Rebalancing the Global Economy

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Abstract

Imbalances are a dominant feature of the world economy and they are often seen as having contributed to the global financial crisis. A revaluation of the Chinese currency is often recommended to reduce the current account imbalance between the US and China. This article argues that emerging Asia’s current account surpluses are a necessary condition for rapid catch-up growth and should not be eliminated soon; instead the excessive dollar bias in Asian holdings of external claims needs to be reduced, because the problem behind the recent crisis was that emerging economies have placed their foreign exchange reserves almost exclusively in US$ assets and have neglected alternative assets like the euro and the yen. A policy proposal for a common Asian peg to a basket of euro and yen is made.

Policy Implications

• Policies to restore global balances must not create additional tensions for China, Asia, Europe or the United States. A cooperative management of the global economy is recommended.
• Chinese exchange rates policy must be seen in the broad context of the Asian development model. A rapid revaluation or shift to flexible exchange rates would undermine the Chinese development model and deprive the world of an immense source of economic growth.
• The undervaluation of the RMB should only gradually be removed as the Chinese economy improves productivity and catches up to advanced economies’ production standards.
• Fixed exchange rates support economic development by reducing uncertainty for investment and trade. Stabilising the exchange rates between major currencies and Asia as a region is important to allow the continuing integration of Asia’s developing economies into the world market.
• The US economy needs flexibility in exchange rate movement while it is going through the necessary adjustment of its current account balance, but not Asia. Asia should peg to a basket of euro and yen and Chinese foreign exchange reserves should be marginally shifted into these new reserve currencies. Europe must not protect its industries, but rather seek to stimulate economic growth by inviting Chinese and Asian.

A global economy needs global management. This was the lesson from the global financial crisis, when policy makers set up the G20. But very quickly the new global economic governance became stuck in the gridlock of international bureaucracy. Banal and dry communiqués are a sure sign that governments cannot agree on substance when partial interests block cooperative decisions in the collective interest. Today, America and Europe are at loggerheads with China and Asia over global imbalances. Exchange policies are a key variable in this debate and the revaluation requests made by the west are resisted in Asia. The stability of the global economy requires cooperative solutions for overcoming global imbalances.

Yet, while imbalances have dominated the world economy for decades, there is no agreement on whether they are harmful or not. For some economists, they are unsustainable and have contributed to the global financial crisis (Obstfeld and Rogoff, 2009); for others they are the unintended consequence of otherwise desirable developments.1 Unless these opposing views are brought together, managing the global economy will remain an empty wish. This article presents a new approach to an old problem and it shows how making use of the euro could contribute to a win-win solution for the global economy.

Global imbalances matter. There is little doubt that high savings and the accumulation of foreign exchange reserves by Asian central banks have fuelled the domestic American credit boom, which collapsed in 2008. As history teaches, the larger the bubble grows, the harder the subsequent fall. Hence, ignoring global imbalances would...
be irresponsible. While it is true that the US current account deficits have recently narrowed, the system that has generated them has not changed. We need to understand why this is so and what can be done about it.

Bernanke (2005) has advanced the proposition of a ‘global savings glut’, which has kept long-term interest rates down, fuelled capital gains and allowed American households to reduce their savings prior to the crisis in 2008. He only missed mentioning that such a glut would cause an unsustainable asset bubble. Most of the global savings glut has originated in Asia and in particular in China. Asian savers lent money to American consumers who then spent it on cheap goods from Asia. This symbiotic relation between the United States and Asian economies was supported by seemingly ever-appreciating financial assets. The global savings glut hypothesis portrays America as the victim of excessive capital inflows, which were pumped into the US because American asset markets were highly efficient and the US dollar attractive. The villains in this story are Asian savers who do not know what else to do with their savings but to keep them in safe dollar assets. The policy recommendation resulting from this analysis is simple: excessive savings and current account surpluses have caused the crisis; therefore Asia’s development model must change. Undervalued currencies should appreciate to make US imports more expensive and exports more competitive, while Asian governments should focus on expanding domestic consumption. This policy consensus is widely shared by policy makers in Washington, Europe and major international organisations.

By contrast, I will argue here that emerging Asia’s current account surpluses are a necessary condition for rapid catch-up growth and should not be eliminated soon; instead the excessive dollar bias in Asian holdings of external claims needs to be reduced, because emerging economies have placed their foreign exchange reserves almost exclusively in US$ assets and have neglected alternative assets like the euro and the yen. This investment strategy fuelled the bubble in American asset prices until it became unsustainable. However, the dollar is no longer the world’s only possible reserve asset. The euro is an alternative store of value. Why has it not become more widely used for the diversification of reserves? The answer is that Asia has invested most of its reserves in dollars, because the exchange rate peg has given protection against uncertainty, and central banks need dollars to maintain the dollar peg. Rebalancing the global economy requires, therefore, reviewing Asia’s currency pegs. Europe and Japan could play a more important role in absorbing emerging Asia’s surpluses and greater diversification of financial investments could stabilise the global economy.

The rest of the article will first assess the facts of global imbalances; it will then analyse the transformation in the world economy that has contributed to this development; and it will conclude with an economic strategy that offers a win-win solution for Asia, America and Europe.

