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How to Handle Global Imbalances: a Role for European Monetary Cooperation with Asia

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Abstract

The crisis happened because misguided monetary policies in the US, and high savings from Asia have also allowed Americans to live above their means. Now the party is over, but global imbalances will not disappear.

China's model based on unlimited labour supply and a competitive exchange peg to the dollar is under threat. Reforms must preserve Asia's growth, give the US flexibility to adjust, and prevent Europe from carrying the burden of global adjustment:

1. Asia should re-peg from the dollar to a basket of euros and Japanese yen.
2. Euro-yen volatility must be minimized.
3. Surpluses are invested in euro and yen, stimulating demand.
4. The basket leads to a future international reserve currency.
5. Coordination should be led by a G4 and ASEM.

How to Handle Global Imbalances: a Role for European Monetary Cooperation with Asia

Stefan Collignon¹

The devastating financial crisis that shook the world in 2008 could not have happened without the large macroeconomic imbalances in the global economy. Yet, the precise impact is controversial. Some argue that the imbalances were one of the crisis' principal drivers; others believe that regulatory distortions caused it, while imbalances can be benign as long as financial markets allocate resources efficiently. Nevertheless, there is little doubt that large savings and the accumulation of foreign exchange reserves by China have financed huge American current account deficits and the domestic credit boom, which has now collapsed. History teaches, the larger the bubble, the harder the fall. Ignoring global imbalances is therefore irresponsible. While it is true that the US current account deficit has come down in recent years, the underlying logic has not changed. We need to understand, why this is so and what can be done about it.

This paper will first explain the link between the financial crisis and global imbalances, then analyze the transformation in the world economy that has taken place in recent years and conclude on a European economic strategy that offers a win-win solution for Asia, America and Europe.

1. Global imbalances and the financial crisis

Mysterious imbalances

A popular view claims that the recent crisis was caused by greedy bankers who made a fortune on hard working people. The best remedy against future crises is to take bankers' bonuses away and to prevent future disasters by better financial regulation. Not much different is the belief that Americans have been living above their means, saving too little, spending too much, and the best remedy against their irresponsibility is to prevent the Chinese from giving credit to America's bonanza. None of these views is helpful in finding a solution to the economic and financial crisis.

Financial bubbles can only develop when speculators find the liquidity to finance their operations. The bubble in America was fed from two sources: lax monetary policy under Greenspan, and capital inflows from what Bernanke (2005) has famously called the "Global Savings Glut". We will need to clarify the relative importance of these factors. It is, however, noteworthy that the Euro Area as a whole did not experience an unsustainable credit boom, nor was its external balance in disequilibrium. It is true, some member states experienced local asset inflations after European monetary union started. For example, in Spain, Italy, Greece and Ireland, falling interest rates relative to the previous national currency rates have stimulated house price increases, while in Germany, where interest rate

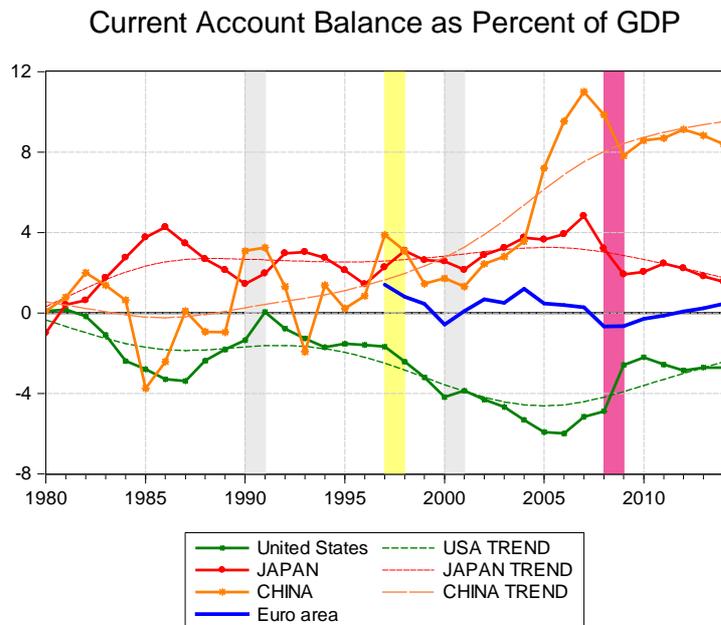
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reductions remained marginal, house prices have fallen consistently. Overall, monetary policy remained more prudent in the Euro Area and the Global Savings Glut did not swell European markets.

Excessive American consumption, compared to more sober European attitudes, shows up in current account developments. The current account deficit is the difference between domestic investment and savings. In a closed economy, investment is always equal to savings, because investment will generate income until planned savings match investment. But in an open economy, the difference between investment and domestic savings may be financed by borrowing from another country. 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 hold the claim in foreign currency. What one country borrows must be the surplus of another. In other words, America’s consumption is excessive, because Chinese products are competitive. 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 foreigners are willing to hold assets denominated in a currency that is not their own. These are three descriptions of the same phenomenon.

For over a decade, the United States has accumulated massive current account deficits. From 1999 to 2009 the aggregate amount came to USD –6,082bn, while the Euro Area’s surplus for the period was only USD 153.4bn. The biggest surplus countries were in Asia: USD 1,787.1bn in China, 1,543.9bn in Japan and even Taiwan (242.4bn) and Singapore (239.4bn) run larger surpluses than the Euro Area. Figure 1 shows the evolution of current accounts to GDP, i.e. the net flow of current transactions between countries as the share of a country’s income.

Figure 1.

