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Session 4: Restoring Global Financial Stability: The Asia Pacific's Essential Role
May 12, 2009

SOOGIL YOUNG, President, National Strategy Institute of Korea: It is my great honor to be chairing this session. In session one, we discussed how the stimulus measures are likely to have masked or suppressed the need for institutional and structural reforms. As a result, the recovery may not be sustained.

In order to avoid such an outcome, the governments in the Asia-Pacific region must do whatever is needed to restore global financial stability. But then the question is, what should the Asia-Pacific countries do toward that end?

This question is the theme for this session. We have three of the most distinguished and the most qualified panelists to address this question. They are Dr. Fred Bergsten, director of the Peterson Institute for International Economics; Prof. Yung Chul Park of Korea; and Dr. Masahiro Kawai, Dean of the Asian Development Bank Institute in Tokyo. We were supposed to have a Chinese participant. He is not be able to join us, but he did provide a short paper.

Amb. Soogil Young, President, National Strategy Institute of Korea

Earlier, I asked the speakers to address the following questions:

(1) What would be your priority agenda for the restoration of global financial stability?;

(2) What is the role of the Asia-Pacific in their effort to restore global financial stability?;

(3) What would be the role of China, in particular, and what for the others?;

(4) What are the prospects for restoring global financial stability? What, if any, are the main obstacles as well as the prospects for overcoming them?; and

(5) How should we organize the necessary international efforts? How is the necessary political leadership to be provided and maintained? Should the U.S. play a particular role? I now invite Dr. Bergsten to speak.

C. FRED BERGSTEN, Director, Peterson Institute for International Economics: Soogil, thank you very much. I would assure you right at the start that your effort to create a conflict between our missing Chinese panelist and me would not have worked.

As some of you know, I've been actively proposing for a few years the creation of a China-United States "G2" to steer the world economic system and hopefully create a more stable world. The Chinese panelist simply gave me his voice today to speak for both the United States and China. So you can assume that everything I say is agreed by Beijing and will be pursued harmoniously and in full cooperation in the interest of global economic and financial stability.

> *It is critically important to avoid a renewal and certainly any future increase in the big global imbalances*

Avoid Global Imbalances

You especially will believe that when you hear my first point: in order to to achieve and maintain financial stability beyond the crisis, it is essential to attack the global imbalances. It is critically important to avoid a renewal and certainly any future increase in the big global imbalances.

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It is certainly true that China and the other surplus countries did not force the United States to make bad subprime loans, over-leverage our financial system, and under-price risk. However, that huge influx of foreign capital, coming primarily from China but also from Japan and other Asian countries, was clearly a major factor in creating the easy monetary conditions that, at a minimum, facilitated the crisis and, I would submit, provided great incentives to take actions that actually caused the crisis.

Interest rates were much lower than traditionally the case, thereby promoting over-leveraging. Under-pricing of risk was certainly promoted. Lax monetary policy and regulatory policy was abetted if not overtly encouraged. And so as we draw lessons from the crisis for the longer-run management of the world economy, I would think one of the very top lessons must be to avoid imbalances of this type in the future.

Now that, of course, puts the finger directly on the Asia-Pacific region, and within it, more precisely on the United States and China. You may not realize this but in 2009, the level of China's global current account surplus will be almost as large as America's global current account deficit. Both will come in about $400 billion, which is a truly remarkable catalyzation of China's role as the big surplus country as well as America's role as the big deficit country.

Global External Positions

So, if we are going to attack the global imbalances, we must attack simultaneously the U.S. current account deficit and China's global current account surplus. Notice I am making no reference —repeat, no reference—to the bilateral balance between the United States and China. I regard that as irrelevant. I'm talking about the global external position of the two countries, which remarkably are about equal in dollar terms this year.

China's global current account surplus rose by 50 percent in the first quarter of this year over the first quarter of last year. China's global current account surplus now accounts for about 70 percent of all current account surpluses by all surplus countries in the world combined. In short, it is now much more clearly a problem for China as well as a problem for the United States.

Alternative Growth Strategies

The long-term implication, of course, is that both countries—the deficit Americans and the surplus Chinese—need to adopt alternative growth strategies that will enable them to achieve resumed and hopefully sustained growth on a different model.

The United States simply cannot consume everything and save nothing as it has been doing in recent years, both at the household level and at the governmental level. The United States has to raise its national savings rate, consume less, and invest more. Ideally, because the United States is still the biggest deficit and debtor country, it should be achieving export-led growth for the foreseeable future.

Domestic demand had stopped growing in the United States by the middle of 2007. However, all through 2008, the U.S. economy kept growing, at least modestly, because its trade balance was improving. U.S. competitiveness improved sharply because of the large decline in the value of the dollar.

The cessation of domestic-demand growth, which was forced by the big external imbalance, permitted the United States to improve its external position and keep output growing even as domestic absorption had leveled off or even declined. The United States needs to maintain the reformed structure of growth that appeared for a while last year as it comes out of the crisis and moves forward in order to avoid undermining the global recovery.

Dr. C. Fred Bergsten, Director, Peterson Institute for International Economics

Of course, it takes two to tango. Deficit countries cannot eliminate their deficits unless surplus countries eliminate their surpluses. It is a zero-sum game, and so that particular algebra has to add up.

I know I'm picking excessively on China. It's not the only surplus country, but it is by far the most dramatic surplus country. The China growth model simply has to change.

China's Model

Here, too, there are encouraging signs. Both President Hu Jintao and Premier Wen Jaibao have said repeatedly and publicly for the last five years that they intend to change the model. Instead of relying on capital-intensive heavy industry, polluting and eating energy with big and growing trade surpluses, they want to change the model to promote domestic consumption growth, government spending on social infrastructure, and less energy in environmentally unfriendly kinds of devices. Incidentally, that would create jobs more effectively and reduce the big international imbalances that cause problems.

