Global Challenges; Global Imbalances; Responsibilities for All

Speech presented by Ernesto Zedillo, Beijing Forum 2010

I am honored to be part of the Beijing Forum 2010. Professor Richard Levin, President of Yale University, asked me to convey to you all his warmest regards and sincere wishes for a successful Forum. I celebrate that this year's event is convened with a theme that encompasses key concepts for the present and future of our planet. The words "civilization," "harmony," "prosperity," "commitment," and "responsibility," when put together in the idea that guides this assembly, tell us a lot about how lucky we are to have this as our time but also how extensive is the onus we bear.

Unquestionably we have inherited from our immediate predecessors a level of progress unimaginable only a few generations ago. Our onus consists of doing what it takes so that by the end of the present century our descendents will think of us the same way we now think of our elders. For this to happen, however, we ourselves, and our children will have to preserve what we have now, make it better, and -- very importantly -- make it accessible to many more billions of people.

This task is not trivial. True, we are now on a trend of scientific and technological advancement that seems to be unlimited. We possess an amazing physical and human infrastructure. And very significantly, the unprecedented degree of interaction, interconnectedness and interdependence, known nowadays as globalization, has become a formidable lever for economic growth and development, to which China's contemporary experience attests.

Paradoxically, globalization, as much as it drives progress, also multiplies the complexity of the challenges to be surmounted if we truly want to preserve and enhance what has already been achieved.

Because of globalization, more than ever before in history ours is a world of common opportunities, but also of shared risks. And this means that the world's promise can be realized and its perils restrained only through ambitious cooperation among nations.

Of course the value of international cooperation has been known for a long time. With shared vision and collective action, major accomplishments have been realized in the past. Indeed, the fact that the recent financial crisis did not become – as conceivably could have been the case -- the great depression of the early 21st century provides solid evidence of what even a modicum of international coordination can deliver.

And yet, despite the evidence that cooperation is in the national interest of all states, achieving it consistently and sufficiently continues to be elusive. This elusiveness stems from the very nature of what international cooperation is meant to provide: global public goods.

As explained in the Report of the International Task Force on Global Public Goods, these goods are those that pursue goals that are broadly conceived as important to the international community, that for the most part cannot or will not be adequately addressed by individual countries acting alone and that are defined through a broad international consensus or a legitimate process of decision-making.

Global public goods are hard to obtain for several reasons. Governments and their citizens are unwilling to accept binding international rules or simply reject international monitoring of their own compliance with agreements. In other words, they look at the boundaries of sovereignty as immovable. Also, governments and societies have differing preferences and priorities. What might be a highly desirable public good for one country or group of people might not be so for another.

There is also the “free rider” problem, where there is an incentive for every party to wait until another provides the desired global public good and then enjoy its benefits. Additionally there is the “weakest link” problem where in the provision of some global public goods – such as in efforts to eradicate an infectious disease -- success can be eroded by a single act of non-compliance.

Finally, there is the “summation” problem, which occurs where the successful production of a particular global public good is literally the result, or sum, of the individual efforts of all the separate participants – such as mitigating global climate change.

Yet over time it has been possible to secure the provision of important global or regional public goods. In some instances, adopting coordinated schemes has been possible only through small incremental steps; in others, however, it has taken major shocks, even huge tragedies, before countries have been willing to cooperate among themselves. The immediate reaction to the financial catastrophe of the fall of 2008 is the latest example of how countries are more likely to come together to organize collective action only under the stress of overwhelming disturbances.

Think of the launching of the G20, which after many years of being proposed to improve global economic governance, was finally assembled under the impulse of the crisis that erupted in September of 2008.

Their first Washington Summit of November 15, 2008 yielded an accurate diagnosis of the crisis and started to outline some of the further actions that needed to be taken. Leaders were right on target when they said:

“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 disruption”.

Also their Washington commitment to reject protectionism and keep the global economy open was particularly meaningful at a time when global trade was literally collapsing.

The most remarkable outcome of the April 2009 London Summit was the allocation of significantly larger resources to the IMF which allowed the institution to put out fires before they spread in some emerging countries that became under financial stress.

