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## **The Global Economic Imbalances: The Dangers of Not Rebalancing**

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### **Abstract**

*“Global imbalances” manifest in the large current account deficits and surpluses in the global economy and blamed by many for the global financial crisis of 2008 has become a source of much friction and discord among the G-20 economies. Rebalancing the global economy is essential to mitigating the divisions and promoting a more sustainable economic recovery. How and why did these imbalances emerge in the first place, what explains why rebalancing has proven to be so difficult, and what are the implications of failure? This paper addresses these interrelated issues.*

### **Keywords**

*global economic imbalances, emerging economies, Chinas currency, currency manipulation, US dollar*

Before the global financial crisis of 2008, the “global imbalance” which refers to the huge current account deficits and surpluses that had build up in the global economy beginning in the late 1990s was viewed as a relatively benign response to the growing economic interdependence and primacy of the U.S. dollar.<sup>1</sup> The United States along with a number of advanced economies, including the United Kingdom and Italy had build up large deficits, while China, Japan, Germany, Russia, Brazil, and the large oil exporting economies had build up huge reserves of dollars. So massive were these surpluses that global central bank reserves skyrocketed from a modest \$200 billion in 1990 to some \$8 trillion on the eve of the global financial crisis, with sovereign wealth funds accounting for an additional \$4 trillion.

Although economic theory informs that rich countries tend to have higher savings, lower investment and large current account surpluses, while emerging and developing economies tend to have low savings and high investment rates (and therefore should be net capital importers), there were several interrelated factors which contributed to this counterintuitive or “uphill”, pattern of capital flows. In Asia, for example, the region's export-growth strategy and domestic macroeconomic policy (such as China's currency policy) led to huge surplus (or what the former U.S. Federal Reserve chair, Ben Bernanke called the “global savings glut”), as the region cut back on investment and increased savings following the Asian financial crisis in 1997.<sup>2</sup> Second, the relatively underdeveloped financial systems in emerging economies (notably China) led them to divert a large portion of their foreign exchange toward the developed economies, in particular, the United States. And third, since many emerging market economies adopted an export-based strategy, this necessitated the maintenance of

highly competitive exchange rates. This, in turn, led to the accumulation of substantial foreign exchange reserves.

The United States, given its rising expenditures and deficits accommodated (indeed welcomed) these surpluses. However, such large volumes of capital inflows also drove down the real interest rates in the United States (and elsewhere), further fueling consumption and speculation. Combined with the already low household savings rates in the United States, this led to a rapid rise in the U.S. current account deficit. Nevertheless, U.S. policymakers saw these developments as generally benign for two reasons. First, that it was the inherent “safety” of U.S. financial assets which created sustained demand for American assets, and second, the assumption that since the U.S. dollar functions as a de facto global currency, the buildup of dollar reserves by foreign countries was not only inevitable but also a positive development for the United States - which among other things, allowed Washington to attract a disproportionately large share of world capital flows for its investment and consumption needs.

However, not well-understood or appreciated was that the widening economic imbalances also created deep and pernicious distortions that made the global economy extremely vulnerable, especially to a downturn in the U.S. economy. Although, a few analysts expressed their apprehension that the growing imbalances could lead to an unsustainable buildup in external claims on deficit countries like the United States, including substantial dollar depreciation, the overall consensus was that these imbalances could be sustained as long as the structural factors noted above remained in place.<sup>3</sup> Clearly, seduced by immediate gains, over-zealous market participants, including policy makers remained unduly sanguine and failed to adequately appreciate how the vicissitudes of economic globalization, in particular, the persistent imbalances by contributing to long period of low interest rates (especially in the advanced economies), and large capital inflows into U.S. and European banks, was also spawning a serious buildup of leverage, the creation of “exotic” (risky) assets and a real estate bubble - especially in the United States and in several Eurozone member states. We now know that imbalances played a significant role in contributing to the U.S. subprime crisis because investors in their search for safe investments forced the U.S. financial sector to create products which were increasingly risky. Specifically, as China and other countries with significant foreign reserves began to accumulate large volumes of U.S. Treasury bonds, they not only pushed down yields and (made Treasuries less attractive), the growing demand for higher yielding U.S. debt provided incentives to the investment banking and financial industry to create new types of high-yielding, yet more riskier, securities and related financial instruments.