1. Assessing global imbalances

The notion of global imbalance needs clarification. It has three dimensions: current accounts, capital balance and changes in reserve assets. First, the current account deficit of a country is the difference between domestic investment and savings. In a closed economy, investment is always equal to savings, because investment will generate income until savings match the initial investment. In an open economy, however, the difference between investment and domestic savings can be financed by borrowing savings from another country. Thus, the equality will only hold at the world level where global balances sum up to zero. Yet, given that savings are the excess of income over consumption, and that a ‘country’ is economically defined by its currency, a country can only borrow from another if the lender is able to sell goods and services to the borrower and is willing to hold the claim on the debtor in foreign currency. What one country borrows is necessarily the surplus of another. In other words, consumption in the US can be ‘excessive’ and domestic savings can be low, because American financial markets are attractive for Chinese investors and Chinese products are cheap for American consumers. Hence, the current account deficit signifies an excess of spending over domestic production, or a higher rate of investment than can be financed by domestic savings, or that owners of wealth claims in surplus countries are willing to hold assets denominated in the currency of the deficit country. These are three aspects of the same phenomenon.

Second is the capital balance, which is directly linked to the third item, namely changes in reserve assets. Capital flows caused by the private sector are recorded in the capital balance; those which depend on policy decisions are recorded as changes in foreign exchange reserves of the central bank. If a country imports more than it exports, it needs foreign currency to pay for it. It can borrow and/or run down foreign reserves. Conversely, an export surplus implies lending money to consumers abroad and/or accumulating foreign reserves by the central bank. If more capital flows into (or out of) a country than it wants to borrow (or lend), the central bank must buy up these foreign currencies (or sell them) and accumulate them in the form of foreign exchange reserves if it wants to keep exchange rates stable. Unless the net inflows of capital are bought by the central bank, the currency will appreciate. However, net capital outflows can only temporarily be compensated by drawing on reserves, because sooner or later authorities will
run out of reserves. During the Asian crisis a sudden stop of capital flows caused countries to draw down their reserves and forced them into massive devaluations. There is therefore an asymmetry between strong and weak currencies. The central bank in an economy with a strong currency has the choice between accumulating foreign exchange reserves and letting the exchange rate appreciate. For weak currencies, the loss of reserves invariably ends up with exchange rate depreciation.

Because current account imbalances are always financed by corresponding capital flows, the real economy and the financial sphere are simply mirror images. If they are primarily financed by private capital flows and leave official reserves unchanged, we will call this weak imbalance. A stronger condition for global imbalance would combine stationary imbalances of current account and capital balances with different means, so that the shares in global foreign exchange reserves reveal trends of structural change. Weak imbalances can be sustainable for a significant period of time and can be justified by intertemporal trade. Strong imbalances, which imply a persistent accumulation or loss of reserves, are unsustainable.

The international system is stable as long as trade and financial strategies are complementary (weak imbalance), but it will crash when the portfolio preferences for goods and services and financial wealth become inconsistent. Such a crash can take the form of exchange crises, like in Asia in the late 1990s, or distort asset prices as in the United States during the 2000s. Hence, the flows recorded in the current account and the capital balance must be consistent with the portfolio preferences of private assets holders and public authorities. Otherwise a crisis will occur and dramatically revalue exchange rates and/or asset prices.

**Empirical evidence**

After these conceptual clarifications, we will now look at the facts and start with current accounts. For over a decade, the United States has accumulated massive current account deficits, while Asia has produced surpluses and the euro area has stayed roughly in balance. In other words, America has borrowed what Asia has lent (see Figure 1). Until 1998 the biggest lender was Japan; despite large fluctuations, Chinese current accounts were structurally balanced in the 1980s and only moved to a permanent surplus after China joined the World Trade Organization (WTO). China’s recent economic success is based on an export-led development strategy, which has already proved highly successful since the Second World War in Japan and Europe and later in the so-called emerging ‘Asian Tiger’ economies during the 1980s and 1990s.

While Figure 1 concentrates on the four largest economies, Figure 2 shows the current account balances for emerging Asia and Korea. Current account balances have improved everywhere in Asia as a result of the currency depreciations in the Asian crisis in the late 1990s, although they were less important in the Chinese world (PR China, Taiwan, Singapore).

As monetary policy tightened worldwide in 2006 and 2007, there was a slow trend for current account imbalances to diminish, especially in Japan and the US, but also in the rest of Asia, most markedly in India. This development was temporarily accelerated by the global financial crisis, which has imposed sharp corrections on the United States, Japan and China. However, even if there is now a tendency to revert to equilibrium in Japan and the US (the trend lines in Figure 1 converge slowly to zero), the issue of global imbalances is not going away soon, mainly because of China. The International Monetary Fund (IMF, 2009) expected the American external deficit to hover around 2.5 per cent in 2014, Japan to maintain a structural surplus, and China to increase its surplus to well above 8 per cent of GDP. It is not clear who will absorb these rising Chinese surpluses. These estimations show that the global imbalances in the strong sense will persist; they are not just a passing phenomenon that is automatically remedied by market adjustments following the global financial crisis. Yet, it remains unclear what drives these imbalances and what policies are required to avoid them becoming harmful.

Global imbalances in the strong sense show up in the distribution of foreign exchange reserves. They confirm the structural imbalance in the global economy. The total volume of reserves has more than doubled relative to world GDP in the last decade, from 5.7 per cent in 1999 to 13 per cent in 2009, but the distribution of this...
increase has been highly asymmetric. Figure 3 shows the share of foreign exchange reserves held by some significant countries or groups of countries. The dominant feature is the rise of the share of emerging and developing countries and the relative fall in advanced economies.