The Pittsburgh meeting of September 24-25, 2009 produced both good and not so good news. It acknowledged the importance of addressing the global imbalances, particularly at a time when the economic recovery was already in sight.

Although the language to stress the importance of the global imbalances was subdued relative to that used in the Washington Communiqué, it is clear that the imbalances continued to be a central concern of leaders. In fact, so much so that they launched something that they called "Framework for Strong, Sustainable, and Balanced Growth", which among other things states that they will work together to "ensure that fiscal, monetary, trade and structural policies are collectively consistent with more sustainable and balanced trajectories of growth," and also will collectively "undertake macro prudential and regulatory policies to help prevent credit and asset price cycles from becoming forces of destabilization." One can call this statement of purpose, and its accompanying compact, impeccable.

However, and this is the bad news, the way for implementing the framework agreed by the leaders seemed to me right away condemned to be ineffectual.

They adopted "a cooperative process of mutual assessment," a sort of peer review mechanism, giving the IMF an essentially advisory and a secretariat role in the process.

My fears of ineffectuality were confirmed by the outcome of the St. Andrews G20 Ministerial Meeting on November 7, 2009 where more details about the process were revealed. No third party – which obviously should be the IMF – had been given the teeth to make countries at least submit consistent policy templates for macroeconomic adjustment, and least of all for enforcing what could eventually be considered the necessary contribution of each country toward rebalancing the global economy.

What was delivered both at the spring ministerial meeting and the G20 meeting of June 26-27, 2010 in Toronto suggests that the process to implement the framework is rather shallow and would hardly serve the purpose of having robust and effective "revised mutual assessment and policy recommendations for final consideration by the Leaders at their summit in November 2010."

It is not auspicious of leaders' willingness to do as they said repeatedly, up through the Pittsburgh meeting, that at the latest summit in Toronto they quietly dropped their goal -- previously stated *ad nauseam* -- of concluding the WTO Doha Round. So I almost take for granted that on the key question of macroeconomic policy coordination, the November G20 meeting will deliver at best another wish list of good coordinated macroeconomic behavior without any institutional mechanism to make such behavior more likely.

Confirmation of this fear will be very unfortunate.

Not doing what it takes to correct the factors that make the global economy have a strong bias towards developing substantial macro imbalances among the key economies is an invitation to another disaster or even worse. A reflection on the causes of the recent crisis should suffice to make the point. We may start by rejecting explanations that, as cause of the crisis, trace just one single event, market failure, or policy stand in the United States (the country from which the crisis irradiated to the rest of the world) or in another individual country.

A crisis of the magnitude endured could not have been engendered by a single factor. Unchecked market failures, regulatory deficiencies and/or outright malpractice in the financial sector, housing bubbles, excessive leverage, loose monetary policy in the largest economy, excessive precautionary accumulation of international reserves by Asian and Middle East countries, are all circumstances that influenced the occurrence and the magnitude of the crisis.

But I join others in strongly believing that the crucial enabling force of the crisis was the global macroeconomic imbalances -- massive borrowing by some, massive lending by others – and of course the policies and structural factors underlying such imbalances.

The truth is that every key player of the global economy "cooperated" – but in a negative sense -- to create the mess that has been, and will continue to be, so costly. The problem now is not what has happened but what may happen in the future. Some people take comfort now in the fact that the macro imbalances have shrunk considerably since 2007**.** Their comfort is not warranted. The correction achieved is more the result of the '08-'09 recession and much less of any fundamental change in policies or structural reforms.

It is not hard to envision that as deficit developed countries try to escape the post-recession low growth-high unemployment trap, while the surplus emerging economies stick to the export-led strategies that yielded high growth and strong recovery, the global imbalances will widen again.

Even worse, the imbalances may not widen again but for the wrong reason. What if each key player engages in a tit-for-tat strategy to undo its perceived competitor or competitors' own strategy, and in the end the imbalances don't widen because economic growth and trade is destroyed?

There is already evidence of the kind of contention that could lead to the worst-case scenario.

Unfortunately China, somehow, is in the eye of the storm. It is being accused of being stubbornly attached to a weak RMB policy to sustain its export-led growth model at the expense of other economies' expansion. The RMB's recent appreciation has done little to placate accusations of currency manipulation and threats of trade sanctions.