The difficulty is that China has been unable or unwilling so far to move very far in that direction. Indeed, China's current account surplus continues to exceed 10 percent of the whole GDP, which is historically

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unprecedented for the second-largest economy in the world, the world's biggest exporting country, and the biggest surplus and creditor country. For a country of that size on the global economic scene to run surpluses that are such a large a share of its economy is simply unprecedented and must be reformed.

China's Fiscal Stimulus

I give full credit to the Chinese for having enunciated a policy goal of making that change. Indeed, their fiscal stimulus package of November 2008 leads the world in terms of effective responses to the crisis. In part as a result of that, along with very aggressive monetary and credit expansion, China is already leading the world recovery from the crisis. China's economy has clearly turned up; March was probably the turning point for them. China will almost certainly show very positive, maybe even 8 percent annual rate GDP growth here in the second quarter of this year. It is clearly leading the global recovery.

My own judgment is that the United States and North America will probably start to pick up in the second half of 2009 and come along in a second wave behind China and much of East Asia. Europe will lag and not begin to turn around sometime in 2010, if even then.

We need changes in both the composition of growth strategies in the biggest creditor and debtor countries as well as a change in the currency relationships

So we're back to a world of decoupling, where the emerging markets -- particularly in Asia, but also Brazil and a few others -- will lead the recovery. The United States will come in second and Europe will lag behind in a replication of the decoupled world economy. For all the talk to the contrary, the decoupled economy existed right up through the third quarter of 2008 and only came apart when everybody fell off the cliff together last September and October.

Exchange Rates

But to return to the basic story, the composition of those growth recoveries in both the U.S. and China must be different. In addition, of course, is the exchange rate situation. China continues to intervene massively in the currency markets and maintain an undervalued exchange rate for the *renminbi*, which further enhances the competitive position of the world's most competitive economy. That not only violates all the international norms and rules of the game, but it creates enormous protectionist reactions and international pressures.

So as we think about financial stability beyond the crisis, we need changes in both the composition of growth strategies in the biggest creditor and debtor countries—which also happen to be the world's two biggest economies now—as well as a change in the currency relationships, particularly between their exchange rates. These two changes will permit a resumption of much smaller imbalances and thereby avoid the risk of replicating the crisis going forward.

New Mercantilism

That leads into my second point. If one is going to achieve adjustments of that type, particularly in exchange-rate relationships, one is going to need much stronger international institutional mechanisms and rules of the game. I've excessively focused on China, but I fear that the international financial stability problem going forward may be broader.

A lot of other countries will probably be trying to export their way out of the crisis. Some will draw a lesson from the crisis that the China model looks pretty good, having built up $2 trillion of reserves at undervalued currency and a trade surplus equal to 10 percent of GDP.

A lot of other countries may say, "Gee, we would like to do that, too." It's what I call the new mercantilism. We know that all countries cannot do that. The planet Mars is not yet ready to import a lot from the Earth, and so all the countries on our planet cannot run surpluses at the same time. That would create a big, big scramble, which could badly depress world growth, push trade policies in a protectionist direction, and the like.

This is the quintessential collective action problem, and it therefore requires an internationally coordinated response. How to do that? The International Monetary Fund is the obvious spot to do it, maybe with an assist from the World Trade Organization.

International Institutions

The IMF got a huge boost at the G20 summit in London: an expansion of its lending capacity by $500 billion and the creation of an additional $250 billion of special drawing rights. All of this will substantially restore the capability of the IMF to operate effectively in the international monetary system.

But that's going to require the IMF and its main members to insist on adherence to rules and to develop stronger surveillance mechanisms so the Fund can become a much more effective policeman and monitor of the world economy. The exchange rate is at the center of IMF responsibilities. It has simply got to step up and when a country is running a grossly misaligned exchange rate, do something about it.

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It may be necessary to take cases to the World Trade Organization [WTO]. There are WTO rules that bar countries from offsetting the benefits of their trade liberalization steps by running undervalued exchange rates. If the IMF informs the WTO that a country is running an undervalued currency, the WTO can then authorize its members to take trade actions against the violating country. It would be unfortunate to go down that path—it's never been done in practice—but it may become necessary if we're serious about avoiding the big imbalances going forward.

IMF Reform

The other point to make about the IMF in the Asia-Pacific context is really twofold. We know that the IMF can only play the kind of role I'm talking about if it enhances its own legitimacy in political and representational terms. That primarily requires a much bigger role for Asian countries in the IMF itself. A whole host of Asian countries deserve bigger roles at the IMF, and unless and until that is done, the IMF is not going to be regarded as legitimate, and therefore a viable source of collective action of the type I mentioned throughout the most dynamic part of the world economy.

The successful evolution of the Chiang Mai Initiative in Asia will put very constructive pressure on the IMF to be more effective

It is imperative for the IMF to move much faster, much further, in bringing Asian countries into the fore. The Europeans have to give up a big chunk of their votes, the Americans have to give up their veto, the Asians have to play an increasingly responsible as well as participatory role. That is the kind of grand bargain that will be necessary to make the world work.

Chiang Mai Initiative

I have two final thoughts for Asia in that context. I may be the only American economist who thinks the Chiang Mai Initiative is a very good thing. I was one of the very few American economists who thought the Euro was a good thing and would work and would be a success and would contribute to global stability, and I think that's proven to be right. I believe similarly about Chiang Mai. I think an Asian regional financial agreement is a good thing. I wish it the best of success. I actually wish it would move a bit faster.

But in addition to the usual substantive reasons for liking it—that is, its ability to provide supplementary global resources and bring more adjustment and surveillance to bear within Asia itself—I have a more Machiavellian reason. The successful evolution of the Chiang Mai Initiative in Asia will put very constructive pressure on the IMF to be more effective, because the one thing that scares any international institution is losing its turf.

