Dialogue on Globalization

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How to Reform the International Financial System? A Chinese Perspective

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1. The defects of the international financial system are key factors causing the financial crisis

The global financial tsunami triggered by the US sub-prime mortgage crisis has pushed the world economy into recession. The crisis has not been caused by a mere mistake of US Federal Reserve monetary policy, nor by the excessive creation of financial derivatives that led to a distortion of financial risk assessment. It was caused by multiple factors that induced chain disequilibrium, leading to a sudden melt-down of the economy. Among all the factors, notorious current account deficits in the United States bred by excessive liquidity played a very important role. Again, this problem is directly linked with the defects of the international financial system.

De facto, the US Dollar standard in the international monetary system enables the United States to irresponsibly neglect its current account deficit and the foreign exchange rate for its currency. As long as there is no replacement for the US Dollar as the international key currency, the United States can use the Dollar to import cheap goods and services. By doing so, the US was able to use an inflationary monetary policy for its own goods while neglecting the asset bubble. However, excessive debt in the US, both public and private, eventually lead to adjustment. When commodity prices surged, and other product and service prices rose, the inflationary monetary policy had to change. Once the monetary policy was adjusted, the financial market responded, triggering the subprime loan crisis. Subsequently, the entire world had to follow the US in stimulating the economy with inflationary monetary and fiscal policies, starting a new cycle of bubble creation. In this process, the US could reduce its debt relative to GDP, while the rest of the world had to suffer in sharing the costs. This is why the international community reached consensus on the urgent need to reform the international financial system.

2. Priorities for a reform of the international financial system?

Obviously, the G20 have not reached consensus on key issues. The US tried to focus exclusively on stimulating recovery and sought to avoid any major reform that might undermine the Dollar standard. Although the US accepted a compromise on an IMF fund increase and SDR expansion, and even proposed to adjust voting shares between Asian and European countries, Washington is not likely to accept any reform that challenges the dominance of the US Dollar. Both G20 summits in November in Washington and in April in London prioritized economic recovery as the first priority for policy recommendations. Reform of the international financial system seemed to be of secondary importance. Every country is utilizing inflationary monetary and fiscal policies to stimulate the economy. The lessons on the cause of the financial crisis seemed forgotten. Maybe everybody hopes that nothing is going to change and we can continue to live happily with global imbalances. However, changes have already taken place. Sooner or later the asset bubble will expand, well before the real economy starts to recover.

If we hope to avoid such an international financial crisis from happening again, we ought to start to reform the international financial system. At the second G20 London Summit, leaders reached some consensus in this regard. IMF financial resources will be increased to US$ 500 billion. SDRs will be expand to 250 billion. Surveillance of the financial markets will be strengthened. However, key issues such as international key currency stability, exchange rate regimes, an adjustment mechanism for imbalances of international payments have not really been touched upon.

The lack of institutional arrangements and stability mechanisms for key currencies, such as the US Dollar, the Euro and the Japanese Yen is at the root of international financial turbulences. After the collapse of the Bretton Woods System, the system of international currencies diversified. On the surface, this overcame the problem of the Triffen Dilemma. But we believe that this defuses the problem rather than solving it. The essence of the Triffen Dilemma is that a national currency acts at the same time as an international currency, and this is the state of affairs today. After the Euro came onto the scene, dramatic fluctuations among the Dollar, the Euro and the Japanese Yen become the principal factor for instability of the international financial system. This is why many developing countries still maintain their currency peg to the Dollar. Today, we are thus highly sensitive to US current account deficits and the US Dollar exchange rate trend. The core reason lies here too.

We need to work more vigorously to gain consensus on the key issues of reform. I believe that an exchange rate stability mechanism among major currencies is the foundation for a stable international financial system. You could name many other factors that caused the shock to the international financial system, but dramatic fluctuations of the US Dollar exchange rate against major currencies is the principal factor. Many financial crises have direct links to the shock of exchange rate fluctuations. Mainstream economic theory believed that floating exchange rates would help to correct economic disequilibria, especially correcting imbalances in international accounts. However, in the real market, short term speculative capital flows dominated the exchange rate fluctuations and distorted exchange rate functions that may help to correct economic disequilibria. In many cases, dramatic fluctuations of exchange rates instead cause problems. Another important point is that dramatic fluctuations in currency exchange rates discourage real economic activities and increase the cost of international trade and investment. If we can establish a certain kind of coordination among major currency exchange rates, we will then create a kind of discipline, which could place some responsibility on key international currencies. This is not easily accepted by the US government. So we should promote diversification of international currencies and enhance competition. At the same time, we need to enhance the function of SDRs as an international reserve currency. Theoretically speaking, a non-sovereign currency used as an international currency is the ultimate way to solve the Triffin Dilemma.

