Rebalancing the Global Economy

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The subprime crisis, which started in the United States, has seriously affected the health of both the advanced and the emerging market economies. But the impact of the crisis on the two groups of states is likely to be asymmetric. The advanced economies have seen a drastic reduction in their share of world output. With their higher growth rates, the emerging market economies will experience an important increase in their economic significance. Moreover, the crisis has uncovered weaknesses in the current international economic order dominated by the US dollar and may even lead to a decline in the economic power of the United States. In this sense, the subprime crisis is likely to have a redistributive effect on the current international power regime.

This is not the first time that the United States' economy has heard alarm bells ringing. After World War II, the United States remained at the helm of the world economy for decades. But in the late 1980s, with the rise of Japan, it was widely believed that the "Anglo-Saxon" capitalist model based on short-termist behaviour in speculative stock markets would be defeated by a Japanese-German model, centred around a banking system with a long-term investment vision. Charles Kindleberger even discussed the possibility of Japan replacing the US as the leading economic power. But such a scenario did not come about. Instead, Japan experienced its "lost decade". And, from the second half of the 1990s until the start of the subprime crisis in 2007, the United States experienced the "great moderation", an unprecedented period of sustained economic stability, based on the "new economy". The United States' ability to manage change in the past has demonstrated, to an extent, the highly flexible nature of its institutions, in particular their capacity for "error-correction". On the basis of this record, many people argue that the United States' financial market leadership, and the associated global economic imbalances, will remain the dominant characteristic of the international economic order for at least another 10 or 20 years. Unfortunately, on this occasion, this may just be wishful thinking.

An exorbitant privilege

The analysis of power shifts among nations remains an enduring interest of economic historians. Their work offers one key insight: economic powers tend to experience three specific phases of development. Initially, their economy relies on commerce and manufacturing, two important wealth-creating industries which nevertheless entail risks and uncertainties. Next, they place greater emphasis on financial markets, the exchange of assets that represent wealth. After that, they proceed to pure rentier status. From this perspective, it is easy to understand why proposals to reform the international monetary and financial system are of such direct concern to the United States, which relies heavily on its dominance and comparative advantage in financial markets.

Currently, the financial sector in the US contributes to about 20% of national output, with the manufacturing sector contributing to only 10%. Furthermore, the United States' national economy has become increasingly dependent on imports of foreign goods and foreign capital, which have not been used for productive investment but have helped sustain both high government spending and excessive mass consumption. This has only been possible because of the unique and biased position of the dollar as the world's key reserve currency, which underscores the United States' right of seigniorage: the privilege of deriving profit from the generalised use of the dollar as international reserve, invoice, and vehicle currency, which in turn has allowed the United States to accumulate large amounts of debt in its own currency.

But can the United States continue enjoying such an "exorbitant privilege" forever? The United States' right of seignorage was critised as far back as the 1960s, not least by the French political establishment. By encouraging a culture of mass consumption and excessive government spending, it is also widely seen as the root cause of today's global economic imbalances. And these global imbalances were in turn responsible for the subprime crisis: the sharp decline in property prices and exposure of subprime mortgages only served to trigger the crisis. This is why so many people are convinced that the only way to avoid a repeat of the crisis, which has had such profound effects around the world, is to resolve the issue of global imbalances.

Carrots and sticks

There is broad international consensus about the need to manage global economic imbalances, which have been increasing since the 1990s. However, the causes of the global imbalances, which affect current account and exchange rate patterns, remain in dispute. This explains why there is as yet no agreement as to the steps needed to rebalance the global economy.

One approach focuses on exchange rate patterns and points the finger at China and other emerging countries. According to this reading, the onus lies on the emerging market economies, who must ensure the appreciation of their currencies against the US dollar. This approach is supported by the United States, and is based on the idea of a short-term weakening of the dollar (which plays a passive role in this process), even though in the long-term the US dollar would be strengthened.