If the IMF seriously fears it might lose some turf to Chiang Mai and the Asians might desert the IMF in favor of their own regional entity, that, I can assure you, will galvanize the IMF to be more effective. So I wish the best of success for Chiang Mai for that reason as well.

Asian Leadership of IMF

Finally, one of the largely unnoticed but most significant agreements of the G-20 summit in London a month ago was a paragraph buried toward the end that said, "Future management and leadership of the international economic institutions will henceforth be based on merit." Period. No reference to nationality. Anymore, there won't be a European at the IMF and an American at the World Bank. It will be based on merit.

What could be more effective to restore the image and effectiveness of the IMF in Asia than to select an Asian as the next executive director of the institution? That could happen very quickly because the current managing director, Dominique Strauss-Kahn, is sometimes tempted to go back to French politics. They have an election coming in the next year or so. The job might even open up in the fairly near future.

I would commend to all of my Asian friends to get your heads together and come up with a very good candidate to be the next managing director of the IMF. I think that would dramatically re-globalize the institution, take it out of the trans-Atlantic nest in which it has been embedded all these years, and hopefully, along with the other reforms I mentioned, would bring Fund into a legitimate role in Asia that could then truly again play a global role.

I do think something like that is going to be necessary if we are going to restore international financial stability beyond the crisis, deal with the imbalances,as well as all the longer-run structural questions that are imposed. I hope that coming off today, all of you will help move things in those directions. Thank you.

SOOGIL YOUNG: Fred, thank you for those very stimulating thoughts. I have given a very quick look at the paper submitted by Dr. Xuan Changneng, director general, Policy Research Department, People's Bank of China, who could not be here. I can summarize what he would have said if he had been here.

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Summary of Xuan Paper

He addresses two groups of issues: (1) the problems of financial regulation exposed by the financial crisis; and (2) the issues meriting special attention in reforming the financial regulatory system.

Under the first heading, he makes three points: (1) the regulatory philosophy was overconfident in self-restraint of market players; (2) the regulatory system needed to upgrade in a timely manner to avoid lagging behind financial innovations; and (3) there should have been effective international regulatory cooperation.

And then he has five entries under "The issues meriting special attention." The first item is, "reform begins with self-criticism." He says that one ancient Chinese philosopher once said, "We should self-examine ourselves three times daily." This epitomizes the Oriental philosophy on the importance of self-criticism in improving oneself.

And in fact, lack of remorse is one key factor leading to the current crisis. Against this background, we should begin with an attitude of self-criticism while addressing the challenges of financial regulatory reform.

And his second point is that we should introduce counter-cyclical multipliers to strengthen countercyclical mechanisms. His third point is that regulatory agencies should be adequately staffed with the people with market experience. Fourth, it is important to strengthen supervision of credit rating services and rating agencies. And finally, he urges the promotion of higher corporate governance standards.

East Asia will not be a driver of the world recovery because it's too small . . . The United States will have to do something to start the recovery

And now, let's move on to Prof. Park Yung Chul, please.

PARK YUNG CHUL, Professor of Economics, Korea University: Thank you. Before answering the questions put to me by Amb. Young, I would like to respond to some of the points made by Fred Bergsten.

Response to Bergsten

Specifically, I don't think that the East Asia, including China and Japan, can lead the world recovery. I think East Asia will not be a driver of the world recovery because it's too small. Rather, the United will have to do something to start the recovery of the world economy. This is my point.

And the second, on the IMF, Fred talks as if IMF is an independent global institution, but it is not. If he is really serious about reforming the IMF and improving the credibility and legitimacy of the IMF, the United States, you should do something about it. But I don't know whether the United States would be interested in reforming the IMF in the way he has proposed. Especially in East Asia, I think IMF will have to do a lot more to regain its confidence among policymakers.

Prof. Park Yung-Chul, Professor of Economics, Korea University

Concerning the priority and the role of East Asia, I agree 100 percent with Fred about the need to reduce global imbalances. I tend to believe that the increase in global imbalances was a cause of the current ongoing crisis. But as an East Asian, I think you will have to understand why these East Asian countries, including Korea, were so eager to accumulate so many reserves.

Korea and Imbalances

From 1997-2007, Korea took the lead in reducing imbalances between East Asia and the United States by letting the currency appreciate substantially to the point where Korea started running a deficit toward the end of 2007. And then what happened? When market participants saw a small increase in the current account deficit, they became frightened and began to think that something was wrong with the economy. They began to withdraw their loans, they started selling their equities and Korean bonds, all of which created a very serious liquidity crisis in Korea.

Before then, Korea was told time and again that we had too many reserves, so we took the advice of the Peterson Institute on International Economies, the U.S. Treasury, the IMF, and so forth. But then we faced the liquidity crisis.

At one point, we really were worrying about the possibility of getting into a very serious financial crisis once again. In reforming the international financial system, the advanced countries and the emerging market economies must agree on a new system that maintains a stable supply of global liquidity.

Accumulation of Reserves

I don't think these countries will stop accumulating reserves. In fact, now these market experts are telling us

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that Korea should have accumulated more than $260 billion in reserves.

If I speak to some of my good friends in the government in East Asia, once the crisis is over, they will just go right back to accumulating reserves by running current account surpluses, because there is no other way of protecting these economies from the speculative attack and currency crisis. This is the basic problem, so we've got to do something about the reform of the international financial system.

Let's go back to 1997 and 1998, right after the Asian financial crisis. All of these advanced countries created about ten international committees for the purpose of reforming the international financial system, including the regulatory system, accounting, governance, and everything. They produced many reports and papers. And then two years later, everybody stopped fretting bout the whole thing. Nothing came up for discussion thereafter. What concerns me is that once the world economy recovers from the current crisis, a similar thing may happen.

Sustaining Interest in Reform

I don't know what the G20 or G-7 would be able to do to sustain interest in reform. I'm not so sure, because we have this rather disappointing previous experience with reforming the international financial system. What guarantees are there that we won't repeat the same mistakes?