## **Correcting the imbalances : domestic structural challenges**

Connecting these massive global imbalances will not be easy as the structural roots that gave rise to and have sustained these imbalances remain largely intact. Both the borrowing or “deficit” countries (namely, the United States) and the lending or “surplus” countries (China, Germany and Japan) will have to first make deep (and painful) structural adjustments in their economies if this problem is to be mitigated. To date, they have tended to blame each other for the problem rather than addressing the problem. Indeed, the intractable policy disagreements on rebalancing between the major economic powers underscore that rebalancing defies quick-fixes. In the case of the United States, Washington must simultaneously tighten fiscal policy to bring its national debt under control and sharply reduce its large trade deficit to boost growth and generate employment. For the latter, Washington will have to effectively convince its major trading partners (in particular, China) to stop artificially propping-up its currency in order to allow the dollar to regain a competitive edge.

Indeed, Nobel laureate Michael Spence has noted that rebalancing will be difficult because the structural changes both in the domestic and in the global economy over the last two decades have created a divergence in growth and employment patterns (Spence 2011). In the case of the United States, growth and employment have become highly dependent on domestic demand. Spence shows that between 1990 and 2008, the U.S. economy created 27 million jobs. However, 98% were in the “non-tradable” sector of the economy such as in the public sector, health care, construction, services and hospitality. Growth in the tradable sector (manufactured goods for exports and services) was essentially negligible as only 600,000 new jobs were created - and much on that in high-end tradable service jobs in finance and information technology. Moreover, Baily and Bosworth note that in the United States,

the 90 percent of manufacturing that lies outside the computer and electronics industry has seen its share of real GDP fall substantially, while its productivity growth has been fairly slow....Second, although manufacturing’s share of total US employment has declined steadily over the last 50 years, recently there has been a large drop in the absolute level of manufacturing employment.... After holding steady at about 17 million jobs through the 1990s, manufacturing payroll employment dropped by 5.7 million between 2000 and 2010.<sup>4</sup>

The financial crisis by sharply curbing U.S. domestic demand has negatively impacted job growth in the non-tradable sector - a problem that will persist in the foreseeable future.

Because the consumption and spending binge in the United States has been fueled by the ready availability of cheap credit facilitated by massive low-interest borrowing from abroad, it has resulted in unprecedented levels of public and private debt. In December 2000, U.S. national debt stood at

\$5.66 trillion. In December 2008, the debt stood at \$10.7 trillion, and in March 2010 the gross national debt was over \$13 trillion (CRS (Congressional Research Service) 2011). As of January 2014, U.S. national debt (the sum of all outstanding debt owed by the Federal Government) was just over \$17 trillion. Nearly two-thirds is public debt (which is owed to the people, businesses and foreign governments who purchased Treasury bills, notes and bonds), while the remaining one-third or “intra-governmental holdings” stood at \$4.74 trillion. As of July 2013, some \$5.6 trillion or about 48% of debt held by the public was owned by foreigners -with China holding an estimated \$1.5 trillion and Japan about \$1.1 trillion. According to the non-partisan Congressional Budget Office (CBO), if the current trajectory is not reversed, by 2020, the annual interest owed on U.S. debt will approach \$1 trillion or roughly 21% of projected federal revenue for that year (CBO 2012). Undoubtedly, without a meaningful resolution of these structural problems, the United States will continue to remain the world's biggest borrower and largest debtor - with adverse implications for economic growth, job creation and living standards.

Spence argues that, in the short-term, one way Washington can reduce these imbalances is through income redistribution, namely tax reform (in particular, taxing consumption more than investment, including giving a “tax holiday” to corporations on their foreign earnings to encourage them to repatriate their foreign earnings back to the United States), and targeted and sustained government spending in education and infrastructure - which he argues is essential to boost productivity. In the long-term, the key is to reinvigorate the tradable sector, especially the country's manufacturing base by creating manufacturing jobs that pay competitive wages and benefits. Indeed, “President Obama's own “Presidential Commission on Fiscal Responsibility and Reform” co-chaired by former Republican Senator Alan Simpson and President Clinton's former Chief of Staff Erskine Bowles released (in November 2010) a broad proposal to rebalance the American economy. The proposal recommended among other things (a) \$200 billion reduction per year in discretionary spending, (b) \$100 billion in increased tax revenues with a 15 cent per gallon gasoline tax and the cancelation of tax deductions like the home mortgage interest deduction, (c) maintain the Obamacare Medicare cost controls with a possible public option for healthcare reform, (d) raise in the retirement age for Social Security, including a raise the payroll tax, and cuts to the corporate tax rate from 35% to 26%. Indeed, the Simpson-Bowles proposal to reduce the large and regressive tax expenditures such as preferential tax rates for capital gains and dividends and deductions for state and local taxes with progressive tax credits have the potential to generate enough revenue to eventually reduce rate for all taxpayers. The fact that even the modest Simpson-Bowles was rejected by members of both parties underscores how hard it is to arrive at an agreement on these issues. Domestic rebalancing entails painful political and economic choices, in particular, for sectors and groups bearing the heaviest burden. If a prudent fiscal policy means a simultaneous increase in tax revenue and deep cuts to entitlements, both the public and the nation's lawmakers (both Democrats and Republicans), remain so deeply divided that even a broad consensus on principle remains elusive.