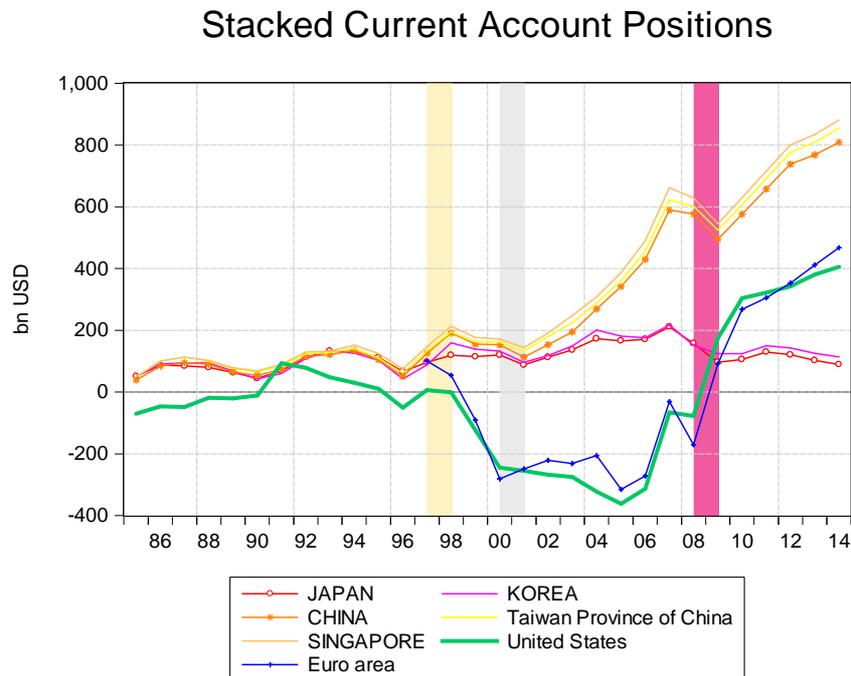


The Euro Area has stayed close to the zero line (the mean is 0.19 percent), while the US balance has continuously deteriorated from the early 1990s to the mid-2000s. As monetary policy tightened world-wide, there has been a slow trend² for disequilibria to revert, especially in Japan and the USA. This trend was temporarily accelerated by the financial crisis, which imposed sharp corrections on the United States, Japan and China. Yet, even if there has been a tendency to return to equilibrium (the trend lines for Japan and the US converge slowly to zero), the issue of global imbalances is not going away. The American external deficit is still expected to hover around 2.5% in 2014. Japan has had a stable structural surplus of 3.15 % of GDP for a long time, and the IMF is not expecting it to come down to less than 2% by the mid 2010s. The biggest outlier is, of course, China. While in the 1980s Chinese current accounts were structurally balanced, despite large fluctuations, they moved into surplus in the 1990s, when China adopted an economic development strategy that resembled Japan's or Asian Tiger's take-off. Nevertheless, Chinese surpluses relative to GDP remained below Japan's until 2000. Only after China joined the WTO in 2001, did they shoot up to peak at 11% of total income in 2007. In the financial crisis, surpluses came down, but the IMF expects the Chinese current account to increase continually as a share of the rapidly growing GDP. The trend balance will reach 9.5% in 2014.

These figures show that global imbalances are not just a passing phenomenon that is automatically remedied by forced crisis adjustment. If the financial crisis was caused by Chinese households feeding the Global Savings Glut, we may well expect a new crisis in a few years. But even if it had different reasons, we still observe fundamental changes in the world economy. For example Figure 2 shows the stacked current account positions of Asian economies, the USA and Euro Area. The point of adding these data up is to demonstrate the net effect of Asian surplus and US deficit positions. We see that until 1998 and again at the time of the financial crisis, the net position is zero; in other words, *America and Asia had a symbiotic relationship*. America borrowed, what Asia lent. The biggest lender at the time was Japan. During the Bush presidency this pattern changed. The United States did not only borrow from Asia, and increasingly from China, but also from Europe and the Middle East. This has now been corrected. However, from 2010 on, the intercontinental balance is moving into surplus because Chinese net exports continue to grow.

² The trends were calculated by the Hodrick-Precott filter.

Figure 2.



It is not clear, who will absorb these Chinese surpluses. The IMF expects the main current account improvements in Developing Asia (295 billion), which includes China and India, and in the Middle East (264 billion). Looking at the forecasts for 2009-2014, the net position of China, Japan, Taiwan, Singapore, Korea, the United States and the Euro Area will swing from USD -170bn to +467bn. By contrast, a deterioration in the current account can be seen only in Central and Eastern Europe (-27 billion) and Asean-5 (Indonesia, Malaysia, Philippine, Thailand, Vietnam) (17 billions). The huge difference between surpluses and deficits is explained by “discrepancies” (a statistical catch-all item) that will rise to about 700 billion dollars.³ It is fair to conclude that there are forces at work in the global economy, which we do not fully understand. All we know is that China is an important part of this new (hi)story, but so is the United States. We will now first analyse the relation of global imbalances and the US economy and then the new role for China.

Roots of the financial crisis

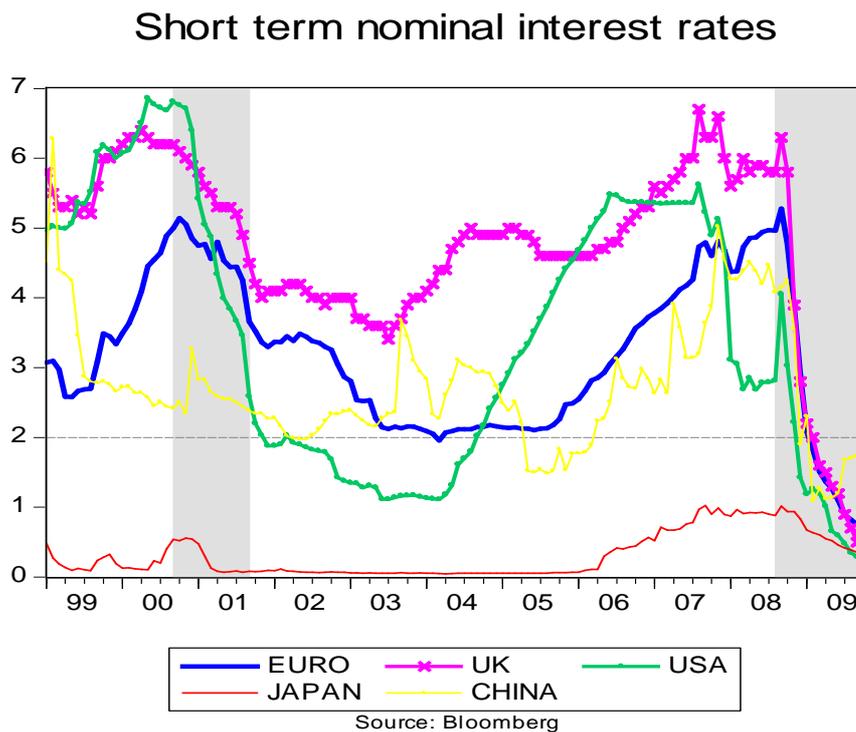
Wall Street was the epicentre of the financial earthquake, which devastated large “territories” of the global economy. The Bank of England (2008) calculated the value of bank losses due to price

³ The IMF (2009:38) is remarkably diplomatic in its language: “The deceleration in global growth during 2008–09 already resulted in some narrowing of the global current account discrepancy in 2008, and some further narrowing seems likely in 2009. Against this cyclical decline works a growing trend for a global services surplus. However, results from simple econometric models for the global discrepancy suggest that the continued large increases in the global discrepancy during 2013–14 implied by the WEO forecasts might be stronger than consistent with historical trends.”

adjustments in the crisis equal to USD 2800-3400 billion, and the Asian Development Bank has estimated that financial assets worldwide fell by more than USD 50 000 billion – a figure equivalent to the value of world output (Loser, 2009). However, a large part of these losses represents inflated asset prices.