The first quarter of 2004 marks a break in the trends of several countries. Advanced economies saw their share fall significantly, with Japan reducing it by 10 percentage points, and Korea and the euro area losing about 2.5 points each. By contrast, fuel-exporting countries, Africa and developing countries generally have accumulated reserves. This break coincides with the tightening of US monetary policy. Between March 2004 and June 2006 the Fed increased short-term interest rates from 1.1 per cent to 5.5 per cent. It is possible that these higher returns have attracted short-term investment from developing central banks, which was then transformed into longer maturities by American banks, and such a development may have caused the Greenspan ‘conundrum’, whereby higher Fed fund rates did not raise long-term interest rates in the United States. However, for our purposes the most interesting observation is the fact that developing Asia, and especially China, followed an unbroken tendency of accumulating foreign exchange reserves faster than the rest of the world. This is a clear indication that Asian emerging economies are deliberately pursuing a strategy of stabilising competitive exchange rates by accumulating foreign exchange reserves, and this strategy contributes to global imbalances in the strong sense.

The reserve accumulation by developing Asia can be seen as evidence for ‘manipulating’ exchange rates. For years economists have argued that this situation was not sustainable and would cause a large depreciation of the US dollar. However, this has not happened. According to neoclassical economists, the lasting disequilibria are an abnormality. Government interventions must have distorted the market mechanism and the imbalances must therefore be remedied by appreciating local currencies. If currencies were allowed to float, they argue, the world would very rapidly return to equilibrium. Yet, if markets have not worked perfectly, persistent distortions must have their own logic. It is in fact possible, as Eichengreen (2007, p. 30) has pointed out, that the set of distortions that reduce welfare in the short term may be offset by another set of distortions that will increase...
it in the long run and that governments adopt such development strategies for the long run. The most important policy instrument for causing these distortions is the exchange rate, because it sets the relative price of goods and services between economies and thereby generates competitive advantages, which determine opportunities for profit making and incentives for the allocation of investment and wealth. We will now look at explanations for emerging economies’ exchange rate policies that seem to have caused these persistent market distortions.

The undervaluation model

There are two models, both based on exchange rates, which can explain sustained global imbalances. A popular explanation for the large current account surpluses of emerging Asian economies is that their governments undervalue the exchange rate in order to be competitive in world markets. As Rodrik (1986, p. 89) remarked, ‘a policy which deliberately maintains the exchange rate at a disequilibrium level can be welfare-increasing by promoting structural change’. The classic examples for a systematic undervaluation strategy that supports rapid catch-up growth were Japan and Western Europe under Bretton Woods. Figure 4 shows that under the fixed exchange rate regime of Bretton Woods, unit labour costs in Japan and Europe remained stable at 40 to 66 per cent of the American level. This strategy produced economic miracles. After Bretton Woods collapsed, exchange rates became flexible, European and Japanese unit labour costs rose 20 per cent above the US level and the miracles disappeared. Note that the Japanese yen has followed the US dollar more closely since the early 2000s than in previous decades, although this did not reflect a pegging strategy in a strict sense, as will be shown below. As a consequence of deflation, unit labour costs in Japan have fallen over the last decade significantly, staying 30 per cent below the US and nearly 50 per cent below the euro levels. Hence, if emerging Asia is following a development strategy of systematic currency undervaluation, it can refer to highly successful precedents. The problem for the global economy is not so much that governments ‘manipulate’ their currencies, but how they will exit the undervaluation strategy when they have sufficiently advanced in their catching-up process.

Dooley, Folkerts-Landau and Garber (2003, 2007) have argued that some essential features of the early Bretton Woods model are now reproduced by emerging Asia, and especially by China. According to their model, the world is divided into a core and a periphery. The core has efficient financial markets and a stable currency, which serves as the international reserve asset. The periphery starts out with low productivity and an underemployed labour force; it then seeks integration into the world market through export-led growth, thereby generating employment and economies of scale. It also
‘develops’ human capital through learning by doing. However, the periphery does not have deep and fully developed financial markets and lacks the skills to invest local savings efficiently. For this reason, investors in the periphery prefer to keep their financial wealth in the hard currency of the centre and invite foreign investment to build up local industries. The government assists this strategy initially by devaluing the currency and then by resisting its appreciation. The devaluation compensates for low productivity and other inefficiencies. The currency appreciation is avoided by accumulating foreign exchange reserves. Because the reserve accumulation could expand the supply of base money, it could cause inflation and the monetary effects of reserve accumulation are sterilised. On the other hand, when central banks in the periphery buy government securities in the centre, they generate seigniorage gains for the centre, and if the centre does not sterilise the capital inflow and keeps interest rates low, growth is improved here, too.

The Dooley et al. (2007, p. 107) model describes a transitory disequilibrium strategy, which has to meet the critical constraint that once the periphery has caught up with the centre, the capital stock accumulated in the periphery should be capable of producing internationally competitive goods, when it is combined with domestic labour paid at the world real wage rate. When this constraint is met, a currency undervaluation by the periphery can be beneficial for the world economy, even if it generates temporary, although persistent, imbalances. However, there is now increasing evidence that China has now reached a turning point, where this logic may no longer apply (Huang and Jiang, 2010).

