Preface[1]

How it Got Started

Since the outbreak of the global financial crisis in March, 2007, “global economic imbalances” has become one of the catchphrases frequently used by monetary authorizes around the world. Developed economies, among them the U.S. in particular, liked to use this term looking for the root cause of the crisis. By attributing the turmoil to imbalances, which was depicted as a “global phenomenon”, they may shift the responsibility of the crisis easily to other countries, especially emerging economies like China. In fact, talks like “China is the responsible party” and the so-called “China threat” are theoretically backed by on other concept than the “global imbalances”.

Relevant governmental departments in China remain highly alert in face of such allegations. They tried to avoid the use of “global imbalances” on public occasions, especially at international conventions. A friend told me that at the G20 summits over the years, one of the major tasks of the Chinese delegation was to keep the term and related expressions from appearing in the communiqués and declarations.

What those departments did is truly understandable. However, from an economist’s point of view, using “euphemism” to get around the real issue seems to me the kind of behavior, as one Chinese proverb describes, of “mistaking the shadow of a bow in one’s cup as a snake,” which is as unreasonable as “burying one’s head in the sand.” Admittedly, on the one hand, it seems that so far people cannot find a better culprit that caused the economic crises other than global imbalances; on the other hand, though, China should not take the blame imposed by a few countries that tried to shake off their responsibility by falsely accusing the Asian economies for causing the crises. So, instead of circumventing the real issue, we need to

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[1] Translator’s Note: In translation of direct quotes, some of the quotes are retrieved from the original English texts with notes by the translator. The rest was translated from Chinese text since the original English text is not accessible. Some of the direct quotes in this book are without citations.

confront the imbalances so as to uncover the truth that global crises was caused by imbalances created by some developed countries; meanwhile, conduct serious research on imbalances will also help us become better aware of the deeply-rooted causes for China's domestic problems such as unreasonable ways to development and the imbalances in economic structure that remain incorrigible for years.

In early 2009, I attended the Forum for Global Economists co-hosted by the then Chinese Premier Wen Jiabao and British Prime Minister Blair at No.10, Downing Street in London. More than 20 world-renowned economists, including Joseph Stiglitz, attended the forum. As the only scholar from China and one of the five speakers, I shared my views on global imbalances at the consent of the Premier. My talk touched upon four main points: First, as problem that has not drawn much attention until recent years, global imbalances have existed as the symbiosis of globalization and with the introduction of the Bretton Woods system. Second, tracking the global economic evolution will reveal clearly that as the only super power, the U.S. has always been the deficit country; at the other end of the spectrum, countries have taken turns in the role surplus country, first Germany and Japan, and since the 1970s, the "four small dragons of Asia", followed by the "four small Asian tigers", who were joined not until recently by China and OPEC countries. If the current crisis was rooted in imbalances, then the ultimate cause lies with the US. Third, in the globalized world economy, global imbalances inherently mean domestic imbalances in different countries. Therefore, to solve the crisis and put the world economy back on track, countries need to join their efforts to adjust the path of development by economic restructuring; and since the developed economies take the lead in globalization, they are obliged to take up the responsibility in initiating the transformation. Fourthly, as early as the end of the twentieth century, the Chinese government had set the strategic goal of transforming pattern of economic development, restructuring domestic economy, and achieving scientific development, for the purpose of solving the economy's over dependency on external demands and domestic investment. Actions were taken as the concrete measures to re-balance the world economy.

Feedback at and after the forum showed that my view was received positively by most of the participants.

It is this forum that led me to focus my attention on the research of global imbalances, among a number of research subjects. The above-mentioned viewpoints also evolved into the main arguments of this book.

Equilibrium and Balance

Imbalances and Re-balancing are the catchwords of most Western political figures and dignitaries. However, few have elucidated what those words actually mean. To explore this issue of crucial importance both in theory and practice, one has to have a close look at the concept of "balance" in the first place.

The "balance" of dichotomy of imbalances and rebalancing has two connotations: equilibrium and balance.