I don't think countries, whether advanced or emerging economies, will agree on a global regulatory system

I'm not in a position to defend China's policies, but when we discuss Chinese issues quite often in East Asia, and Chinese officials have maintained that they are in the process of reforming their pension system, healthcare system, and education system. They're spending enormous amount of money to establish a new fiscal infrastructure, and then they always very proudly display the sharp appreciation of the *renminbi* vis-à-vis the dollar, saying, "Well, you know, these American critics are wrong. Well, we'll have to see."

China's Responsibility

I agree completely that China needs to readjust its exchange rate. But they also have to step up in terms of reforming their institutions. There is not external pressure on China to speed up institutional reform. Instead, you recommend that China adjust its exchange rate. But the United States and other advanced countries must engage in serious institutional reform.

Simplification

What types of reforms to the financial system are needed in the future? I think we must simplify the financial system. There are too many financial institutions to begin with, and I don't know what they do. They seem to be just shifting around risk without knowing who is holding risk and at what price. So we'd better simplify the financial structure, and at the same time reduce the size of the menu of the financial instrument.

Can you imagine how many financial instruments there are, and do you know how many you are dealing with? I don't think these instruments have contributed to stabilizing the global financial system or improving the allocation of resources in the global economy.

Regulatory Reform

At the same time, we must improve the regulatory system, if not at the global level, then at least at the individual country and regional level. But I don't think countries, whether they are advanced or emerging economies, will be able to agree on the type of global regulatory system.

I cannot imagine that any international institutions would be allowed to examine the books of U.S.-based financial institutions or Europe-based financial institutions. Regulation is a national matter. It's something that is directly related to the rules and the regulations of sovereign nations.

We cannot expect much improvement in regulatory reform at the global level. At the individual country level, however, there are many things that need to be done to improve financial regulation and supervision.

There are too many international organizations, and sometimes you don't know what they do. What we need is some sort of competition among these institutions, and then we chose the one that could deliver the most to us.

I don't know exactly how to create competition between these organizations, but if there is not something like that, there will continue to be new international organizations, one after another, doing the same thing without producing any kind of tangible results. Just think about what has G20 accomplished so far. Very little. Thank you.

SOOGIL YOUNG: Thank you. Dr. Kawai?

MASAHIRO KAWAI, Dean, Asian Development Bank Institute:
Dr. Kawai's PowerPoint presentation is available at—
http://www.pecc18.org/materials/kawai4_pecc.pdf

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Financial Stability in U.S./Europe

When we talk about global financial stability, what is most essential from the Asian perspective is the restoration of financial stability in the United States and Europe. **[Slide 1]** That really has been the source of various difficulties encountered by many emerging market economies. They are experiencing massive capital outflows and some countries' exchange rates—particularly in many Eastern European countries—have been depreciating to the point where there is a currency crisis-like situation. As Prof. Park said, Korea had a difficulty last year and also faced some difficulties this year. So that is my first important point—the importance of restoring financial stability in the United States and Europe.

Stress Tests

In that regard, I welcome the results of stress tests, which have provided a degree of transparency in the market and some confidence. Some people may argue about assumptions behind the stress tests. It also is difficult for financial officials to go to the Congress for more money, but I think it's a good first step.

Looking at the Japanese experience during the 1990s—the so-called "lost decade"—we have yet to see what was the most important part of the exercise in Japan, which was removing toxic assets and other nonperforming loans from the balance sheets of banks and ensuring that banks are adequately capitalized. **[Slide 2]**

Dr. Masahiro Kawai, Dean, Asian Development Bank Institute

And in the case of Japan, even after the authorities took a fairly aggressive stance after 1998, new nonperforming loans began to emerge, which that put a lot of pressure on the banking system. I think that also may happen here in the United States, so the authorities and banks have to be ready to address new nonperforming loans which can put further strain on the banking system.

Role of IFIs

The role of IFIs [International Financial Institutions] is quite important. Fred put a lot of emphasis on the IMF's role of surveillance, in particular of the exchange rate, and U.S.-China collaboration in reversing the global payments imbalance.

I think that's an important function of the IMF, but an Asian perspective is that the IMF's surveillance over the U.S. economy hasn't been quite effective. When it comes to a very important country in the global economy, the role of the IMF appears to be quite limited. That's an unfortunate situation.

But nonetheless, the IMF role is quite important, given that there are many emerging market economies under stress. So IMF resources, which will be expanded, will be quite useful.

IMF Reform

Now, in this context, I also welcome the discussion of IMF governance reform. Fred was optimistic that the United States would give up veto power. I'm not sure if that would really happen, and I don't think Asians believe that it will happen.

Asians don't believe that Europeans would reduce their voting power in a massive way. Maybe some marginal changes will take place and the veto power of the United States would remain as is. Maybe the nationality of the IMF's managing director will change. A new managing director may come from Latin America or Eastern Europe or somewhere. Perhaps that's the extent of IMF reform, because it would involve a significant shift in power, which would be very difficult to accept politically in the United States and in Europe.

IMF reform would involve a significant shift in power, which would be very difficult to accept politically in the United States and Europe

So Asians are not very optimistic about the IMF reform. Nonetheless, the role of the IMF is very important for global financial stability. The only thing is that East Asians do not want to come to the IMF for financial help because of the bad memory from the financial crisis of 1997-1998.

Chiang Mai Initiative

Regional financial arrangements can play a very important role. **[Slide 3]** The Chiang Mai Initiative multilateralized, as agreed by the ASEAN+3 finance ministers, and will be in place by the end of 2009. It will have financial resources of $120 billion. That level will be supplemented by Japan's contribution of about $60 billion and currency swap arrangements of $94 billion. There will be a total of $300 billion, which is a quite a significant amount of money.