The roots of the bubble go back the so-called dot.com crash in 2000 that destroyed asset values of 7 trillion US dollars, and to the Asian crisis of 1997/8. The two events together generated the dynamics that flooded asset markets with liquidity. In 2000, the Federal Reserve System cut interest rates in order to prevent the ITC stock market crash from spilling over into the real economy. After the 9-11 attack on the World Trade Centre interest rates were lowered again. See Figure 3. For the next three years, real short-terms interest rates were negative in the United States and close to zero in the Euro Area. Such highly accommodating monetary policies fuelled the new asset bubble, and appreciated values for stocks, real estate and commodities. Given extremely low lending rates, banks sought to increase their return on capital by leveraging their operations.

Figure 3.



Rapidly rising asset prices in the United States attracted capital from across the world. Many East Asian countries had learned from the Asian crisis in 1997 that they needed to accumulate foreign exchange reserves as a buffer against future monetary instability. They increased their savings and placed them in dollars, where asset markets yielded good returns. Asian central banks kept their foreign exchange reserves in profitable US government bonds and contributed to lower long term

rates in the USA. European commercial banks bought American assets of subprime quality to get a share in the booming American market. The resultant large capital flows into the US economy seemed to indicate a “Global Savings Glut” (Bernanke, 2005). The resulting low interest rates allowed governments and households to borrow cheaply.⁴ Taxes could be cut. Home equity loans were affordable. US households felt wealthy and that spurred consumption and imports. Hence, the US current account deficit widened. It is interesting to note that deficits also deteriorated in many other countries with housing bubbles. Wealth effects from rising house prices seem to feed quickly into consumption and lower savings (Jagannathan et al., 2009). However, when a property boom crashes, the wealth effect is gone. Consumption will not pick up again and economic growth is permanently lowered.

Fearing inflation, the FED started raising interest rates in the middle of the decade. The initial rate hikes had no effect on booming demand until they reached the level of 7%. Such “irrational exuberance” is frequently observed during financial bubbles. But the subsequent crash is usually quick and dramatic. Asset price increases first slowed down and then turned negative in 2007, thereby weakening banks’ balance sheets, ultimately leading to the collapse of major banks like Lehman Brothers in 2008. One lesson from this development is certainly that one must not keep interest rates too low for too long, for otherwise one bubble generates the next.

The accommodating policies in the United States and in other countries, like the UK, who followed similar strategies, explain why the Global Savings Glut bloated financial markets in the Anglo-Saxon world, and why the more conservative ECB succeeded in preventing the worst excesses in the Euro Area. Nevertheless, the decade of the “great moderation” was characterized by a large and atypical expansion of liquidity (Visco, 2009); it may not have been so moderate after all. How the world could be awash with liquidity without inflation taking off, remains a puzzle. To understand this mystery we need to look at Asia.

The transformation of the global economy

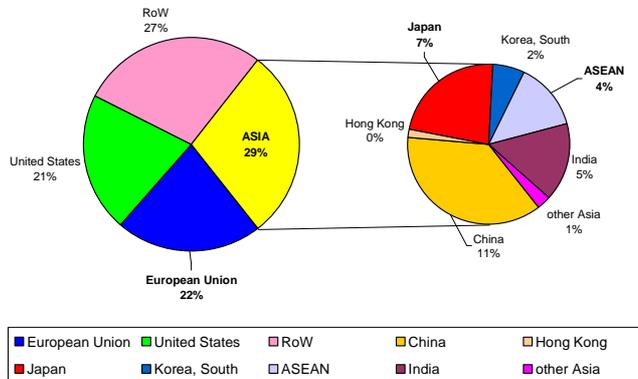
« *Quand la chine s'éveillera, le monde tremblera* ». The famous book by Alain Peyrefitte, written in 1973, is now reality. Yet, when the future comes, it rarely looks like expected. The emergence of China as an economic actor has coincided with the age of globalization. The combination of these two historic facts has caused a shock that few people understand, many fear, and all have to face up to.

In 1980, China represented less than 1% of World GDP. In 2007, it counted for 11% measured at purchasing power parities. It has twice the economic power of India (or Germany), three times that of ASEAN. Asia as an economic region is now more important in the world economy than either Europe or the United States. See Figure 3.

Figure 3.

⁴ They also caused the “Greenspan conundrum”, whereby long term interest rates did not respond to short term interest hikes by the Fed.

Regional Shares in World GDP
ppp 2007



Source: CIA Factbook, 2008

There is nothing unique, nor exceptional, about the rapid growth of the Chinese economy. Japan also grew on average by over 8% per annum during the post-war Bretton Woods period. The high-growth Asian Tigers (Hong Kong, Korea, Malaysia, Singapore, Taiwan and Thailand) equally expanded at 8% p.a. from 1960 to 1995. In other words, China's development is following the well-established Asian model, which is based on high investment, quasi unlimited supply of labour,⁵ and fixed exchange rates. What is different with China is its size. Its population is 1.3bn today, i.e. over 20% of the world; it will peak at 1.5bn by 2030 and then slowly descend. China's labour force is 812.7 million, a quarter of the world's total, and nearly four times the EU's. It used to increase by 10 million a year in the 1990s, but due to demographics this has slowed to 6 million per year in the 2000s and will stop around 2015. 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 industrializing coastal cities and Special Economic Zones. Over the last decade, China has been adding the workforce of France or Italy to its labour supply every year.