The volatility model

The undervaluation strategy can take the form of fixed exchange rates if the government can control wages (as in China), or of crawling pegs that compensate for domestic inflation (as in the Philippines, India and Indonesia). However, the system needs the centre’s currency as the anchor for its undervaluation strategy. A successful exchange rate strategy must peg local currencies to a leading world currency, because that guarantees integration into a large and open market capable of absorbing imports from emerging competitive producers and offers deep and efficient financial markets.

Pegging exchange rates serves two purposes: it fixes relative price levels between the two economies and it minimises the uncertainty caused by rapid exchange rate fluctuations. Competitive and undervalued exchange rates are only a necessary, not a sufficient condition for rapid economic development. The profitable environment must also be sustained over time if the accumulation of capital and skills is to accelerate. The more certain future returns are, the higher will be the rate of investment. By pegging to an anchor currency, governments can reduce economic uncertainty in foreign transactions, while the uncertainty created by volatile exchange rates has the same effect as a tax or tariff wedge between economies. Such a wedge would require higher returns on investment in order to attract capital into the domestic economy. This is true for domestic investment in export industries, but also for foreign direct investment (FDI) and portfolio investment in emerging economies. However, exchange rate volatility can also deter the diversification of foreign reserves.
and this may create a bias in favour of holding reserves in the anchor currency. For in order to compensate for the higher risk resulting from exchange rate volatility, the return on financial assets held for reserve purposes must be higher. But if the returns on financial assets in potential foreign reserve currencies is low, as has been the case in recent times for the dollar and euro, a country will keep its foreign exchange reserves in the currency of the country it is pegging to because that is where the risk–return trade-off is most advantageous.

Collignon (1999, 2003) has argued that the desire to lower exchange rate volatility caused the emergence of a system of bloc floating after the demise of Bretton Woods in the early 1970s. In a system of bloc floating, local currencies have been pegged with fixed or crawling rates to an anchor currency because removing the uncertainty wedge increases investment and growth. During the time of the European monetary system, the Deutschmark served as anchor for Europe and the US dollar for Latin America and Asia. After the creation of the euro, a number of European countries within and outside the EU reduced exchange volatility to the new currency, but most of Asia has remained on the dollar standard, even after the Asian crisis. The yen has never become an anchor currency for Asia, despite its high significance for FDI in Asia (Collignon, 2006).

The upper panel in Figure 5 shows the daily exchange rates of the three freely floating exchange rates: euro, dollar, yen. An upward movement represents a depreciation. We find long-term trends of euro weakness from the mid-1990s to the early 2000s. After 2000, the euro had a tendency to appreciate against the dollar until the global financial crisis hit. The euro appreciated even more relative to the yen, because the yen first depreciated and then kept more stable against the US dollar than in previous periods. The overall picture of the movements between these key currencies is one of short- and long-run instability. The lower panel shows the volatility trends. They were calculated by estimating a GARCH (1,1) model to determine the conditional variance in the daily exchange movements and then putting these values through an HP filter. From 1995 until 2000 and again after 2006, exchange rate volatility between the US dollar–euro rate tended to be lower than for the yen rates. Except for some short periods in 2002 and 2004–05, the volatility of the yen–US dollar was lower than the yen–euro rate. This indicates that Japanese exchange rate policies have sought greater stability with the dollar bloc than the euro bloc.

Figure 6 gives an overview of the exchange rates of Asian emerging economies relative to the US dollar, the euro and the yen. Only China and Malaysia have totally fixed their exchange rates against the US dollar. Most of the other emerging Asian economies have accepted some exchange rate flexibility, although they have kept their exchange rates to the dollar more stable than to the euro or the yen (see below). This is evidence for the phenomenon of bloc floating described above. As a consequence of the dollar’s weakness relative to the euro and Japan’s shadowing of the dollar, Europe’s currency appreciated against all of Asia including the yen and, because the yen has been less volatile relative to the US dollar since 1999, other Asians have also depreciated less against the yen. Thus, the broad picture is nominal exchange rate stability relative to the US dollar and an appreciating and volatile euro. After the Asian crisis, the undervaluation of Asian currencies was reinforced by the dollar weakness, and the low volatility within the dollar bloc has supported Asian development and marginalised Europe.

Figure 7 presents formal indicators for daily exchange rate volatility in Asia. It appears that for most Asian...
economies, volatility was higher for the euro (blue) and the yen (red) than for the US dollar (green). The Asian crisis in 1997 marked a period of significant devaluations and exchange rate volatility. However, subsequently all Asian currencies returned to a stable US dollar peg: the volatility was clearly lower for the dollar than for the euro or the yen. While the Asian crisis has temporarily disrupted bloc floating, as theory would suggest (Collignon, 2003), the long-run tendency has been to continue with the integration into the dollar bloc.

Thus, a clear picture emerges: Asia has pegged to the US dollar at competitive rates, which have generated current account surpluses and attracted capital flows, which were reinforced by the stable exchange rate environment. Governments have resisted exchange rate appreciations resulting from capital inflows by accumulating reserves. This development model poses a problem to neoclassical economics: how was it possible that these distortions persisted for so long? The answer lies in the profound transformation of the global economy.