Emerging economies that reject this approach are frequently labelled "currency manipulators". And yet, how reasonable and feasible is this approach? Let us reflect on this question from another perspective, namely, the possibility that the current dollar-based international financial system may actually be the source of global imbalances. This is the perspective taken by China and other emerging economies, who argue that we need a new global reserve currency to replace the US dollar. Adopting a new global reserve currency would result in a reduction in US dollar reserve holdings. It would also give other economies an incentive to move away from the US dollar in their own currency reserves. As a result, their local currency would naturally appreciate against the dollar and facilitate the unwinding of the global imbalances.

The two approaches would have the same short-term effects, but rely on totally different mechanisms with different long-term results. The first approach tries to maintain the current international financial system with the dollar remaining as the dominant reserve currency. The second approach attempts to reform the system by replacing the US dollar as the dominant reserve currency. Most importantly, in the first case, other countries are forced to appreciate their currency, while in the second case they have the incentive to diversify their currency reserves with the appreciation of their currencies as the natural byproduct. An added benefit would be that, as a result of the dollar's reduced global significance, the United States would no longer be able to abuse its "exorbitant privilege" through overconsumption, thus contributing to a rebalancing of the US current account deficit.

A rebalancing process is also needed in relation to the decision-making structures of the international financial system. According to IMF data, the emerging market economies were responsible for about 36% of world output in the 1980s; by 2008, their share of global GDP had risen to 45% based on purchasing power parity. Moreover, the IMF estimates that the output share of emerging market economies will surpass that of the advanced economies by 2014. This shift in the distribution of global economic power has not yet been reflected in the rules, norms, and governance structures which make up the international economic order. This is why the emerging economies are demanding a greater voice in the IMF and World Bank and in other international organisations. It is also the reason why they advocate a change in US consumption patterns, and monitoring of US economic policies by international supervisory bodies.

The way forward

There is no doubt that the new power dynamics represent an important challenge for the United States. In his book entitled "World Economic Primacy: 1500 to 1990", Charles Kindleberger examines the factors that allow one country to achieve economic superiority over other countries and what it is that makes a one-time global leader decline. He argues that two combined factors typically lead to the decline of a superpower. The first is advances in knowledge and technology, which erode the value of old comparative advantages. (For example, once the Portuguese penetrated the Indian Ocean and brought goods directly from the east, the role of the Venetians and Genoese as intermediaries was greatly diminished.) The second and more important factor is the incapacity and unwillingness of a nation to respond to changing circumstances. In the present case, the United States still enjoys a comparative advantage in international finance. The key to maintaining its success therefore depends on the attitude which the United States adopts towards the changing world around it.

The United States should accept the fact that the emerging powers are here to stay, and should invite them to sit around the table to set global rules together. The decision by the IMF and World Bank to give more voting rights and voice to the emerging economies is therefore an encouraging sign. However, a rebalancing of decision-making power within the international financial institutions will necessarily take time and involve conflicts of interest. It will require tolerance on the part of the advanced economies and patience on the part of the emerging markets. But that does not mean the latter should just wait and see. Rome was not built overnight, and both the advanced and emerging economies have to take substantive actions to avoid repeating past mistakes. Let us not forget that economists had already warned of the dangers of the dollar-dominated system during the Asian financial crisis. Ten years on, the system has hardly changed.

During the G20 summit and IMF and World Bank meetings this spring there were encouraging signs of action, albeit small and gradual ones. One thing is clear: the change will come about through incremental reforms, not a revolution. At first glance, reform and recovery may seem contradictory since reforms usually take a relatively long time while promoting global economic recovery is an urgent priority. But in fact, if correctly tuned and coordinated, the processes of reform and recovery could reinforce each other. Indeed, reform of the international financial system may not only ensure the global recovery but also speed it up. Without reforming the IMF, for example, it is difficult to see how emerging economies will agree to provide increased funding for its activities. Only through reform of the international monetary and financial system, will advanced and emerging economies be able to take joint action to tackle the ongoing crisis, thus bringing about a more harmonious international economic order.

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