"Balance" is an extensively used concept. The *Dictionary of Modern Chinese* defines "balance" as "quantitatively or qualitatively being equal or offsetting each other in opposing elements."

"Equilibrium" is a concept of physics, referring to static caused by a state of balance between opposing but equal forces. In economics, equilibrium refers to the state of the market when the two opposing market forces, i.e., demand and supply are in equal amount. To take a step further, there are two types of "equilibrium" in economics: one is the Walrasian equilibrium, achieved when supply equals demand, with market clearing; the other is non-Walrasian equilibrium, which posits that price mechanism alone cannot clear the market, and market balance in most cases is non-Walrasian, i.e., supply does not always equal demand, but the market remains stable regardless. Obviously, compared with Walrasian equilibrium, non-Walrasian equilibrium is a concept in a broader sense, proposing that after adjustment of variables in the system, there will be no tendency for further change. Such equilibrium, when extrapolated, presumes that when external forces cause the equilibrium to deviate beyond the balancing point, there will always be an internal movement that will bring the system back to balance. In this sense, non-Walrasian equilibrium is a stable equilibrium. On the other hand when external forces tip the balance, and the economy will not return to equilibrium, the equilibrium is unstable.

Notably, in economics, "equilibrium" and "imbalance" refer to two totally different things. Equilibrium is a typical economics terminology, and a concept has long been a subject of discussion among economists. As for "balance", the definition is relatively vague, and in many cases, it is used to describe surplus, referring to the equal match between supply and demand, asset and liability.

The "imbalance" discussed in this book is derived from the concept of equilibrium, since the authors are not particularly concerned about the surplus or deficit in international balance of payments. Actually, imbalances are normal for countries, often in the forms of trade surplus and deficit, imbalances on current account, and even reflected in imbalances of international balance of payments, in the form of international imbalances in savings and investment, i.e., the relative inadequate savings in developed economies, and the "excessive" savings in emerging economies. What we really care about is that whether such imbalance can be sustained.

"Good Imbalances" and "Bad Imbalances"

The differences (surplus or deficit) on a country's foreign trade or international balance sheet result from cross-border allocation of resources of the country. Economic implications of imbalances can be reviewed from the perspective of dynamic allocation of resources. With this approach, current account imbalances can be categorized into two types: "good imbalances" and "bad imbalances."

"Good imbalances" result from the optimal decision reached regarding allocation of consumption and investment within a relatively long period. For example, current account deficit comes from optimization of dynamic and forward-looking policies about savings and investment. Imbalances as such brings no harm to economy, instead, they contribute to the welfare of the society. “Good imbalance” is possible in at least one of the following three situations: First, the imbalances and alternating shifts between surplus and deficit happen synchronizing with the cyclic periods of domestic economy. Second, the imbalances occur when a country’s economy is reasonably structured, its enterprises are developing soundly, and the macroeconomy foretells a bright prospect. In this case, imbalances are the outcome of making optimal decisions about domestic economy, which will definitely bring about favorable economic results. Third, the imbalances appear when the term and regional structure for foreign investment are sound. Long-term imbalances on current account will inevitably trigger corresponding responses on capital and financial items. Therefore, if the term and regional structure of capital and financial items are reasonable, domestic economy will become resilient under pressure from international capital and able to maintain overall balance in international payments, even when current account imbalances (either surplus or deficit) are deteriorating.

“Bad imbalances” refers to the situation where a country fails to achieve long-term optimal allocation of domestic and foreign resources, and has been sustaining one-way increase in either surplus or deficit, which eventually leads to distorted economic structure with aggravating risks. “Bad imbalances” often take the following forms: first, an imbalanced domestic economic structure, i.e. irrational industrial and sector structure; and failure to adjust the export-oriented strategy in a timely manner; second, imperfect financial structure, including irrational saving behavior, bad loans, lack of financial supervision and regulation, over-evaluation of local currency, etc.; third, excessively capital flows, which increase external risks and further distort the matching of currencies and terms in the existing, unreasonable foreign debts, which results in either shortage or excessive growth of foreign currency reserve.