With some reason China is pointing to the correction of structural factors – chiefly too low savings rates -- by deficit countries, in particular in the United States, as a condition *sine qua non* to avoid a re-run of the huge macro imbalances.

Rather drastic ideas to fix one or another of the purported culprits have popped up in recent months, China, however, being the chief subject of most proposals. Bills in the U.S. Congress to apply discriminatory import tariffs on China; imposition of capital market restrictions to prevent China from purchasing U.S. Treasury bills; countervailing currency interventions to upset China's own intervention in foreign exchange markets; asking China to adopt dual exchange rate; and even outright suggestions to declare trade war with China; all are examples of ideas put forward by otherwise reasonable people. Some of these proposals, irrespective of being advanced for the most part by serious people, could be characterized as impractical, counterproductive or even silly.

But this agitation of extreme ideas must not be ignored. All in all, this sounds like the drums of a currency and trade war. It may remain just noise, but the dispute may well become a real and bloody battle.

From each country's perspective, it may look like a battle worth fighting. But it isn't because there is a better option for each one, if only they got organized to pursue it. The problem is that increasingly the large surplus and deficit economies are, as in the classic dilemma, captive in the prison of mercantilism. As long as they are trapped in this edifice, each one's unilateral actions might be effective to hurt the competitor, but also will boomerang with great force and damage on the originator.

Yet, global friction is real and dangerous and unless the present circumstances change drastically, it can only get worse. Actions, or at least talk, by a number of monetary authorities –- from Japan's intervention to hold down the yen to the U.S. Fed announcement that it will reload quantitative easing, transiting through Brazil's taxation on capital inflows and a host of other steps taken by both developed and emerging countries – all carry clearly a strong unilateralist imprint.

The blame game around the global imbalances and the unilateralist instincts must be defused at once because it is folly.

The solution lies in having the G20 leaders truly do as they say. They must do it under the reasonable principle that all parts have a role and the responsibility to play it and all available policy instruments should be part of the adopted strategy. The bipolarity that has characterized the debate is futile -- it's up to China, no it's up to the U.S.; it's about the RMB, no it's about the lack of frugality in the U.S. - and should be discarded at once.

What is needed is for the G20 to commit to a Grand Compact, more specific and comprehensive than the one they sketched at their Pittsburgh meeting.

Indispensably, they must commit to a reform that truly empowers the IMF to carry out its surveillance responsibility. This is too big an issue to be discussed in this opportunity, but let me insist that without such reform no Compact will work, however good and balanced it looks.

Also it is essential for that Compact that leaders not shy away from saying clearly that for rebalancing to happen, on the one hand, deficit countries need both to save more and sell more to the rest of the world so that greater savings are accompanied by an increase in net exports, and on the other hand, surplus countries must spend more domestically and sell less to the rest of the world.

All sides must compromise, adjusting synchronically in the right direction and at the proper speed.

It must be done in a way that meets some essential conditions. For deficit countries, it must allow the elimination of the massive excess capacity that currently affects them and it must not compromise imprudently their future fiscal consolidation. For surplus countries, the agreed adjustment must not compromise their future economic growth, by unduly requiring, for example, an abrupt compression in savings rates.

The idea that the correction of the imbalances is fundamentally a G2 (US-China) issue should once and for all be trashed. It is wrong and misleading.

Every significant economy –- deficit or surplus -- has not only a stake but also a responsibility for correcting the macroeconomic imbalances.

This is clearly the case for Germany that for a long time it has sustained large current account surpluses, not much talked about before because they were disguised in the Eurozone's nearly balanced current account. The truth is that Germany's surpluses were, among other things, feeding consumption binges in Greece, supporting exuberant construction booms in Spain and Ireland, funding unsustainable fiscal deficits in Portugal and even helping to inflate the real state bubble in the U.S. –- as not a few of the German banks' balance sheets painfully revealed in due time. Germany must commit in the Compact to reduce its large surplus in a way that both helps to correct the global imbalances and enhances the probability of recovery of its Euro partners.

