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Introduction

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

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

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

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

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

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

Africa and East Asia

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

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

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

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

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

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

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

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

Addressing Global Imbalances and the Role of the IMF

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

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

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

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

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

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

Reform of the International Monetary System

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

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

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

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

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

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

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

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