It is worth noting that surplus does not necessarily mean “good imbalances” and deficit “bad imbalances,” because either could imply a country’s inability to effectively allocate domestic resources, which will compel the monetary authority to resort to the international market to achieve balance. Therefore, whether the imbalances are “good” or “bad” depends on a country’s capability of allocating global resources. Meanwhile, imbalances also mean long-term, one-way movement of internal capital under capital and financial items, which has prolonged impact the domestic financial system. In an inefficient domestic financial market, such external impact will harm the real economy by way of foreign exchange rate, interest rate, international reserve, credit and loans, as well as securities market. If such situation continues, the country’s domestic monetary policy will in effect be “hijacked,” and only a well-versed monetary authority with a sound monetary policy structure can put an end to this tendency. Otherwise, the countries’ monetary policy will gradually go out of effect.

Sustainability of Imbalances

Since our discussion of imbalances is built on the concept of equilibrium, sustainability of imbalances is the crux of the issue. In fact, the above-mentioned "good imbalances" are sustainable, because they help a country's real economy develop soundly, and bring dynamics to its microeconomic entities with a good prospect.

In essence, global imbalances mirror the situation of the real economy. In a "pure" real economy without currency as the intermediary, imbalances is nowhere to be found, since exchange through "barter" leaves no space for trade difference.

The international monetary system makes imbalances not only possible, but also highly complicated. If deficit countries can clear the account and pay the difference in its local currency, imbalances will be sustained to a great extent within long period of time. In this sense, the focus of the debate on global imbalances should be shifted from issues like the causes and magnitude of the imbalances to sustainability: if, in the world economic system, deficit countries are allowed to pay off the deficit by local currencies, imbalances can be sustained; otherwise, imbalances will trigger global economic crisis.

The evolution of the Bretton Woods system has testified to this argument and left a trajectory of the world economic development with sustainable imbalances to imbalances that is no longer sustainable.

The Bretton Woods system was founded in an unbalanced world economy, where the US remained the surplus country vis-à-vis other deficit countries, constituting a pattern that had lasted for a long time. The pattern begun to change in the 1960s, when the US's foreign debts exceeded its gold reserve, to one that featured the US being the debtor and other countries the creditors, as the gap between them kept on widening. Such imbalances had been maintained to the 1960s, because the Bretton Woods system was dominated by the US dollar, and the US enjoyed the privilege of issuing the dollar to cover the differences on its current account—while all other countries, debtor or creditor, had to use dollar to pay and settle. This trend was reserved after the "Nixon Shock" of 1971, when the domestic prices in the US begun to soar and the value of dollar in foreign markets plummeted unstoppably. What had happened made the US and other countries realize that it was no longer profitable to stick to the dollar standard, and subsequently triggered the outbreak of global financial crisis, which lasted for almost a decade and ended with the demise of the Bretton Woods system.

However, this is not the end of story for the dollar. After the collapse of the Bretton Woods system, although the dollar's dominant role as the international reserve currency has been greatly challenged by a number of reserve currencies that emerged as was represented by the euro, the rising of the Asian countries has actually eased the pressure. Most of those countries pegged their currencies to the dollar in one way or the other, and among them some even adopted fixed exchange rate pegged to the dollar. As those economies rose as the new "periphery" of the dollar, the dollar hegemony was enhanced, subsequently bring the dollar-centered international system back to life. The predominance of the US dollar in the international monetary system had been further consolidated with the “drastic transformation” in the former Soviet Union and Eastern European countries. Prior to the 1990s, the former Soviet bloc countries adopted a monetary system in parallel to the Bretton Woods system, with rubble as the major reserve currency. After the drastic changes, those Eastern European countries endorsed market economy with no exception, making the US dollar their reserve currency. The “defection” of economies of such a magnitude further consolidated the status of the dollar at the core of the world monetary system.