2. The transformation of the global economy

The role of emerging China

From a neoclassical point of view, the undervaluation of peripheral currencies is not sustainable, because it
should lead to inflation, which will erode the competitive advantage. However, many Asian currencies have been able to sterilise the inflationary effects of reserve accumulation. If the centre economy also sterilised the loss of reserves, it would slow down its own growth. With modern financial systems, however, where central banks target consumer price stability, it is possible for the periphery to accumulate reserves and for the centre to relax monetary policy as well, as long as inflation is kept at bay. Hence, the system of bloc floating, where Asia becomes part of the dollar bloc, generates a win-win structure for the centre and the periphery. The undervaluation of the periphery is beneficial for the centre, too, because imports from the periphery are cheap and competition restrains domestic inflation (Bean, 2006; Borio and Filardo, 2006; Tootell, 1998).

Nevertheless, bloc floating also carries costs for the centre economy. If the purpose of the stable undervaluation strategy is to integrate the underemployed labour force of the periphery into the global economy and to make it more efficient, it also causes a fundamental restructuring of the labour force in the centre (Dooley et al., 2007). Hence the transformation of the global economy is not without social costs, and these costs must be balanced by economic benefits, which come from two sources. First, cheap imports increase real wages at the centre. This contributes to social stability, provided the gains are fairly shared. Cheap imports also
increase profits in the economy of the centre, and this is good for investment, growth and employment. Second, because wages in the periphery are below the world equilibrium level and prices are competitive, inflation is contained in the centre. This makes it possible to relax monetary policy and thereby stimulate growth. However, because consumer prices are kept down by cheap import competition, the excess liquidity will generate asset price inflation.

Monetary policy in the United States prior to the global financial crisis clearly underestimated this risk, but the alternative strategy of sterilising capital inflows might have been even worse, as it would have placed all the burden of the globalisation process on the centre economy. Thus, it was the symbiotic relation between Asia and the United States that made the costs of globalisation socially acceptable in the US, but outside the dollar bloc the effects were less benign. Asia benefited from the euro’s strength after 2000, but the social costs of restructuring the world economy were not compensated by capital inflows into Europe comparable to those of the United States. Nevertheless, the euro area did also benefit from cheap imports from Asia, which allowed the European Central Bank (ECB) to follow a more accommodating monetary policy.\textsuperscript{13} As a consequence, Europe’s domestic dynamics have improved during the first decade of the euro, but the social costs of globalisation were higher in Europe than in the US. This may have led member states in the euro area to adopt fiscal policies that have proven highly problematic after the global financial crisis hit in 2008.

While it is true that all emerging economies in Asia have pursued policies of export-led growth, the most fundamental transformation of the global economy is due to the integration of China into the world market. In 1980, China represented less than 1 per cent of world GDP. In 2010, it counted for 10 per cent, measured at market exchange rates. It has now more than four times the economic power of ASEAN or India and twice that of Germany. Asia as an economic region is now an equal partner in the world economy together with Europe and the United States (see Figure 8).

The rapid growth of the Chinese economy is neither unique nor exceptional when compared with the well-established Asian model of other emerging economies which is based on high investment, quasi-unlimited supply of labour\textsuperscript{14} and fixed undervalued exchange rates. What is different with China is its size. Its population is 1.3 billion today, that is, over 20 per cent of the world; China’s labour force is 812.7 million, a quarter of the world’s total. It used to increase by 10 million a year in the 1990s, but due to demographics this growth is slowing down. However, labour supply is even more strongly affected by the migration of an underemployed rural population moving at the rate of 20 million each year to industrialising coastal cities. Because the ICT revolution has lowered the cost of communication without having to move people, China’s labour force has now effectively become part of the western workforce through industries that export to the west. Thus, global labour supply has become highly elastic.

The integration of China and its labour force into the world economy was only possible because the export-led growth strategy combined competitive and stable exchange rates with long-term wage stability. Unless exchange rates had fixed competitive cost levels for exports, rapid economic growth would not have taken off. Without elastic labour supply, competitive wage costs would not be sustainable. And stability of exchange rates is necessary to ensure a reliable framework of stable expectations, without which investment would remain low. Dooley et al. (2007) are right to emphasise that this development strategy has a transitory character, but this transition will not be over for another decade or two.\textsuperscript{15} However, considering Chinese labour market dynamics, China has now reached the Lewis Turning Point and wage costs will rise in the near future (Huang and Jiang, 2010). As a consequence, capital productivity will have to improve in order to sustain the undervaluation model.

Figure 8. Regional shares in world GDP (billions of US$ – 2010)
The competitive currency peg also explains why savings rates are so high in China and why they are invested in the United States: the undervaluation generates high profits; the low volatility makes investment in the centre safe. Chinese savings are high, although not exceptionally so given its stage in development. While total savings are 53 per cent of GDP, half of this amount is saved by the corporate sector.\textsuperscript{16} The household savings rate, as a percentage of GDP, has fluctuated between 15 and 20 per cent over the last 15 years, while the overall gross savings rate has improved from 36 per cent to close to or above 50 per cent. High corporate savings are not surprising given that high profits imply low real wages. According to Akyüz (2011), profits as a percentage of GDP have increased by nearly two-thirds from 19 to 31 per cent. In-depth analysis shows that a large part of these savings come from retained earnings, which are reinvested by firms in fixed or financial assets, because the Chinese government does not have a well-defined dividend policy for state-owned companies (Anderson, 2008). Hence the competitive level of the yuan’s exchange rate\textsuperscript{17} is a crucial driver not only for China’s rapid economic growth, but also for its high savings, which until now have been held mainly in assets of the United States.