In addition, a new surveillance unit will be set up, which is supposed to function just like a mini IMF staff.

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This surveillance unit is expected to perform regional surveillance and to come up with a set of conditionality once the Chiang Mai Initiative is to be triggered.

Market Shrinkage

Finally, I just want to mention the trans-Pacific payments imbalance. **[Slide 4]** This is a reality. The evaporation of U.S. consumption that is forcing adjustment in the United States will force more adjustment by East Asian economies. The United States and Europe have been the major destination of finished manufactured exports. So the shrinkage of U.S. and European markets is causing a significant strain on East Asian economies. **[Slide 5]**

The emerging markets as a group account for 50 percent of the world economy at purchasing power parity and 40 percent at market rates

We have done some CGE [computable general equilibrium] exercises. One exercise found that if the U.S. current account deficit is shrinks 4.5 percent of GDP, this will reduce East Asian current account surpluses and alter exchange rates. **[Slide 6]** In terms of sectoral impact, the CGE found that Asian auto, electronics, machinery, textile, and apparel industries will be hurt. And actually, that's what we observed. There is going to be a permanent shift in the mix of production. **[Slide 7]**

Non-Tradeables Sector

What is interesting is that the services sector, essentially non-tradeables sector, must be stimulated. So if the trans-Pacific adjustment is going to be smooth, this would require a significant rebalancing of growth on the part of Asian countries, not only on the demand side, but also the supply side.

This would entail a shift away from traditional manufacturing-oriented economic structure towards a more nontradeable services-oriented economic structure, and more consumption, and more investment for East Asia collectively. In this regard, green growth is a very important component for Asia. Japan and Korea are trying to pursue green growth. China has become aware of the importance of green growth as have some ASEAN countries.

Social Sector Protection

Social sector protection also is an important item on the Asian agenda. That would strengthen regional demand. Regional economic integration is quite important in this process because an integrated Asian market can create new business opportunities and stimulate demand in Asia.

The U.S. dollar is still strong, but once U.S. financial institutions become more stable and less required to hold U.S. dollar liquidity, then the dollar can depreciate because capital can flow out of these financial institutions toward a growing vision in the world economy, which is East Asia.

There was, in fact, no decoupling during this crisis. But if you draw trend growth rates for emerging market economies and advanced economies, we can see a clear divergence in trend growth. **[Slide 9]** China, India, and ASEAN are the major parts of developing economies globally, and they are the ones that can support global economic recovery.

But as Prof. Park said, they still are relatively small economically compared to the United States and Europe. So developing Asia, China, India, and ASEAN, can collectively support global economic recovery and hence financial stability, but ultimately, it's the United States and Europe that have to pull the global economy out of the current recession and instability. Thank you very much.

<u>QUESTION & ANSWER PERIOD</u>

SOOGIL YOUNG: I would like to launch the discussion by first inviting each speaker to comment on some of the points which have been made by the other panelists. Maybe Fred would begin?

C. FRED BERGSTEN: Yes, I have a few thoughts about what both Yung Chul and Kawai-san said. Let me first address a point they both made that these poor emerging markets and Asians are just so small, they can't have much impact. It's just not factually correct.

Size of Asian Economies

The emerging markets as a group account for 50 percent of the world economy at purchasing power parity exchange rates and about 40 percent at market rates. More importantly, their share of the world economy is growing by two to three percentage points every year. Prior to the crisis, they were growing at 6-7 percent, and the industrial countries were growing at 2-3 percent. They were growing twice as fast. Their share was therefore increasing rapidly.

In the crisis period, that gap is even greater. China and India are still growing at 6-7 percent while the United States is growing at -6 in the last six months and Europe is even worse. The gap is growing. So I beg to differ with my Asian friends when they say their poor, puny little economies are just too small to have any impact.

China alone in the pre-crisis period was accounting

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for one-quarter to one-third of all world growth. China accounts for 10 percent of the world economy; it was growing at 10 percent. That's one percentage point out of global growth of 3-4 percent. China accounted for a quarter of world growth by itself.

In the aggregate, the Asian economies account for about a quarter, the North American economies, about a quarter, the Europeans about a quarter, and everybody else, the remaining quarter. So I simply would reject the notion that it's up to the United States or Europe to lead the recovery. Obviously, the United States and Europe have huge responsibilities and have to do the right things or the world economy does not recover.

But to hide behind this anachronistic view that the emerging markets as a whole or the Asian economies as a group are too small to make a difference is just factually incorrect. I must say it undermines the prospect for Asia assuming the leadership and major participatory role in the world economy that I think should happen.

U.S. Actions

Yung Chul quite correctly said, "Well, the U.S. must do something." The United States has the second-biggest stimulus package in the world, second only to China. Its monetary expansion totals now $3 trillion worth of Federal Reserve injection of liquidity and credit. The government itself has done more than $1 trillion. The United States is doing something.

Going forward, I said very clearly the United States must change its development model and its growth composition. Dr. Kawai's very interesting chart and elaboration pointed out how that change in composition needs to take place. He focused on the Asian side but also referenced the U.S. side. Of course, the U.S. must do something, and it is doing something, and it must do more.

U.S. View on IMF Reform

With respect to the IMF, Yung Chul said, "The IMF is not an independent institution; the United States should do something about it." Well, yes, the United States should do something about it. Dr. Kawai may turn out to be right; the United States won't accept an elimination of its veto. I would urge all of you not to give up before the discussion starts. The United States fully agrees on the need to reform the governance of the IMF and the other international economic institutions.

The Obama administration understands that will not happen without big changes in the role of the United States and the Europeans. The United States has certainly been pushing the Europeans hard, and I suspect we'll be willing both to give up the presidency of the World Bank and to give up the veto in the IMF. You all should test it if you don't believe it, but don't give up before the discussion starts and say, "This is impossible, so we won't bother." That, I think, would be a huge mistake.