China's labour force has now effectively become part of the Western workforce through industries that export to the West. As Jagannathan et al. (2009) have noted, "the size of the increase in the developed world's labour supply is of a magnitude similar to the increase in the Western world's access to land and natural resources following the discovery of the Americas". This tectonic shift in the world economy has become possible because the ITC revolution has lowered the cost of communication without having to move people. "Labour in developing countries – countries with vast pools of grossly underemployed people – can now compete with labour in the developed world without having to relocate". For example, a radiologist in Shanghai or Hongkong can analyze the X-Ray of a patient taken in London over the internet and send her diagnosis back, thereby competing with a local radiologist in Europe. Global labour supply has become highly elastic. This development has

⁵ The benchmark model is Lewis, 1954

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 has declined from 64% at the beginning of reform to 10% in 2004. In advanced industrial countries, however, it has contributed to regional and sectoral deindustrialisation, higher unemployment and stagnant wages. With globalization, open markets, and highly elastic labour supply, the world has become richer, but also more complex, and harder to govern.

The emergence of an elastic global labour market has also transformed the conditions under which monetary policy operates. Money supply does no longer fix prices for goods and services, because the stabilization of wage costs has kept inflation down and produced the "great moderation" observed over the last decade. In this context, accommodative monetary policy does not create inflation for goods and services, but rising asset prices. In the short to medium run, it may generate growth and employment, but in the longer term it can fuel devastating bubbles. The triumph and the tragedy of Alan Greenspan, as chairman of the Fed, was that he understood the first part of this sentence, but not the second.

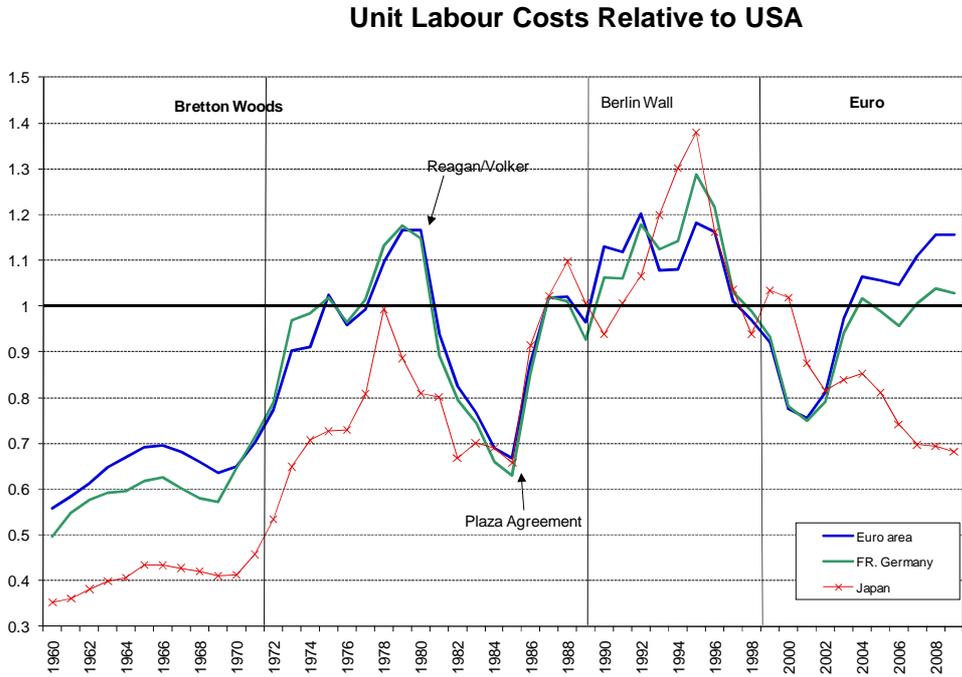
2. Asia's role in the International Monetary System

Fixed exchange rates

However, the integration of China and its labour force into the world economy required specific policies. Having a large labour pool is not enough, as people need to be put to work. The Asian development model provided Chinese authorities with a successfully tested and proven policy strategy. At the core stands the exchange regime. Fixed exchange rates have laid the foundation first for Japan's and then for emerging Asia's rapid development by combining *competitive* and *stable* exchange rates with long term wage stability. Unless exchange rates fix competitive cost levels for exports, rapid economic growth will not take off. Without elastic labour supply, competitive wage costs would not be sustainable. And stability of exchange rates is necessary to ensure a framework of stable expectations and minimal uncertainty, without which investment would remain low.

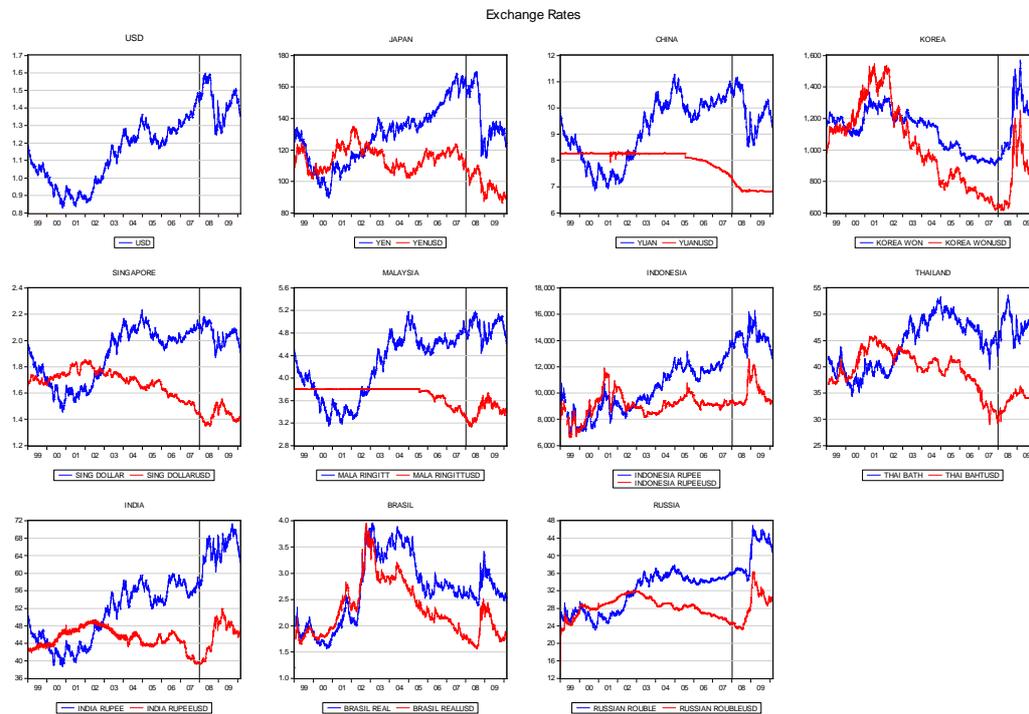
Labour market conditions determine the long run feasibility of the competitive exchange rate regime, but monetary policy can be used for minimizing volatility. Europe and Japan are familiar with this model of development, as they have gone through a similar experience in the 1950's and 1960's. As Figure 4 shows, under the fixed exchange rate regime of Bretton Woods, unit labour costs in Japan and Europe remained stable at 40 to 66 percent 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 percent above the US-level and the miracles disappeared.