The Bretton Woods System laid the foundation for the Dollar-dominated international system after World War II. Although the Bretton Woods System collapsed during the early 1970s, the US Dollar remained as the principal international currency for many reasons. Even without the responsibility of maintaining value stability, namely the stability of the US Dollar exchange rate, backed by the US monetary authority, the US Dollar continued to enjoy a hegemonic position in the international financial system. All of these reasons can be summed up in a word. That is, that there is no competition that could provide the same alternative function of an international currency. However, this situation should not be allowed to last any longer without responsibility being assumed by the US government. We now have the Euro and several other international currencies. None of them may replace US Dollar in the near future. If some day the Euro could replace the Dollar, current problems would remain as long as key international currency issuers bear no responsibility. Therefore, the first step for us is to enhance fair competition among international currencies. When the diversification of international reserve currencies reaches a level that ensures that no one enjoys a dominant position or no one would refuse to take responsibility in the international financial system, we will be ready to establish a global exchange rate stabilizing mechanism, and a more stable international financial system will emerge. For now we should encourage the expansion of SDRs and other currency internationalization and create more competition in the international financial system.

We are not advocating any repudiation of the US Dollar as the key international currency. We are actually accepting the fact that US Dollar will still be the key currency. What we propose is that the key currency should bear responsibility while it enjoys seigniorage.

3. The importance of an adjustment mechanism for imbalances in international payments

The other important aspect of reform of the international financial system is an adjustment mechanism for imbalances in international payments, again linked with the concept of responsibility. The current system abandoned the principle of promoting and encouraging the balance of international accounts. In practice, imbalances of international payments are offset by shot-term capital flows and floating exchange rate adjustments. Therefore, the international currency issuing country, the US, makes full use of its hegemonic position in the international system, carelessly expanding its current account deficit. It relies basically on capital inflows to balance the current account deficit while being reluctant to tighten the money supply and raise the national savings ratio. On the other hand, many East Asian countries have been passively maintaining their international accounts in surplus for fear of falling, again, into the trap of an Asian financial crisis. Some other deficit-prone developing countries have also learned from the US and rely only on short-term capital inflows to maintain their balance. As a result, the global imbalance is growing to the historically high levels that breed international financial risk. Disorder in the mechanisms of adjustment of balance of international payments represents in key ways the contradiction between globalization and the current international financial system. It distorts the signals of interest rates, exchange rates etc. that are important for resource allocation, misdirects international capital movements and breeds financial instability and turbulences.

Under the Bretton Woods System, when a country ran a deficit that affected its fixed exchange rate, pegged to the US Dollar, the deficit country was obliged to adjust its deficit with the help of

IMF financial resources. Typically, with financial resources from the IMF, a course of tightening monetary and fiscal policies was to be adopted. Although the fixed exchange rate system collapsed, the basic principles of the system embodied in the IMF Agreement still remain in place, as the Fund is being preserved. The principle of the IMF Agreement that the deficit country is obliged to adjust applies to every member country, including the US. The only difference is that the US does not need IMF finance to assist in adjustment. The responsibility to adjust current account imbalances seemed, though, to have been reversed as the US pushed surplus countries to adjust by appreciating their currencies. However, exchange rate appreciation of surplus country currencies has not proven to be effectively in adjusting current account imbalances. Historical Deutsche Mark and Japanese Yen appreciations, and more recent Chinese RMB appreciations, all show that exchange rate appreciations of surplus countries were unable to solve the adjustment problem. In the real world, it is the cross-border flow of increasingly large amounts of short term capital that helps ease the imbalance adjustment problem. However, these capital flows have caused many other problems, namely excessive speculation and distortions that create instabilities in the international financial market. Thus, we have seen long-lasting global imbalances and eventually the outbreak of global financial crisis.

Without a clear obligation based on an imbalance adjustment mechanism, we will not have a stable international financial system. This is the key issue on which we need to have consensus at the next G20 summit. But the pity is that China is being blamed for accumulating an increasing surplus in its balance of payments. There are many structural reasons, including the impact of globalization for China's increasing surplus, as MNCs account for 58% of China's exports and the processing trade dominates China's international trade. China does need to import more and invest more abroad. China has no intention to maintain such big surpluses and foreign exchange reserves. Actually Chinese imports in the past 5 years have grown quite rapidly. However, China is passively accumulating foreign exchange reserves at increasing cost. The problem is that what China wants to import is more or less controlled by the US, and by the EU as well. Therefore, the first step to take is to help China to import more technology-intensive products from the developed countries to reduce the scale of the imbalance. Nonetheless, this does not imply that the principal obligation to adjust in the global system should be shifted from deficit country to surplus country.

