listing the two main causes for the current global financial crisis – the policy and regulatory failure of the US, and global imbalances. As a result of their export-led growth strategy, since 2003 many countries especially China had been running huge current account surpluses and building up their foreign exchange reserves. These surpluses were used to purchase US financial assets, thus allowing US consumers to finance their profligate consumption through borrowing.

To prevent further global financial crises, the problem of global imbalances had to be addressed. Dr Subramanian cautioned that the automatic rebalancing seen in the last two quarters would not be sustainable, especially when the Chinese yuan remained depreciated and Asian countries maintained their strategy of export-led growth.

Reasons for Current Account Imbalances

Dr Subramanian gave two reasons why countries considered it in their interests to have current account surpluses and build up huge foreign exchange reserves. First was the desire for self-insurance to thwart speculators and prevent potential foreign exchange crises. Second was the development strategy of export-led growth in these countries. He opined that small countries could pursue this strategy without significantly upsetting the international financial system, but a big country such as China had greater international responsibilities.

Although many countries had current account surpluses, these were small compared to China's. Hence potential solutions to the imbalances would require China's voluntary cooperation. Part of the global imbalances reflected societal behaviours i.e. excess savings in Asia and overspending in the US. Hence some solutions to the imbalances might have to be implemented gradually. That said, short-term policy variables such as China's undervalued currency, also had significant impact on global imbalances and should be addressed.

Possible Solutions

Multilateral Insurance

Dr Subramanian saw three possible solutions. First was the role of multilateral insurance as a substitute for self-insurance to provide liquidity during financial

crises. This should ideally be in the form of the IMF responding quickly by providing liquidity in Special Drawing Rights or lending money to crisis countries. In this crisis, the IMF had created flexible credit lines which were disbursed quickly to crisis countries with little conditionality.

Mexico, Singapore and Korea also had dollar swap arrangements with the US which helped stabilise the volatile economic condition in Korea. Countries would rather approach the US Federal Reserve than the IMF for help, resulting in the failure of the IMF's role to provide multilateral insurance. Several Asian countries had adopted a strategy of self-insurance because they wanted to avoid approaching the IMF for help, remembering the stringent conditionality imposed by the IMF during the Asian financial crisis. The IMF was perceived to behave more like Euro-Atlantic Monetary Fund than an International Monetary Fund, and faced a problem of eroding legitimacy. It also faced the problem of asymmetric surveillance and inadequate leverage – it had more leverage on borrowing countries and little leverage against creditor countries.

Asian countries had to believe that the IMF was also their institution, and governance reform of the IMF was a prerequisite for it to play an effective role as multilateral insurance. To increase its legitimacy, the selection process of the IMF Director-General, the shares of Asian countries in the IMF's quotas, and the veto power of the US and Europe over major IMF decisions had to change. The current governance structure of the IMF reflected the global power structure of 1945 and it had to be updated. However Dr Subramanian was not optimistic of governance reform at the IMF because that would require the US and Europe to give up some power in the institution. While the supply for change in the IMF was rigid, Asian countries had also not taken the recent opportunity to sufficiently assert their demand for change.

Regional Insurance

The second possible solution to the global imbalances was the use of regional insurance schemes such as the Chiang Mai Initiative in Asia which had recently been strengthened. However it fell short of an ideal regional insurance because the initiative was still linked to the IMF. Further, historical rivalries between countries might impede the development of regional insurance in Asia.

Enhanced Role for the WTO

The third possible solution was an increased role for the WTO to deal with the trade-related dimension of the global imbalances. Unlike the legitimacy problem faced by the IMF, the WTO's governance structure had evolved with the changes in global power landscape over time. Small countries had a smaller role in the WTO, but countries get bigger roles in negotiations and decision making when they become bigger international traders. Disputes in the WTO received less asymmetric treatment, with rich and poor countries having more equal opportunities to initiate and win cases brought before its court. These made the WTO more appealing than other international institutions as a political forum for international cooperation.

Dr Subramanian proposed that the WTO could address the trade imbalance problem by treating undervaluation of currencies akin to export subsidies and import tariffs which were generally prohibited under WTO rules. There was also the possibility of IMF-WTO collaboration, with the IMF providing the technical expertise to identify currency undervaluation and the WTO being the political forum to address the undervaluation.

International Politics of Exchange Rates

Voluntary cooperation of the relevant countries was required to achieve the desired outcome. The US had considered ways to address the problem, e.g., proposals to levy taxes on Chinese imports which were equivalent to the exchange rate undervaluation. These proposals did not obtain the support of US corporations because many of them had operations in China from where they exported back to the US. However, there could be a possible revival of such proposals under the Obama administration which had been vocal against currency manipulation. Notably, top economic adviser Larry Summers had warned that the US wanted to reduce its current account deficits. This meant that the US might depreciate its currency to encourage exports. One reason why the US wanted to reduce its current account deficit was because it compromised the US' exercise of power over China.

Dr Subramanian did not see dollar depreciation necessarily leading to a decline in its role as an international reserve currency. However if countries holding significant US dollar reserves did not have confidence in the US fiscal position, that might lead to a disorderly depreciation of the dollar which could reduce its role as a reserve currency. Although China was grooming the yuan to be a reserve currency and Shanghai to be a financial centre, the yuan would not be replacing the dollar as dominant reserve currency. Rather Dr Subramanian saw both US dollar and Chinese yuan being co-reserve currencies, with the yuan being used more by Asian countries as a reserve currency.

Enhancing the prospects for solutions also required a broader coalition of countries. Countries such as Mexico, Turkey, Brazil and others in East Asia were competing with China to export, and their exchange rate policies were dependent on China's. Dr Subramanian pointed out that other East Asian countries would like to appreciate their currencies too, but would not do so if China did not take the lead. If China and the East Asian countries revalued their currencies, their current account surpluses would decline. However these countries had been reticent in voicing their concerns with the imbalances, and they had to recognise that the imbalances was a systemic issue and not just one between the US and China.

The imbalances could only be resolved if China saw it as in its interest to reduce the imbalances. Dr Subramanian suggested looking at carrots to induce China's cooperation, but he recognised that there might not be any possible carrots or sticks to induce China's cooperation for now.