Korea's Currency Appreciation

I agree with Yung Chul that Korea got out on a limf when it let its currency appreciate. I applauded Korea doing that. As Yung Chul said, it did the right thing. The problem was not that Korea did the right thing; it's that the rest of Asia did the wrong thing. The rest of Asia did not follow the playbook, and so Korea got out there on a limf by itself. What that revealed was the need for Asian monetary cooperation, and we're back to Chiang Mai

From left, Dr. Masahiro Kawai, Dean, Asian Development Bank Institute; Dr. C. Fred Bergsten, Director, Peterson Institute for International Economics

Initiative and adjustment cooperation among the Asians.

Of course, if Korea's currency appreciates and China continues to massively undervalue the *renminbi*, it causes a huge problem for Korea because China's now is its major trading partner. But Korea's problem, therefore, is with China, and Korea should be part of the coalition pushing the IMF to push China to live by the rules. So the problem is very clear. Yung Chul is exactly right, that Korea got out in front, but the problem is that the other people didn't come along and play by the rules.

Accumulation of Reserves

Yung Chul says everybody wants to build up reserves, and that's justifiable, and we should go ahead on that front. Yes, and that's why the G20 at the London summit agreed to create $250 billion of special drawing rights which will enable countries to build up their reserves without running trade surpluses. The only constructive answer to the new mercantilism that I described in my initial remarks is to enable countries to legitimately build up their reserves but to do so in a way that is not a zero-sum game, forcing deficits on others and juggling the surpluses all around to everybody's detriment.

Special Drawing Rights

Fortunately, there is a solution. Forty years ago, the IMF invented special drawing rights. They went into

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hibernation for a long time, but now they are back. I believe the IMF over the next few years should create at least $1 trillion of special drawing rights (SDR).

My guess is that it will do that, and those additional SDRs will enable countries who want bigger reserves to insure against future crises to have their own reserves without having to run trade surpluses and pursue beggar-thy-neighbors policies. So the IMF again, I think, can play a central role in the crisis.

Systemic Improvements

Quite justifiably, Yung Chul said that nothing happened to the international financial architecture after the Asian crisis; same thing might happen again. Yes, it might, but I would urge all the participants not to give up before making an effort. If this crisis does not focus the minds of policymakers around the world on the need to improve the system, then maybe nothing will, and we're condemned to repeat these crises in the future. It would be a huge error to give up before we start.

Asian Leadership Opportunity

I have great encouragement, because the next chair of the G20 is Korea. So with the chair of the global steering committee in Asia, the lead is now in Asia for the next year as we come out of the crisis hopefully and look to the longer-term implications and consider systemic reforms that will be needed. It would be a particular tragedy if Korea gave up before we started, or more broadly, that Asia did not take the opportunity of leading the steering committee to try to do something constructive about these steps.

It is unrealistic to expect that Asians can pull the United States and Europe out of the current crisis

SOOGIL YOUNG: Thank you, Fred. Prof. Park?

PARK YUNG CHUL: I'm in a no position to challenge what Fred was saying because I need him right now and I asked him to do something for me, so what can I say?

Since we are talking about the policy cooperation and the regional arrangement, the regional cooperation, I confined my remarks to the ASEAN+3, in which you supported this Chiang Mai Initiative. None of the countries are growing except China and perhaps Indonesia, but then, who knows?

Yes, China is growing very rapidly, and it accounts for a large percentage of the gross. But in terms of size, China is a little bigger than California. This is what I was told, and I may be wrong.

With respect to reform of the IMF, this must be consistent with U.S. global interest in managing global economic affairs. In that respect, I hope you are right. If the United States is serious about creating genuinely independent international institutions, then fine. But I don't think Europeans would allow Asians, or for that matter, Latin Americans, to head the IMF. And in fact, I don't think the managing director is that important.

I think what is important is the independence of the organization, which will be able to garner the public support as well as the support of the member countries. And in that respect, Mr. Kawai and I have some misgivings about the restructuring of the IMF.

With respect to the G20, I strongly hope that Fred is going to help us to invite G20 heads of state to come to Korea to discuss these important issues and come up with the solutions to the current crisis and the reform of the international economic system.

SOOGIL YOUNG: Thank you. Dr. Kawai?

MASAHIRO KAWAI: Just a few words. I didn't quite say that Asia was so tiny that it didn't matter. Asia is growing—that's true—but relative to the total size of the United States and Europe, China, India, Vietnam, and Indonesia still are relatively small in comparison to the two advanced regions in the world.

C. FRED BERGSTEN: Why did you leave out Japan?

MASAHIRO KAWAI: Well, Japan is still not growing. It's going through a very difficult period.

C. FRED BERGSTEN: Neither is Europe.

MASAHIRO KAWAI: That's right, but you have to remember, the epicenter of the current crisis was in the United States and Europe. The whole earthquake started from the United States and Europe. And still, the financial systems are in trouble in both regions. The first priority is for them to address that issue.

Of course, Asians want to help, so they are expanding fiscal policy. They are trying to do everything possible. But it's unrealistic to expect that Asians can pull the United States and Europe out of the current crisis. That assumption is simply unrealistic. They can provide minimum support for the global economy, but essentially the United States and Europe have to do the job.

I also want to comment about the global payments imbalance and capital inflows into the United States. I

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got the sense that Fred blamed the Chinese, Japanese, Asians for providing savings to the United States and thus helping to create a bubble in the United States.

The availability of liquidity or savings in the rest of the world was a fact, but management of one's own economy is totally the responsibility of the country receiving liquidity. That country has its own economic tools—monetary policy, fiscal policy, regulatory oversight. The Japanese, Chinese, Asians have no authority over the U.S. monetary or fiscal policy, or for U.S. regulatory oversight.