Figure 4.



Recent developments in East Asia follow a similar logic. Most countries have pegged their currency to the dollar and changing this regime risks undermining their development model. This makes remedying global imbalance particularly sensitive. Not all Asian countries have kept their exchange rates totally fixed to the US dollar, as China and Malaysia did, but for most of them exchange rates are more stable in relation to the dollar than to the euro (see below). As a consequence of the dollar’s weakness relative to the euro, Europe’s currency appreciated against Asia. See Figure 5.

Figure 5.



A successful exchange rate strategy must peg local currencies to a leading world currency, because this guarantees the integration into a large market capable of absorbing the supply from emerging competitive producers. Local firms reap benefits from the improved skills and productivity of their workers (“learning by doing”). Unit labour costs therefore remain low relative to international standards, even if real wages rise and standards of living improve. As firms reinvest their attractively high profits, they generate accelerated economic growth. Hence, maintaining a fixed and competitive exchange rate to the UD dollar, which is still the world’s leading currency, has guaranteed Asian exporters access to the world market. Europe with its protectionist propensities and confusingly small currencies could not offer attractive development perspectives, at least until the euro was created. This could now change, as will be discussed below.

High profits generate high national savings. The competitive currency peg explains why savings rates are so high in China. In fact, Chinese households’ savings are not particularly excessive.⁶ The household savings rate, as a percent of GDP, fluctuates between 15 and 20 percent, while the overall gross savings rate is close to or above 50%. To a small extent, the difference is explained by government savings (5%), but the largest part, with about half of the total, is corporate savings. In-depth analysis shows that these savings come essentially from retained earnings, which are reinvested by firms in fixed or financial assets, because the Chinese government does not have a well-defined

⁶ 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.

dividend policy for state-owned companies (Anderson, 2008). Hence the competitive level of the yuan's exchange rate⁷ is a crucial driver for China's rapid economic growth, but it also generates the excess savings, which until now have been placed largely in the United States. This dual effect constrains Chinese policy options severely. A shift from exports to domestic consumption, as 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. No wonder exchange rate policies are so controversial. For, while the United States and Europe push China to revalue its currency, Chinese authorities know that the appreciation could ruin the model, on which their development depends.

Exchange rate volatility

Pegging exchange rates serves two purposes: to fix relative price levels between two economies and to minimize 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 be sustained. The more certain it is, the higher will be the rate of investment. There is now significant evidence that stabilizing exchange rate volatility encourages trade and investment.⁸ While the elastic labour supply keeps destabilizing wage developments at bay, foreign exchange markets are a permanent source of risk and uncertainty, especially given the underdeveloped nature of local financial markets. Floating exchange rates could easily undermine China's development model. Other East Asian countries made the painful experience during the Asian crisis in 1996-7, when the sudden reversal of capital flows caused a deep economic crisis. Unstable and volatile exchange rates create uncertainty and deter investment; they lower savings and impede economic growth. In the absence of complete and perfect markets, public authorities can reduce uncertainty by intervening in the exchange market, stabilizing the pegged rate and thereby raise foreign investment (Collignon, 1999; 2003). Such strategy, however, will only work with undervalued exchange rates, because the competitive advantage will yield current account surpluses and capital inflows, which allow monetary authorities to accumulate the reserves necessary for market interventions. Hence, policies of pegging exchange rates and minimizing volatility are successful, if they lock-in competitive advantages, but they will fail for overvalued currencies as one has often witnessed in other less developed countries.

⁷ There are two names for the Chinese currency, the casual yuan and the official Renminbi (RMB). We will stick here to yuan.

⁸ See Rose, 2002 for a review of the evidence and Collignon 2003 for a theoretical model.