This dual effect of high profits and high savings constrains Chinese exchange policy options severely. A shift from exports to domestic consumption, which is recommended by those who think China should concentrate on its domestic market, or a less competitive exchange rate, which is the aim of western pressures on Chinese authorities, would lower the rate of capital accumulation and economic growth. This turns macroeconomic policy coordination into a zero-sum game. While the United States and Europe push China to revalue its currency, Chinese authorities know that an appreciation could ruin the model on which their development depends. China’s development has generated opportunities for some and painful losses for others. In one generation, China’s growth has lifted 500 million people out of poverty and the poverty rate declined from 64 per cent at the beginning of reform to 10 per cent in 2004. In advanced industrial countries, however, it has contributed to regional and sectoral deindustrialisation, higher unemployment and stagnant wages. Thus, with globalisation, open markets and a highly elastic labour supply, the world has become richer, but also more complex and harder to govern. To overcome global policy gridlock, one has to broaden the zero-sum game between the US and China and include Europe, Japan and the rest of the world.

Regional integration and Asia’s fixed exchange rate regime

The Asian development model with fixed exchange rates has two further important and unintended consequences for the global economy. The first concerns regional integration in Asia. The common peg to the US dollar has rendered exchange rates between East Asian currencies more stable. It has reduced uncertainty not only between Asia and America, but also within the East Asian region and this is a condition for the region’s integration into the global economy (Kawai, 2010). Regional integration is therefore increasingly driving economic growth in Asia. Any policy proposal dealing with global imbalances must, therefore, look at emerging Asia as a whole and not only at China.

Second, the Asian choice of linking their currencies to the US economy has far-reaching implications for Europe, too. Given that the dollar–euro exchange rate is highly volatile, Asian currencies move with the dollar against the euro. Exchange rates between Asia and Europe are therefore less predictable than they are with respect to the dollar. This heightened uncertainty drives a wedge between Europe and Asia; it deters trade and investment and isolates the two continents. The exchange rate stability within the dollar zone privileges transpacific financial flows, so that Asian surpluses finance US deficits and US FDI is largely driven by cost-cutting delocalisation of American firms. On the other hand, because the higher exchange rate volatility acts like a tariff or tax wedge, financial flows do not stimulate European growth and demand for Asian imports, although European investment into China is driven by the objective of market penetration, which may stimulate exports in the initial phase but not necessarily in the long run (Collignon, 2006).

These two tendencies, namely regional integration in East Asia and the symbiotic relationship between Asia and America, make the correction of global imbalances difficult as long as the dollar remains the privileged reference currency for Asia. To sustain its development model, Asia needs to generate current account surpluses to maintain high profits and accelerated capital accumulation. If the dollar remains the reference currency, the United States will have to continue to buy cheap goods from Asia. Yet, if the American external balance is to come closer to equilibrium and the US dollar cannot be adjusted \textit{vis à vis} Asia, the US will be forced to generate trade surpluses with Europe and the rest of the world and this is only possible if the dollar depreciates considerably against the euro and/or if European consumption and growth improve substantially. However, European consumption is unlikely to accelerate significantly, as long as financial flows from Asia finance essentially American consumption and are deterred from European financial markets by high volatility. The world is therefore caught in a dilemma. If the ‘old world’ in the west imposes an appreciation on China, the ‘new world’ in Asia will lose momentum and could disintegrate; but if the present system does not change, imbalances will
continue and Europe could disintegrate under the pressure of global adjustment. We will now consider an alternative solution.

3. Opportunities for monetary cooperation between Europe and Asia

China bashing

European policy makers have followed Americans in pressuring China to revalue. Chinese authorities have resisted them, although some moderate face-saving concessions have been made (see Figures 6 and 7). Complaints about China’s exchange rate regime are expressions of protectionism: firms denounce unfair competition, because they wish to keep cheap imports out of the American and European markets; trade unions lament the loss of jobs, but rarely talk about the potential for job creation. They ignore the fact that cheap consumer imports increase the purchasing power of wages. This is not to say that unfair trade practices are justifiable. Insisting on strict social standards should be part of Europe’s leadership in the global economy. It would help emerging economies to improve their own standards of living. Yet, unless Europeans (and Americans) understand that Chinese authorities have good reasons for keeping their exchange rates fixed at competitive levels, the dialogue with China will go nowhere and global imbalances will persist. Asia is the EU’s most important growth market and sustained and rapid economic growth in China serves Europe’s interest. A reform of the international exchange regime must respect China’s strategic objectives as well as those of Europe, Japan and the United States.

Hence, a different strategy is needed: a win-win strategy, where Americans switch demand from foreign to domestic production in order to reduce unemployment after the global financial crisis, lower their current account deficit and restore trust and confidence in America’s leadership. Asia must continue to generate export surpluses, which are the foundation for the catching-up process to higher living standards. For Europeans, it is crucial that the global adjustment will not take place at their expense. These are the objectives. They assign a role to exchange rate policies.

A Euro–Asian cooperation proposal

In the benign macroeconomic environment of the euro’s first decade, European policy makers concentrated on their domestic agenda: price stability, fiscal consolidation, structural reforms. National governments have been more concerned with protecting narrow domestic advantages than with improving opportunities for the European economy as a whole. After the global financial crisis, there is a need for a global strategy. Such a strategy should take account of the following five points.