Any country experiencing capital inflows has to manage the problem. The IMF has been talking about this for many years, that is to say, how to manage capital inflows and how to ensure macroeconomic stability. Nonetheless, since the United States ran your huge current account deficits and Asians ran huge surpluses, adjustments now are common issues. It's a common agenda.

SOOGIL YOUNG: Thank you. Prof. Park?

PARK YUNG CHUL: I just wanted to ask Fred one simple question: suppose we are able to curtail China's current accounts surplus by 50 percent. What percent of U.S. current account deficit will shrink?

Some studies indicate that very little would happen. As long as you increase the domestic savings rate and reduce the fiscal deficit, the reduction in China's surplus will become the surplus of some other countries. This is the sort of the study I saw.

C. FRED BERGSTEN: Those studies are ridiculous because they assume that the change in China's surplus would have no impact on saving and investment rates in the U.S. economy, or the competitiveness of the U.S. economy through the exchange rate, which in turn affects saving and investment rates in the United States.

The Peterson Institute surveys show that every 10 percent change in the exchange rate of the *renminbi* takes something like $25-$30 billion off the U.S. account deficit. It doesn't solve the whole thing, but our assumption is that when the *renminbi* goes up by 10 percent or 20 percent or more—as it should—other Asian currencies will go up somewhat in sympathy. When you put the whole package together, you get a reduction of probably a one-quarter to one-third in the U.S. global current account deficit. That doesn't solve the whole problem, but it's an important part of it.

SOOGIL YOUNG: Thank you, Fred. I'm going to open the session to the floor.

J. STAPLETON ROY, Chairman, U.S. Asia Pacific Council: I just want to follow up on the earlier point. Fred, you have demonstrated convincingly that the Chinese are good Leninists and have shown that if you give the capitalists enough easy credit, they will hang themselves.

But I look at it from a capitalist position, and you're not addressing the policy measures the United States should take in order to address our current account deficit. In other words, granted, if the Chinese do the right things, it will have an effect as you demonstrated on our current account deficit. But how do we close the other two-thirds of that problem? What are the measures the U.S. government should take?

C. FRED BERGSTEN: The one thing we know would help and is within the power of the federal government is to run budget surpluses. The U.S. obviously has to increase net national saving so we don't depend on foreign capital and therefore run big external deficits. I said in my remarks we had to sharply increase our saving rate and stop consuming as much.

You fairly say, "How do you do that?" Two things: One is to increase private saving. Household saving has already gone up from zero to 5 percent. It will probably rise to at least 7 or 8 percent before leveling off. That's in reaction to the $15 trillion destruction of private wealth. It is leading to an increase in the private saving rate through market forces.

Unfortunately, we don't know how to increase private savings in policy steps. But I suspect a much higher level of private saving coming out of the crisis—which, incidentally, is consistent with resumed growth, because once private saving rises to the 7 or 8 percent level, future income growth can increase consumer demand by enough to grow the economy again.

What we've had is a pause of growth for two or three years. We must get private saving back up to an equilibrium level and then we can resume growth of domestic demand. But in addition to that, the one policy step we know how to take that provides results is to literally run a balanced budget over the course of the economic cycle. We therefore run surpluses in boom periods.

The biggest error of all in U.S. economic policy leading into this period was running huge budget deficits during the boom period of 2003-2006. We should have been running budget surpluses. We were running them as recently as 1998-2001. We had three consecutive years of budget surplus. It's not impossible, but we threw it away. So when the crisis hit, we had a very precarious starting position.

Now the budget deficit goes to 10 percent of GDP over the next year or two. We have a huge adjustment requirement, but to do its part absolutely right, the United States has to take the lead—it's the deficit and debtor country—but that would be for our own reasons as well as global reasons.

Even if the rest of the world would finance our deficits in the future, it would be folly for the United

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States to go back to those bad old ways. It's a lose-lose proposition. If the rest of the world doesn't finance our deficits, the dollar crashes, interest rates soar, and we have a crisis.

If the rest of the world does finance us, we go back into the bad old ways, consumer of last resort, build up more debt and deficits, only coming off now a much worse starting position, so we replicate the sources of the crisis next time. So whether you think the rest of the world will finance us or not finance us, it really doesn't make any difference; we need to correct our fiscal position.

SOOGIL YOUNG: Thank you. Yuen Pau?

YUEN PAU WOO, President and CEO, Asia Pacific Foundation of Canada: Implicit in Dr. Kawai's presentation is the belief that after the crisis, the United States is going to grow at what I would call sub-potential GDP growth rates. The reason is that there will be a big debt overhang, interest rates will rise, probably that will stifle growth, in addition to some destruction of capacity because of prolonged recession.

The question is for Dr. Bergsten. After the crisis, do you think we will see a period of sub-potential growth in the United States?

C. FRED BERGSTEN: I think potential growth in the United States will be lower coming out of the crisis than it was before. Before the crisis hit, there was a lot of evidence that U.S. productivity growth had dropped by maybe half a percentage point a year. We know from the demographics that U.S. labor force expansion has also dipped by maybe 0.3 percent of GDP per year from where it was, so when you combine that, U.S. potential output growth is almost a percentage point per year lower going forward than it was.

There exists a symbiotic relationship between the United States and China, which seems to reinforce each other's worse tendencies and sustain the disequilibria

We don't quite know yet how the crisis might have exacerbated that. In addition to the structural shift I mentioned, big-picture between consumption and investment, we're undoubtedly going to come out of the crisis with a sharp decline in the share of the financial sector in our economy.

The question is: what replaces that, or if anything replaces that in the near future. There are important structural changes that will undoubtedly lead to a slower U.S. trend growth going forward.

ZHI WANG, U.S. International Trade Commission: I have a question for Fred. You mentioned that one country's surplus in fact becomes another country's deficit. But could we ask, why China and Japan and some East Asian countries save so much and the United States save so little? Are there any kind of structural reasons for this?

