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Emerging Market Economies, Global Trade Imbalances, and the U.S. Dollar

An Interview with Pieter Bottelier

By Graham Webster
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International financial institutions and leaders from key countries met in mid-April to discuss the world economy. Following these meetings, NBR spoke with Pieter Bottelier of Johns Hopkins University's School of Advanced International Studies. A 25-year veteran of the World Bank, Bottelier explains where the tensions lie in the U.S. relationship with emerging market economies, and what we might miss reading only the U.S. media. This interview was published on the NBR website: http://www.nbr.org.

In mid-April, the IMF, World Bank, and G-20 finance ministers held important meetings. How can we understand the significance of these meetings for developing economies in Asia and elsewhere?

First, it bears mentioning that simultaneously there was an important meeting of the five heads of state of the BRICS countries—Brazil, Russia, India, China, and South Africa. Although the communiqué that came out of the Hainan meeting is very much concerned with financial and currency issues, the BRICS countries seem to have become a political grouping also. These five emerging market economies agreed to limit the use of the U.S. dollar for the settlement of trade transactions between them, instead relying as much as possible on their national currencies. The broader G-20 finance ministers meeting and the IMF/World Bank spring meeting in Washington were important, but failed to solve the major international financial and currency issues that are facing us. I was disappointed that China attacked Secretary Geithner's proposal, made in Seoul in November last year, to agree on a limit (he proposed 4% of GDP) on current account deficits. Geithner's proposal was sound in principle; it was designed, in part, to distract attention from the unproductive debate on nominal exchange rates.

The U.S. dollar is used all over the world for a variety of purposes. How is this connected to one major issue discussed at the various meetings, the question of global imbalances?

The issue of global current account imbalances came to prominence five or six years ago when it was feared that persistent imbalances, with the United States as a reserve currency country with large deficits, would eventually lead to a dollar crisis. Instead of a currency crisis, we had the financial crisis that started in the U.S. financial sector and became a global crisis after the Lehman collapse in September 2008. The connection between global imbalances and the crisis that actually happened was then thought to lie in the depressing effect of China's surpluses invested in U.S. Treasuries and similar dollar instruments. This, the argument went, held down medium- and long-term yields on U.S. capital markets, and encouraged efforts by Wall Street to raise yields artificially through all sorts of fancy financial innovations. This position was advanced by Adair Turner, chairman of the Financial Services Authority in London, and other prominent economists who believed, with Ben Bernanke, that U.S. current account deficits were the result of a deliberate "savings glut" in Asia, especially in China, driven by that country's exchange rate policy. I never believed much in that theory. I thought and still think that U.S. current account deficits were primarily the result of domestic U.S. policies.

There are still people who stress the role that external factors played in the crisis, but the overriding opinion now is that, though global imbalances may have facilitated the crisis, 90% of the responsibility must be assigned to mismanagement of the U.S. financial sector by both regulators and market participants (especially in the mortgage sector).

One other way investors look for higher yields is by moving money to emerging market economies. This so-called "hot money" is another major issue in international financial discussions. How does this form of investment create problems for developing economies?

There is widespread unhappiness, especially in emerging market economies (e.g. Brazil, China and Turkey), with the current international financial system and the way it has evolved since the United States abandoned the gold standard in 1971. This enabled the U.S. to increase the dollar supply by printing money without the external constraints that the gold standard imposed. Brazil is perhaps the most outspoken critic of current U.S. monetary policy, especially QE2. Brazil has a rapidly growing economy with higher returns on investment than the United States and, unlike China, a convertible or floating currency. This means that investors who can lay their hands on cheap U.S. dollars, which have essentially become a carry-trade currency, will try to invest in countries like Brazil in order to earn higher yields, thereby driving up the exchange rate of those countries, reducing their international competiveness, and possibly driving up inflation. That's why those countries are determined to change the international financial system if they can. They would like to create a system based on a currency that is not the national currency of any country (as in the case of the U.S. dollar), perhaps a synthetic currency such as a modified IMF special drawing right (SDR) as proposed by China's central bank governor Zhou Xiaochuan in 2009.

Of course, the Chinese currency's link to the U.S. dollar is another perennial issue in global financial talks, especially from the U.S. perspective. Are we moving in a direction of greater understanding on this issue?

Although U.S. complaints about China's undervalued exchange rate are in my view well-founded, there are some angles to this issue that are conveniently being overlooked in the United States. When, how, and for what reasons did the Chinese currency become undervalued? The answer to that question is important if you want to understand China's perspective on this controversial issue. With the support of the East and Southeast Asian region and the United States, China fixed its exchange rate tightly to the dollar in late 1997, after the collapse of the South Korean economy.

For more than seven years, there was no international complaint about China's exchange rate policy. Then suddenly objections came from various sources—Japan, Europe, the United States—that China was unfairly subsidizing its exporters by maintaining an undervalued currency. The question as to how China's fixed exchange rate became undervalued around 2003–04 was left unanswered. China and the U.S. have different perspectives on this issue, and that is one of the sources of tension in the bilateral relationship.

China feels that U.S. macroeconomic policies, essentially the Bush tax cuts and Greenspan's monetary policy of the early 2000s, had more to do with the explosion of China's trade surplus with the United States than anything China did. Basically, China, Brazil, and many other countries don't believe that the United States, as custodian of the world's principal reserve currency, can reconcile domestic monetary policies driven by economic and political needs in the United States with the need for a stable international financial system. That's why they want to change the system.

Graham Webster is an Intern at the National Bureau of Asian Research. He is also a Ph.D. student in political science at the University of Washington.