Figure 6. Daily Exchange Rate volatility

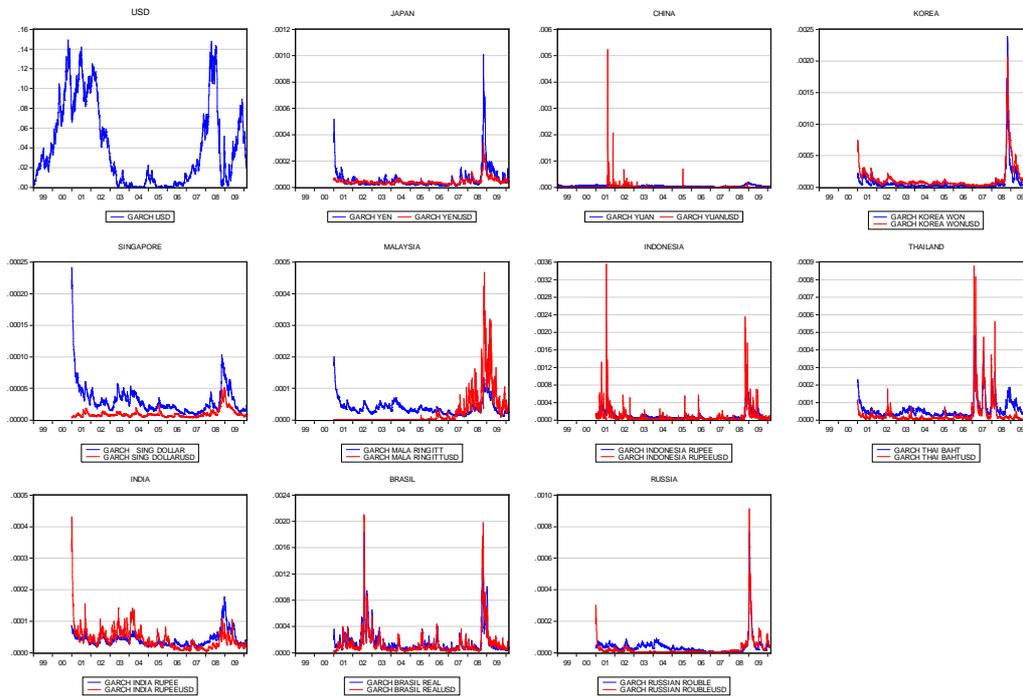


Figure 6 presents indicators for daily exchange rate volatility in Asia, and for Brazil and Russia.⁹ It appears that for most Asian economies, volatility was higher with respect to the euro (blue colour) than to the US dollar (red colour), at least until the financial crisis started in 2007. Occasional policy shifts show up as huge spikes. For example, hesitations about Chinese exchange policies in 2001 or the appreciation of the yuan in 2005 came as a surprise and generated periods of uncertainty. Similarly, Malaysia’s abandonment of the fixed peg to the USD generated large uncertainty during the financial crisis. Overall, however, volatility was higher for the euro than the dollar in most countries, in the Chinese case more than twice as much. Table 1 synthesizes this information. It confirms that with the exception of Korea and India, Asia operates on the dollar standard.¹⁰ This fact has two important implications.

⁹ The volatility was estimated by a GARCH (1,1) econometric model. It consists in estimating the unpredicted (and therefore uncertain) component in the change of the exchange rate.

¹⁰ This is also true for Russia and Brazil, although volatility is much higher for Brazil.

Table 1.

Volatility of Daily Exchange Rate					
	1.1.1999-23.1.2010				
Country	Currency	Mean	Std. Dev.	relative	lowest
				volatility €/ \$	volatility
CHINA	YUAN/EURO	0.045	0.000026	2.094	\$
	YUAN/USD	0.021	0.000155		
INDIA	RUPEE/EURO	0.041	0.000022	0.954	euro
	RUPEE/USD	0.043	0.000036		
INDONESIA	RUPEE/EURO	0.098	0.000108	1.159	\$
	RUPEE/USD	0.085	0.000192		
KOREA	WON/EURO	0.067	0.000172	0.522	euro
	WON/USD	0.129	0.000197		
MALAYSIA	RINGITT/EURO	0.038	0.000023	1.514	\$
	RINGITT/USD	0.025	0.000054		
SINGAPORE	DOLLAR/EURO	0.031	0.000024	3.157	\$
	DOLLAR/USD	0.010	0.000007		
THAILAND	BAHT/EURO	0.059	0.000055	1.873	\$
	BAHT/USD	0.031	0.000072		
JAPAN	YEN/EURO	0.061	0.000084	1.372	\$
	YEN/USD	0.044	0.000029		
RUSSIA	ROUBLE/EURO	0.038	0.000057	1.504	\$
	ROUBLE/USD	0.025	0.000065		
BRASIL	REAL/EURO	0.147	0.000176	1.050	\$
	REAL/USD	0.140	0.000209		
USA		-			
	USD	0.042	2.87E-05		

Consequences of Asia's fixed exchange rate regime

The Asian development model with fixed exchange rates has two important unintended consequences for the global economy. First, a common peg to the US Dollar renders exchange rates between East Asian currencies more stable and reduces uncertainty not only between Asia and America, but also within the East Asian region. It therefore supports regional integration in Asia. Europe has made a very similar experience under the Bretton Woods system, when fixed exchange rates to the US dollar fostered economic integration in the European Economic Community. In fact, trade within the East Asian region has already become more important than trade with the United States or Europe. See Table 2. Asia (i.e. ASEAN plus 4) trade more than a third of all exchanges with each other. The region is also becoming increasingly interconnected by capital flows, with Japan as major power house for foreign direct investment in the region. Many European companies use Japan, Korea or Taiwan to access the Chinese low wage labour force indirectly. Regional integration is therefore increasingly driving economic growth in the region and it depends on exchange stability in the region.

Economic integration is also matched by political cooperation. Asia has already a long tradition of regional cooperation, with ASEAN being the second most successful regional cooperation

arrangement after the European Union.¹¹ This cooperation is now going beyond the South East Asian grouping. Inspired by the European experience of reconciliation and human exchanges, the Japanese Prime Minister Hatoyama has declared regional cooperation a top priority for his government. He has launched the idea of creating an East Asian Community, based on a group of countries (ASEAN plus 6) that would include more than 3.2 billion people.¹²

Table 2.

Import and export shares for Asian countries (2008)										
Export destination										
Exporter	China	Japan	Korea	India	ASEAN	ASEAN+4	USA	EU12	RoW	World
China		8.1	5.2	2.2	6.7	22.2	17.7	14.7	45.4	100.0
Japan	16.0		7.6	1.0	12.2	36.8	17.8	10.3	35.2	100.0
Korea	21.7	6.7		2.1	9.7	40.1	11.0	8.5	40.3	100.0
India	5.6	2.0	2.1		9.5	19.1	11.8	16.2	52.9	100.0
ASEAN	12.4	10.3	4.1	2.8	22.9	52.6	10.9	8.8	27.7	100.0
ASEAN+4	9.1	6.5	4.7	2.0	12.2	34.5	15.0	11.7	38.7	100.0
Usa	5.5	5.1	2.7	1.4	5.0	19.7		15.5	64.8	100.0
EU12	2.5	1.3	0.7	0.7	1.6	6.8	6.5	63.9	26.7	100.0
Import source										
Importer	China	Japan	Korea	India	ASEAN	ASEAN+4	Usa	EU12	RoW	World
China			9.9	1.8	9.9	34.9	7.2	9.6	48.3	100.0
Japan	18.8		3.9	0.7	12.2	35.5	10.4	7.3	46.8	100.0
Korea	17.7	14.0		1.5	8.5	41.7	8.9	7.5	42.0	100.0
India	10.1	2.5	2.6		7.9	23.1	7.8	10.4	58.7	100.0
ASEAN	11.3	11.3	4.8	2.0	21.6	51.1	7.7	8.1	33.1	100.0
ASEAN+4	10.0	9.0	5.5	1.4	12.9	38.7	8.3	8.6	44.4	100.0
Usa	16.5	6.6	2.3	1.2	4.5	31.2		13.1	55.8	100.0
EU12	4.8	1.8	0.8	0.7	1.8	10.0	4.6	60.6	24.8	100.0

Secondly, 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 deters trade and investment

¹¹ European Commission, 2008. *Quarterly Report on the Euro Area*, Volume 7.1 (Focus – Economic and monetary integration in East Asia: Are there lessons to be learned from the European experience?)