4. Capital controls and their role in stabilizing the international financial market

The London G20 summit agreed to enhance supervision and regulation of international capital flows. However, how to implement this sort of supervision and regulation is as yet unclear. I believe that capital account liberalization does not mean freedom from supervision and regulation. Every country needs to maintain certain capital account controls in line with its economic and market conditions.

In the today's world, the free flow of capital seemed to be a politically correct norm that could not be challenged. Free flow advocates believed that without the free flow of capital, we would not have correct price signals and efficient allocation of financial resources. However, in the real world, we also see frequent distortions of capital flows and excessive speculation and even manipulation in the financial market. This is of course neither good for efficient resource allocation, nor helping to adjust the imbalance as distortions in capital flows often give the wrong signal for exchange rate fluctuations. What is more, exchange rates nowadays are increasingly influenced by pure financial market flows instead of real economic fundamentals. Capital flows are affected more by people's psychological reflections and expectations. In a globalized financial market, the contagion effect is increasing rapidly. Herd behavior could engender a sudden shock on an economy originally healthy, infecting this economy with the other market's virus. Thus a chain reaction of capital flows would take place, with one crisis following another. Disorder of capital flows not only provides the condition for this kind of effect, it also worsens the degree of shock to the foreign exchange markets of developing countries. Thus, creating some international standard for cross-border portfolio capital flows and allowing developing countries to maintain certain control measures on their capital accounts would help to stabilize the international financial market. The G20 should clearly understand this principal, and not confuse this with protectionism.

5. The role of regional monetary cooperation in international financial system reform

The global financial crisis has made regional monetary cooperation more attractive. For instance, East Asian monetary and financial cooperation was launched during the East Asian financial crisis that broke out in the late 1990s. Since then, East Asian countries have made a lot of progress in monetary and financial cooperation under the ASEAN +3 framework. After the US financial crisis contagion spread into other parts of the world, East Asian countries believed they needed to deepen their regional monetary cooperation by announcing their intention to upgrade the Chiang Mai Swap Agreement into a common reserve pool. Other measures of cooperation are under discussion.

Will regional cooperation help to stabilize the global financial system? The answer is yes. For instance, when sudden outflows of capital induced by the US financial crisis led to a sharp depreciation of the won in the market, the Korean government needed the Chiang Mai Swap Agreement to provide liquidity help. However, it was not effective enough, and Korea had to come to the US and sign a US $ 30 billion bilateral swap agreement with the US government. If there is an Asian Monetary Fund in place that could help member countries when they need it, this will certain create market confidence and ease speculation.

For East Asian countries, regional monetary cooperation has an additional function. As a region, East Asia has achieved the fastest economic growth and has the highest savings rate in the world. East Asia's problem is that its financial system is weak. The region on the one hand has injected huge financial resources into the US financial market, while on the other hand it has attracted huge amounts of FDI from multinational corporations. In addition, the region is highly dependent on traditional banking, and its banking system has accumulated huge risks. Its financial markets and financial instruments are still underdeveloped. If East Asia could reduce the risk and develop the financial system through cooperation, the East Asian Economy would become a lot stronger and reduce its dependency on the US financial system.

Foreign exchange rate fluctuations and external shocks have frequently made East Asian countries a net loser in the international financial market. The US has been trying to push East Asian countries to appreciate their currencies, and China was only one of them. This kind of adjustment pressure is not in the interest of countries in the region. While in times of crisis a sudden outflow of capital would occur, with some countries facing sharp depreciation pressure, this would also affect the economies concerned. The US Dollar would become again the most important means of intervention in the market. As a result, countries in the region would passively hold more Dollars as a reserve currency. This kind of external pressure has put East Asian countries in a dilemma. Therefore, enhancing monetary and financial cooperation to avoid external shocks and instability is imperatively important. If we could achieve regional financial stability through regional cooperation, this would contribute to global stability as well.

Last but not least, East Asia is the biggest holder of foreign exchange reserves, with more than US $ 3 trillion, which is 50% of the whole world's reserves. A big proportion of these reserves is held in US Dollars. This is a precious resource that the region could make full use of for its own economic development. However, the capital was recycled back to the US and used by US financial institutions. East Asia bore the pure risk of exchange rate depreciation and inflation of the US Dollar. As a result, rapid contraction of the value of US assets during the crisis led to huge losses of value for East Asia. If we can cooperate to avoid this kind of passiveness and speak with one voice in the international arena, we could reduce our risk by taking common action and at the same time promoting reform of the international system.

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