Japan is another large surplus country that needs to take an active part in the rebalancing, undertaking at last structural reforms that would make it less dependent on foreign demand to drive its economic growth.

The same applies to those emerging countries with large surpluses. They would find it healthier and more sustainable to rebalance their growth towards domestic demand, attract more exports from deficit countries and, in the process, take some current account deterioration. This adjustment must, of course, be part of the Compact, where those countries' appetite for large accumulations of foreign exchange reserves should be mitigated with greatly enhanced multilateral insurance against international liquidity droughts. Korea, the host of next week's G20 meeting, is totally right in pursuing vigorously a firm agreement on this crucial point.

For very valid social and political reasons, China must seek to preserve its high rate of economic growth, which, by the way, is good not only for this country, but also for the world at large, and certainly for other developing countries. It is understandable that as part of that objective of high growth, China rejects unduly compromising a key ingredient of its economic success: its large domestic savings rate. However, China, as it proved exemplary in the recent crisis, needs to continue being supportive of an international economic environment propitious for its own economic growth.

Just as all the other significant players, China, as part of the Grand Compact, needs to adapt some of its policies, albeit in a pro-growth framework. This involves a mix of even more increased domestic investment –- accepting some temporary fiscal deterioration and credit expansion, and a somewhat more dynamic adjustment path of the RMB, but certainly not to the extent that some pundits demand in Washington and in other capitals of rich countries.

Let me insist that China is in the fortunate situation of being capable of reducing its current account surplus by raising investment, which in turn will raise growth. Furthermore, Chinese growth would be less dependent on net exports if distortions that now favor excessively the traded-goods sector were corrected. Those are distortions that by compressing the cost of capital, labor, land and other resources, end up excessively biasing production towards the export and import substitution sectors. This correction could be complemented with polices to foster productivity in the non-traded goods and services sector.

Undoubtedly, among the largest countries, the US has the most difficult balancing act to accomplish. It must, on the one hand, escape the low growth-high unemployment equilibrium in which now it seems trapped and, on the other, must undertake a practically unprecedented effort to stop and reverse the growth of its national debt.

Some of the slack in the US economy would be fixed by the larger demand for its exports from the surplus countries as these comply with the Compact. But more than that stimulus may be needed. Going straight for a stimulus of domestic consumption would not be wise. The US household's sector deleverage must continue for a while. Private investment will be forthcoming only if there is additional demand, some of which would come from increased exports, but more would be needed if unemployment is to be abated to a decent level.

A boost on expenditure in public infrastructure would seem to be the ideal solution. Short term, it fills the demand gap; long-term it expands the economy's productive capacity. New hires could also be fostered with temporary relief in pay-roll taxes, a reduction that could eventually be made permanent in exchange for a carbon tax.

Needless to say, the Grand Compact will commit all deficit countries, with deteriorating public finances, to undertake the necessary fiscal consolidation as soon as prudently possible. For the U.S., such fiscal consolidation would be less painful the faster it escapes its low growth-high unemployment trap, particularly if it does so with a lower bias toward current account deficits that would be made possible by the international coordination instilled in the Compact.

I have bored you with this description of what a possible Grand Compact to rebalance the global economy would entail for each of the key participants because it is important to show that there is a way out of the present mercantilist dilemma.

I am absolutely convinced that addressing the present predicament in a cooperative way is the litmus test of whether the international community will be capable of managing interdependence as a positive force for global peace and prosperity.

If we fail this test, then it will be harder, if not impossible, to address other imbalances of greater complexity that will be encountered in the not so distant future. Just consider that the so-called rich countries will have reduced their participation in world output from 55% in 1990 to 30% in 2030 –mere twenty years from now. China's GDP alone will be twice as large of that of the US. This is a monumental rebalancing in the distribution of economic power.

To proceed in harmony and prosperity, rather than through a confrontation of civilizations, will require firm commitment and heightened responsibility, not by just few, but by all members of the international community. As a friend and sincere admirer of the history, culture and achievements of this great country, I am absolutely confident that China will do its part.

Xie, xie.

Ernesto Zedillo

Yale Center for the Study of Globalization

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