¹² “The central idea of my “East Asian Community” initiative is based upon reconciliation and cooperation in Europe. In my initiative, I propose that countries sharing a common vision promote cooperation in various fields. This would be based on the principle of “open regional cooperation.” Through this, our region would develop a multi-layered network of functional communities. I attach the greatest importance to the promotion of concrete cooperation in a broad range of areas such as trade, investment, finance and education.” Address by Yukio Hatoyama, Prime Minister of Japan: *Japan’s New Commitment to Asia - Toward the Realization of an East Asian Community* . 15 November 2009, Singapore;

http://www.kantei.go.jp/foreign/hatoyama/statement/200911/15singapore_e.html

between Europe and Asia and isolates the two continents. Table 2 shows that the importance of the United States as an export markets exceeds that of the Euro Area by more than 25%. By contrast, imports are more balanced, in part reflecting the different quality of European exports to Asia. Thus, the American current account deficit mirrors the strong net exports from Asia. The relative stability within the dollar zone privileges trans-pacific relations. The symbiotic relation between Asia and America, which we observed above, is ultimately determined by the exchange rate regime.

These two tendencies, namely regional integration in East Asia and the exclusion of Europe, make a correction of global imbalances difficult as long as the dollar remains the privileged reference currency for Asia. Asia needs to generate current account surpluses to keep high profits and accelerated capital accumulation going. If the dollar remains the reference currency, the United States will continue to buy cheap goods from Asia. Yet, if the American external balance is to return to equilibrium, the USA 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. Such development would be a disaster for the Euro Area, and for its export-oriented member states like Germany. 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 would lose momentum and could disintegrate. However, 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

Fuzzy thinking has led European policy makers to follow Americans in pressuring China to revalue. In November 2009, President Obama went to China and asked for a revaluation of the Chinese currency. President Hu Jintao refused. Two weeks later, the European trio Barroso, Juncker, Trichet went to Beijing with the same request and got the same response. It is, however, likely that Chinese authorities will make some moderate concessions later this year. A slight appreciation would serve them diplomatically, and it could also moderate inflationary pressures, which have recently emerged in the Chinese economy. However, such adjustments will remain modest without changing the fundamental logic, which has driven the global economy for the last two decades.

A common view among Europeans and Americans is that China manipulates its currency to gain unfair trade advantages, and this is why European authorities have joined Americans in pressuring China into the appreciation of the yuan. Such request may help Americans, but it makes no sense for Europeans to echo such demands. The complaints about China’s exchange rate regime are nothing but a latent form of protectionism: firms denounce unfair competition, because they wish to keep cheap imports out of the European market; trade unions lament the loss of jobs in certain sectors, but rarely talk about the potential for job creation in others. They seem to ignore 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 is part of Europe’s leadership in the global economy. It would also

push 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 and deal with it intelligently, 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.

A different strategy is needed. A win-win strategy! Americans must switch demand from foreign to domestic production in order to reduce unemployment after the crisis, lower their current account deficit and restore trust and confidence in America's leadership. From a Chinese point of view, the continued generation of export surpluses is the foundation for their catching up process to higher living standards and it will take several decades until this will change.¹³ 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 have 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. The Lisbon Treaty offers now a new perspective. It explicitly calls for policies that "encourage the integration of all countries into the world economy" (art. 21), an aim one should keep in mind when dealing with Asia. It will be the task of the President of the European Council and the High Representative for Foreign Affairs in the European Commission to translate this objective into a coherent strategy that takes into account the euro as the second world reserve currency. Here is a five point plan of what they could do.

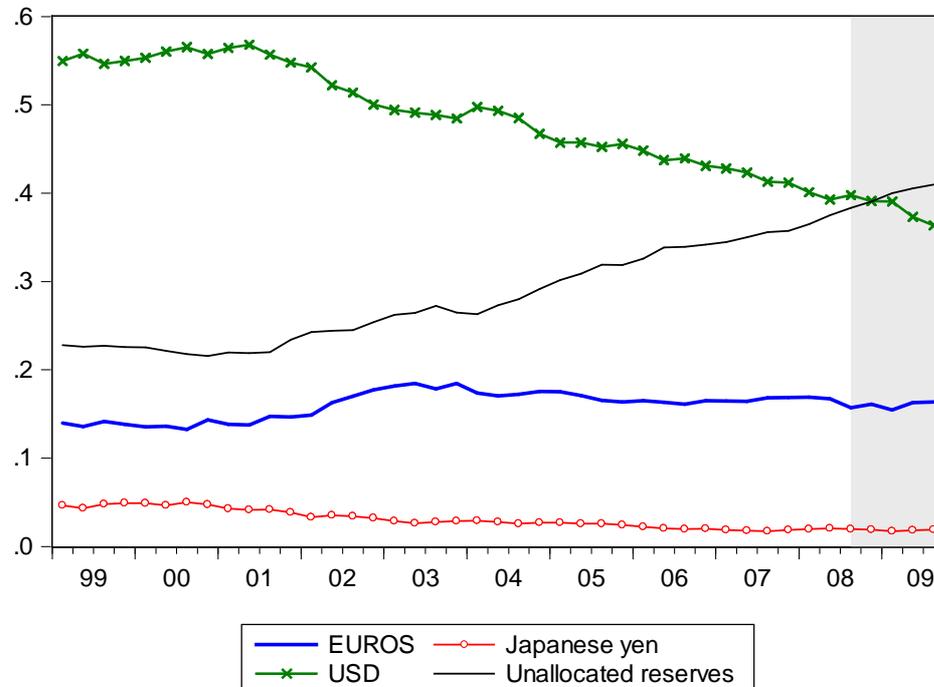
1. The first objective must be to rebalance the symbiotic relation between the United States and Asia. While Asia is to remain a net exporter for years to come, America cannot remain the consumer of last resort in the world. Hence, the European Union must take up some, but not all, of the global demand for products from Asia. The same is true for Japan, which has persistently absorbed less than it has produced at home. With this in mind, the three main players could agree on a target for each of their economies to run a current account deficit of 1% of GDP. This would reduce absorption from the USA relative to 2009 by USD 226bn, but improve demand from the Euro Area by USD 40bn and from Japan by USD 147bn. The overall impact for the rest of the world would be negative and the major burden of adjustment would be on Japan. A fairer deal would therefore set a deficit of 1.5 % 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.