1. First, the symbiotic relation between the United States and Asia must be opened up. While Asia is to remain a net exporter for years to come, America cannot remain the global consumer of last resort. Hence, the European Union and Japan must take up some of the global demand for products from Asia. The three main industrial players could agree on a target for each of their economies to run a current account deficit of 1 per cent of GDP. This would reduce absorption from the US relative to 2009 by US$226 billion, but improve demand from the euro area by US$40 billion and from Japan by US$147 billion. The major burden of adjustment would then be on Japan. A fairer deal would therefore set a deficit of 1.5 per cent for the euro area. These targets would redistribute the American deficit, but they would hardly generate additional demand for Asian products. This must come from growth in the three advanced industrial economies and from the rest of the world.

2. Besides domestic policies that stimulate demand in Europe and Japan, the redistribution of current account deficits requires a change in relative prices, that is, in exchange rates. The dollar has to depreciate against Asian currencies, while the euro and yen need to appreciate. However, many European policy makers would resist such an appreciation on grounds that China is unfairly competitive. They ignore the fact that the level of exchange rates is only one of two policy variables. As we have discussed, exchange rate stability, that is, low volatility, can support the redirection of trade and investment by reducing uncertainty. Such support is especially warranted if Europe is to accept an appreciation against Asian currencies, because lower volatility would improve the expected returns on capital. Hence, Asia’s pegging strategy should be reviewed. Several policy options may be considered. First, East Asian countries may simply re-peg from the dollar to the euro. This would generate monetary stability between Asia and Europe and give the US economy the necessary flexibility to adjust its current account deficit. However, if the Japanese yen remained freely floating, this measure could disturb investment flows between East Asia and Japan and affect growth negatively. Therefore, Japan must be part of any new monetary arrangement in Asia. A second option consists in pegging East Asian currencies, including the Chinese yuan, to a basket that contains large portions of Japanese yen and euro. Simultaneously the Bank of Japan and the ECB would establish close cooperation with the purpose of minimising volatility between their two currencies. This stabilises the conditions for Japanese FDI into East Asia and trade relations with Europe.
Japanese and European markets together represent a viable and attractive alternative to the dollar bloc. The measures proposed here would not restore global balances in the strong sense, but they would narrow the size of imbalances.

3. If monetary authorities in East Asian countries started to peg a basket of euro and yen, they would gradually increase reserve holdings in these currencies. Thus, in the interest of export-led catch-up growth in Asia, global imbalances in the weak sense would also be maintained for a significant but transitory and limited period of time. Although there is no logical link between pegging and reserve holdings (Obstfeld and Rogoff, 2009), the practical reasons for doing so are strong, because liquidity requirements for market interventions will increase demand for holding anchor currencies. To see this, imagine a speculative attack against a country that has pegged against the euro but keeps foreign exchange reserves in dollars. If the dollar is weak at this very moment, the mobilisation of reserves to defend the euro peg would be more costly. Prudent reserve management, therefore, requires keeping reserves in the pegged currency. Over time, pegging to a basket of euro and yen could lead to a more balanced system of reserve currencies that offers diversification benefits at the world scale.

4. Strategic pegging to a basket should not be confused with the choice of the best reserve currency. The dominance of the US dollar as the internationally accepted reserve asset has contributed to the global financial crisis, because excess liquidity in the United States has generated an asset price bubble. The Triffin Dilemma has described the contradiction between a reserve currency country’s national interests and international obligations. After the global financial crisis, times may have become more conducive to a reform of the global reserve regime. However, there is no point in swapping the Triffin Dilemma from the dollar to the euro. An international reserve currency could solve this problem and the euro-yen basket could contribute to this development. In this context, the idea of Chinese central bank governor Zhou Xiaohuan (2009) is of interest. He has suggested actively promoting the use of special drawing rights (SDR) in international trade, commodities pricing, investment and corporate bookkeeping. This would support a more balanced global reserve management. Nevertheless, using SDRs today as the reference for exchange pegging is not recommendable. The composition of SDRs, even if expanded as proposed by Zhou, does not allow the pursuit of a competitive exchange rate strategy, which has been the basis of China’s success. However, as the catch-up growth process advances in China and Asia and the US economy adjusts to internal balance, the basket should be gradually broadened to include other currencies, including the US dollar, until it will effectively coincide with a reformed version of SDRs.

5. Finally, monetary cooperation between Europe and Asia must be put on solid institutional foundations. Organising monetary cooperation with Asia goes beyond purely bilateral or regional relations. The strategic interests of Europe, Asia, America and the rest of the world are also affected. These policy decisions must therefore be debated in the G20. However, this is a large and already fairly bureaucratic institution, where practical decision making is tedious – witness financial regulation. One could therefore imagine a lead group of the euro area, Japan, China and the US, a G4 within the G20, which would assume a pilot function for working out details of the reform. Monetary cooperation between Europe and East Asian central banks can also find an appropriate forum in the Asia–Europe Meeting (ASEM).

Conclusions: whose interest is it, anyhow?

This article has argued that global imbalances exist and that they are a double-edged sword: they have enabled the integration of China and Asia into the world economy through rapid export-led growth, but they have also fuelled the asset bubble that put the world into its deepest recession for over 70 years. However, if carefully handled, even a double-edged sword can be put to beneficial use. This means that Asia’s catch-up process must not be prematurely interrupted and Asia’s economic regional integration must continue. A modest form of global imbalances would serve this purpose, provided the burden of adjustment and the absorption of Chinese surpluses are more equally shared between the US, Japan and Europe.