Prof. Richard Cooper of Harvard University published a paper in 2007, which argued that the root of the global imbalance has to do with financial architectures and populations structures. What is your opinion about this?

C. FRED BERGSTEN: I published Prof. Cooper's first paper on that topic at the Peterson Institute deliberately because it provided a contrarian view, albeit a respectable and respected view. Certainly, the underlying saving and investment performance of the United States and China and the underlying causes of the imbalances and are dramatically different.

The United States has over-consumed and under-saved and China has under-consumed and over-saved. Consumption is less than 40 percent of China's GDP, which is way off the charts, not just for the United States or Europe but for India and other developing countries. So China has a structure that promotes under-consumption, both by households and by businesses.

Why by households? Because the collapse of the state enterprise system meant that the old sources of health care coverage, education, and pensions disappeared. Since the government had not yet picked them up, the households had to rely on themselves for all of the social welfare needs that are taken care of largely if not wholly by governments in all industrial parts of the world.

So the Chinese household has to save a huge amount in order to protect itself, and therefore consumer demand is at an incredibly low level for even a low-income country, let alone a rapidly growing economic superpower as China has become. That's a structural problem of the first order.

Social Welfare Spending in China

Therefore, in looking at the revised structure, and Dr. Kawai laid that out in his slides, the Chinese government needs to increase its social welfare programs and spending. That's an increase in domestic demand. It will reduce the proclivity of the Chinese households to save and therefore promote private consumption as well. Those changes in the structure of the underpinnings of China's economy will over time reduce that massive saving investment gap.

Likewise, the Chinese almost wholly agree that they have invested too much of the economy. They have been investing close to 50 percent of output. That's way off the charts, again, by comparison with the other Asian growth

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miracles or anybody else in development history. From a Chinese standpoint, here is the bottom line.

Misallocation of Capital

When you look at typical regressions of Asian and other developing country growth stories, the interesting question is not why China has grown so fast, but why China has not grown much faster. If you posit any of the other Asian growth models and impose China's saving and investment rates of 40-50 percent of GDP, you would have predicted that China would have grown not a lousy low 10 percent a year for the last 30 years, but 15 percent or more. Why has it not? The answer is clear: misallocation of capital.

There has been poor efficiency in the utilization of capital. As China thinks about its own future growth, I think that's what's motivated the leadership to say that it wants to change the composition of its development strategy and its whole growth model.

There are certainly underlying structural issues in the United States. I mentioned a moment ago the need to downsize the financial sector. It's gotten way overblown; its productivity growth, if any, was dubious. So both countries do have underlying structural problems. I don't think that's an excuse to let the imbalances and the exchange rate disequilibria continue. Indeed, making conscious efforts to change those international relationships would promote the desired domestic changes.

U.S.-China Symbiosis

The final point I'd like to make is actually a question: Has the interaction between the Chinese and American growth models reinforced each other and helped keep each other in disequilibrium positions? I invented this G2 idea about five years ago. People talk about Chi-America like we used to talk about the United States and Japan, that is to say, there's one big saver and exporter and one big consumer and importer.

There exists a sort of symbiotic relationship between them, which seems to reinforce each other's worse tendencies and sustain the disequilibria. Whereas it's easy to let nature take its course until it all blows up as it now has—and as it did in the Japanese case—I think it is better to get on with the business or reforming what needs to be reformed in both countries to avoid replication of these crises, which next time may be even worse.

SOOGIL YOUNG: I want to use one minute at least to make some concluding observations. I think we have raised more questions than answers, and we have discussed very many issues. I find that what turns out to have been the organizing issue was the problem of imbalances. And although Kawai-san wondered how much of a factor that was in causing the U.S. subprime mortgage crisis, I think we all agreed that that U.S.-China imbalance needs to be reduced.

Shifting Growth Models

For that purpose, we discussed the need to bring in some international mechanism for exchange rate adjustment and the need to shift the growth model in the United States as well as in Asia, especially in China. But then Prof. Park raised the issue of what I might describe as sense of insecurity that East Asians believe in trying to follow the policy prescription given by IMF.

Chiang Mai-Type Institutions

Fred also agreed that there is a need to strengthen the Chiang Mai process, eventually with the goal of creating an Asian Monetary Fund. This, according to Fred, would pose a very healthy competition to the IMF. So here is one agreement, at least.

Feasibility of IMF Reform

But then, with respect to the need to reform the IMF, we all agreed about the direction the reform must take, but there was a fundamental difference of sentiments as to whether that would be feasible. In that respect, I am reminded of the proverbial glass of water which is half-full or half-empty. I think one's view of the feasibility of IMF reform depends on one's personal temperament or your experiences.

There was a lot of discussion about this need for the new growth model. In this regard, on behalf of the PECC standing committee, I'd like to inform the rest that PECC is going to work on what kind of a new growth model can be recommended to the Asian countries and governments. The idea would be to recommend to those nations to invest in institutional and physical infrastructure much more than before in order to improve the well-being of the people, which should be the true and ultimate purpose of development.

Political Feasibility of U.S. Reforms

But then I'm reminded that what the United States government should do to its own economy should be the opposite of what Washington is telling Beijing to do and that is to reduce your social spending, reduce infrastructure investment and so on. That would help you bring down your expenditure. But I'm not sure if that would be politically feasible, and I think that would exactly go against the grain of the Obama administration. So I wonder about its political feasibility.

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Green Growth Model

This new growth model in Asia is also being talked about as a model for green growth, although we still have to fill in the contents of that new green growth. Kawai-san has been working on that idea quite hard, and so has the Korean government.

We should come back to what is said by Dr. Xuan, who is absent here, but he gave us this recommendation, that reform begins with self-criticism. Our work toward a better future begins with the effort to do what one can do and then hope for the best. Each of us has to look for the role he or she has to play, and maybe things will work out better if we trust each other and work together with optimistic outlook for the future. Thank you very much. ♦