¹³ To be precise: given today's per capita income of USD 6200 in China and USD 28 800 in the EU, and assuming China grows at an average rate of 7% and the European Union at 2.5%, it will take 35 years until per capita income in the two countries will be equal.

2. The redistribution of current account deficits requires a change in relative prices, i.e. in exchange rates, and also domestic policies that stimulate demand in Europe and Japan. The dollar has to depreciate relative to Asian currencies; the euro and yen need to appreciate. However, as we have discussed, exchange rate stability, i.e. low volatility, can support the redirection of trade and investment by reducing uncertainty. Such growth-supporting framework is especially warranted, if Europe is to accept an appreciation relative to Asian currencies. Several 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 the new monetary arrangement. A second option consists in pegging East Asian currencies, including the Chinese yuan, to a basket that contains large portions of Japanese yen and euros. Simultaneously the Bank of Japan and the European Central Bank would establish close cooperation with the purpose of minimizing volatility between their two currencies. This stabilizes the conditions for Japanese FDI into East Asia and the trade relations with Europe. The Japanese and European economy together represent a viable and attractive alternative to the symbiotic relation with the USA.
3. Monetary authorities in East Asian countries will gradually increase reserve holdings in euro and yen. Although there is no logical link between pegging and reserve holdings (Obstfeld and Rogoff, 2009), liquidity requirements for market interventions might increase demand for the 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 that moment, the mobilization of reserves to defend the euro-peg would be more costly. Prudent reserve management therefore requires keeping reserves in the pegged currency. Over time, this could lead to a more balanced system of reserve currencies that offers diversification benefits at the world scale. No doubt, diversification tendencies are already at work in reserve management, with the role of the US dollar diminishing, but neither the euro nor the yen have increased their shares (see Figure 7). On the other hand, an increased role for their currencies in international reserve management would deepen bond markets in the Euro Area and in Japan and structurally lower long term interest rates. This could stimulate economic growth in the anchor countries and this is especially useful when the currency appreciation might dampen export demand.

Figure 7.

Foreign Exchange Reserve Holdings Share of total reserves



Source: Bloomberg

4. Strategic pegging to a basket should not be confused with the choice of the best reserve currency. No doubt, the dominance of the US dollar as the internationally accepted reserve asset has contributed to the financial crisis, because excess liquidity in the United States has swamped the rest of the world.¹⁴ The Triffin Dilemma has described the contradiction between a reserve currency country's national interests and international obligations. For this reason, Keynes had proposed at Bretton Woods the creation of an international or supra-sovereign reserve asset. The political balance of power at the time did not allow the realisation of this plan, but its intellectual soundness remains. After the financial crisis, times may become more favourable for a reform of the global reserve regime. However, there is no point of swapping the Triffin Dilemma from the dollar to the euro. The way ahead must be an international reserve currency. The euro-yen basket could contribute to this development. In this context, the idea of the Chinese central bank governor Zhou Xiaohuan (2009) is of interest. He has suggested actively promoting the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping. This could be useful for more balanced reserve management. Nevertheless, using SDRs today as the

¹⁴ 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 the asset inflation in the 2000s, and not consumer price inflation.

reference for exchange pegging is not recommendable. The composition of SDRs, even if expanded as proposed by Zhou, would not allow the competitive exchange rate strategy, which has been the basis of China's success.¹⁵ However, as the catch-up growth process advances in China and Asia, the basket could be gradually broadened to include other currencies, until it will effectively coincide with a reformed version of SDRs.

5. Finally, monetary cooperation between Europe and Asia must find an institutional foundation. Organizing 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 Euro Area, Japan, China and USA, a G4 within the G20, that would assume a pilot function for working out details of the reform. On the other hand, the practical and more bilateral issues for monetary cooperation between Europe and East Asia, including China and Japan, find an appropriate forum in ASEM (the *Asia-Europe Meeting*). Coordination between Asian central banks and the ECB would also have to be strengthened.

Who's interest is it, anyhow?

The reform proposal advanced in this paper may appear to benefit exclusively Asia that will speed ahead with accelerated growth, while Europe is lagging behind, afraid of its own weaknesses, “disloyal” competition, and “social dumping”. Such conclusion would be misleading.

First of all, exports depend not only on the relative prices, but also on demand from importing economies. Table 3 shows the results of estimating the elasticities of imports from Europe into China as a function of relative prices and Chinese growth; it also measures trade in the opposite direction. These estimates indicate that trade with China responds significantly more strongly to changes in economic growth than to changes in the nominal exchange rate. A 10% increase in China's growth rate (approximately equivalent to a 1 percentage point increase in GDP) would raise bilateral exports by 28.8%, while a 10% appreciation of the euro against the yuan lowers exports by 6.7%. 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 to pursue their dynamic growth.

¹⁵ For the underlying theoretical argument why basket pegs are suboptimal compared to straight pegs to large currencies, see Collignon, 1999.

Table 3.

Import and Export Elasticities for China and Europe					
	Imports			Exports	
	Coeff	t-Stat		Coeff	t-Stat
c	0.079	1.476		0.061	0.693
trend	-0.001	-0.500		-0.005	-4.202
GDP growth E	6.604	12.172			
GDP growth China				2.885	2.381
Yuan/euro	0.649	5.683		-0.676	-5.380
R-squared	0.800			0.514	
Adjusted R-squared	0.774			0.455	
S.E. of regression	0.077			0.088	
Sum squared resid	0.228			0.316	
Log likelihood	53.327			50.868	

Secondly, the industrial tissue will change across the world in any case, and this development is welfare augmenting at the global scale if managed properly. For decades Europeans have claimed that they wish poorer countries to develop; they must not turn against those who are successful, now that it is happening. Nevertheless, the distribution of welfare gains matter. Europeans, too, will benefit from more efficiently allocated resources, and wage earners would see their purchasing power improved. This is, however, no consolidation for those who are losing their jobs. Supporting Asia's development is politically only defensible, if it would generate more and better jobs sufficient to compensate for previous job losses. Yet, this exactly what our reform proposal aims to achieve. Job creation depends on economic growth.¹⁶ The question is, whether a *moderate* appreciation in the euro's real exchange would on balance destroy more jobs than economic growth from 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 slow-down 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. This is also in the best tradition of Jean Monnet's ideals for the European Union.

¹⁶ New jobs are created when GDP growth exceeds the increases of labour productivity. See Collignon, 2003.

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