Following the trajectories of imbalances, some researchers gave the name of “Bretton Woods System II” to the international monetary system after the Jamaica Agreement. In our view, this term is not unjustified taking into consideration the fact that the US still has the privilege of issuing the major reserve currency. Nevertheless, in terms of the obligations assumed to the US, the two systems are widely different. Today, free from any constraints and pressure, the US takes no responsibility to address global imbalances and facilitate global economic development, let alone is willing to pay any cost for necessary adjustments. In our view, complete separation of rights and privileges is the major contradictions of the current international monetary system. With no external constraints, the US monetary policies are targeted at domestic goals, disregarding the financial “deluge” in other countries. Such contradiction makes reform of the international financial system an imperative task if the world needs to bring its economy back to balance.

Heading Towards New Balance

Global imbalances remains the biggest conundrum of today’s world, hence rebalancing the world economy becomes our top priority. The reason being, global imbalances were the root cause of the 2007 global crisis, which is still running rampant.

If, by definition, crisis is the symptom of a “derailed” economy, then economic recovery can only be achieved in the following two ways: to steer the economy back onto the old track; or, as the alternative, to blaze a new path. Often, crises on small scale did not rattle the whole system, and therefore could be dealt with by patchwork measures that would bring the economy back onto the right track after chaos; however, if the crisis became so severe that it shook the whole system with global impact at much deeper level, and with new factors intervening the process, recovery will take on a totally new trajectory.

The current financial crisis obviously falls into the second category, since after the crisis, global economy has undergone two major transformations that most probably would usher in a new global system.

In the first place, the transformation is taking place in the real economy. Since the end of the 1980s, the emerging economies have contributed more to global output increase than their developed counterparts. The crisis has mired the latter in sluggish economy for long periods of time; meanwhile, the emerging economies have seen sustained high growth, a trend which is going to continue in the foreseeable future. Such economic power shift is historical, and will allow the emerging economies to take over the leading role in global development step by step, as new patterns of economic growth starting to replace this round of globalization under the leadership of the developed economies. In the similar vein, transformation is taking place in the financial sector. Capitalist global economic crisis are always accompanied by financial crisis, which mostly featured debt crisis of the developing countries or emerging markets. With no exception, no recoveries could be achieved without global debt restructuring, which in effect had consolidated and strengthened the hegemonic role of the developed economies in the international financial system. The current crisis, however, has a totally different picture. This time it is the developed countries, the rule markers of the system and issuers of the international reserve currencies that are deep in debt and not able to pull themselves out of the quagmire. Being tied up by the genie set free by themselves from the bottle, the developed countries created international coordination mechanisms like the G20 in the hope that the emerging markets may come to their rescue. As the result, the emerging economies have bigger voices and more influence in the international financial sector, in an effort to diversify the international reserve currencies; in the meantime, the decision-making power of the developed economies regarding rule-making has been gradually weakened. The trend suggests that a new pattern of global economy is taking shape.

The transformations towards a new balance also give China new opportunities to achieve development. First, as the world economy and industries started to restructure, China is in a favorable situation to foster the “new edges” and “seize the strategic commanding heights for future development amid the competitors.” Second, as far as global development is concerned, with the “rising of the emerging markets,” and the world economy enters the “stage of governance reform”, China can build up its strength and participate more effectively in global governance.

It is true that every several decades would witness a new round of global industrial and economic restructuring, even governance reform, and such occurrences have become an normality of the economic cycle; but now it is the first time since the Industrial Revolution that the emerging economies have caught up with the developed economies in terms of economic aggregate, a transformation teamed with new opportunities. For China, it is the opportunity once in a thousand years. Whether China can seize this opportunity and find its new position in the rebalancing process depends on whether the country will be able to transform its development model and economic structure, making them more efficient and better in quality.

This is where the real challenge lies.

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Beijing, China

Yang Li
Xiaojing Zhang

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