It may appear that the reform proposal advanced in this article would only benefit Asia, which will speed ahead with accelerated growth, while Europe is lagging behind. Afraid of Europe’s own weaknesses, policy makers often complain about ‘disloyal’ competition and ‘social dumping’. Such views are misleading. First of all, exports depend not only on relative prices, but also on demand from importing economies. CER (2010) has shown that European trade with China responds significantly more strongly to changes in economic growth than to changes in the nominal exchange rate. A 10 per cent increase in China’s growth rate (approximately equivalent to a 1 percentage point increase in GDP) would raise bilateral exports by 28.8 per cent, while a 10 per cent appreciation of the euro against the yuan lowers exports by 6.7 per cent. The effect of domestic demand in the euro area on imports from China is even stronger. Hence, if Europe and the United States pressured China to change the exchange regime in ways that
affect economic growth in China negatively, Europe would suffer more than it would gain. It is in the European interest to create jobs at home by supporting China and Asia in pursuing their dynamic growth.

Second, industrial structures will change across the world in any case, and if managed properly, this development can be welfare augmenting on the global scale. For decades Europeans have claimed that they wish poorer countries to develop; they must not turn against those that are successful, now that it is happening. Nevertheless, the distribution of welfare gains matters. Europeans, too, will benefit from allocating resources more efficiently, and wage earners will see their purchasing power improved. This, however, is no consolation for those who are losing their jobs. Supporting Asia’s development is only defendable politically if it generates more and better jobs that can compensate for previously lost jobs. Yet this is exactly what the reforms proposed in this article aim to achieve. Job creation depends on economic growth. The question is, whether a moderate appreciation in the euro’s real exchange rate would on balance destroy more jobs than economic growth from more trade with Asia could generate. Any alternative exchange rate regime, whether it leaves the present system unchanged, or appreciates the yuan, or moves to a free-floating exchange rate, is likely to harm Europe more, either by excessive euro strength or by a slowdown of growth in Asia. The social and political consequences for Europe could be dramatic. Unless Europe engages in a positive and respectful dialogue with emerging Asia and Japan, economic and political tensions in the world will increase. It is therefore in Europe’s interest to play a cooperative game with China, Japan, East Asia and the United States.

Notes

I would like to acknowledge research assistance from Centro Europe Ricerche, Rome.

2. Catch-up growth implies wealth creation by the rapid accumulation of capital, which consists of domestic investment and the accumulation of foreign assets. As I will argue below, an undervalued currency creates the conditions for attractive locations for private investment and foreign reserve accumulation by central banks does the rest. If imports are part of consumed income, they reduce savings and therefore the accumulation of wealth, but if they are part of domestic investment, this must be qualified. Korea and Taiwan may be examples that exported growth can go through periods of current account deficits due to importing materials and capital goods.
3. The only economically meaningful definition of a country is that it is a payment union where no foreign reserves are needed for making payments. The euro area is a ‘country’ in the economic sense, with individual member states being economic provinces, because euro area member states get money from the ECB and not from using foreign exchange reserves when they borrow from other member states. Regional current account positions, like Germany’s, only add up to the euro area’s aggregate. By contrast, economies under the gold standard, or dollarised economies, are not ‘economic countries’, because they cannot issue base money as the accepted reserve asset for the domestic payment system.
4. Strictly speaking, the current account balance includes the claims on returns from foreign investment. In Japan this is an important part of the current account surplus.
5. I interpret the stochastic noise around the mean as manifestations of intertemporal trade. Unit root tests for the current account data in Figure 2 all reject the assumption of stationarity.
6. During the Bush presidency this pattern changed slightly. The United States not only borrowed from Asia, and increasingly from China, but also from Europe and the Middle East. This excess has now been corrected.
7. The trends were calculated by the Hodrick-Precott filter.
8. The IMF World Economic Outlook in 2011 has not invalidated these projections.
10. For a critical review and the difference between the original Bretton Woods system and today’s pegged exchange rates, see Eichengreen (2007).
11. The impact of monetary policy on long-term interest rates may not be instantaneous if foreign investors buy up securities, as Greenspan’s famous ‘conundrum’ has shown.
12. Collignon (1999) presents a model where the volatility between key currencies has a tendency to increase with the size of the currency blocs. Collignon (2003) shows that the blocs are unstable and collapse when the key currency appreciates too much.
13. This was an improvement over the previous Deutschmark bloc, where the Bundesbank needed to be excessively restrictive in order to generate the current account surpluses on which the anchor function of the DM rested. For a formal model see Collignon, 2003.
14. The benchmark model is Lewis, 1954.
15. To be precise: given today’s per capita income of US$6,200 in China and US$28,800 in the EU, and assuming China grows at an average rate of 7 per cent and the European Union at 2.5 per cent, it will take 35 years until per capita income in the two countries will be equal.
16. See Guonan and Wang, 2010. As Anderson (2008) shows, the widely believed argument, whereby Chinese households save massively because reform policies have dismantled the old communist welfare system, does not stand up to scrutiny.
17. There are two names for the Chinese currency, the casual yuan and the official renminbi (RMB). We will use yuan here.
18. A similar liquidity spill by the United States in the 1960s contributed to the collapse of the Bretton Woods system and the ‘Great Inflation’. Because of the increased elasticity of labour supply, excess liquidity caused asset inflation in the 2000s, and not consumer price inflation.
19. For the underlying theoretical argument why basket pegs are suboptimal compared to straight pegs to large currencies, see Collignon (1999).

References


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