Similarly, internal and external rebalancing by China, the world's leading "surplus" economy will not be easy. Beijing's difficulty is compounded by the possibility that China may be entering into a period of much lower growth rates due to the "middle income trap" - a twilight zone where countries are neither able to compete with low-wage countries in basic tradable goods nor with the advanced high-wage countries in technology-intensive goods and services. Specifically, the steady rise in China's labor and production costs is making it much harder for Chinese businesses to compete with countries with much lower labor and production costs. China is not only losing global market share in tradable goods, its once overwhelmingly complementary trading relations with other countries are increasingly becoming competitive. Moreover, as Eichengreen, Park and Shin demonstrate: the growth rates of rapidly growing economies decline on average by 2% per annum once its per capita income reaches about \$17,000 in purchasing power parity (PPP) dollars (Eichengreen, Park, and Shin 2011). China is already close to that threshold. This means that China can no longer expect double-digit growth in GDP - which was, after all, largely due to its competitive advantage in low-cost manufacturing. Moreover, it remains to be seen if China's manufacturing sector dominated by large (and not very profitable and efficient) state-owned enterprises are agile enough to innovate and become globally competitive. What is certain is that China's ability to move up the economic and technological value chain is constrained by the country's institutional weakness which does not allow for a smooth transition into the ranks of the high-income countries. Preoccupation with such daunting domestic challenges will make resolving the outstanding China-U.S. trade and currency imbalances even more testy and difficult.

Although, China's 12th five-year plan calls for internal rebalancing away from export-led growth toward greater reliance on domestic demand via greater household consumption, translating these goals into reality will be difficult. While some see the recent drop in China's current account surplus (as a share of GDP), as evidence that rebalancing is already at work, such conclusions may be premature. Indeed, closer inspection suggests caution as recent IMF research shows that the fall in China's current account surplus is largely due to high levels of investment, a tepid global demand, and an increase in prices for commodity imports that has outpaced the rise in prices for manufactured goods (Ahuja et al. 2012). Moreover, as Pettis has noted, China's distorted financial system imposes a "financial repression tax" on households and businesses. This not only discourages household consumption (and encourages household saving), small- and medium-sized privately owned firms limited access to credit (the result of the government's directed lending policies) forces them to engage in precautionary savings (Pettis 2012).

The reality is that rebalancing the Chinese economy from its deep export dependence (given that its manufactured export sector has been engine of the country's economy for the past several decades), is easier said than done. Not only will domestic rebalancing entail huge social costs such as short-

term job losses and the resultant mass protests that deeply worry the political elites in Beijing, vested interests, including powerful regional and local elites in the sprawling export-zones of China's wealthy coastal provinces have every incentive to stifle what they perceive as unfavorable, indeed, hostile and dangerous central directives. In fact, not only is there no consensus in Beijing on either internal or external rebalancing, the rich (and influential) coastal provinces -the economies of which are heavily dependent on the export of manufactured goods have vigorously opposed any such adjustment.

### **Each for himself**

Instead of responsibly dealing with this problem, the key players continue to kick the can down the road or engage in practices that are zero-sum. For example, the United States has been trying to shrink the value of its debt by inflating its national currency. This lowers the amount the debtor repays on existing debts in real, inflation-adjusted terms. However, "debt monetization" by printing money, coupled with the Fed's policy of keeping interest rates near zero, carries potentially serious costs: it can trigger run-away inflation (including higher inflation premiums in future borrowing) and significantly reduce real incomes. This, in turn, not only hurts foreign creditors but also investors and individuals on fixed incomes, especially seniors, retirees and savers.

Predictably, the U.S. Federal Reserve's continuation of its Quantitative Easing (QE) program has led to a tat-for-tat response by other G-20 members. From November 2008 through March 2010, Quantitative Easing 1 (QE1) bought \$1.75 trillion in long-term Treasuries. From November 2010 through June 2011, Quantitative Easing 2 (QE2) bought \$600 billion of U.S. government debt in the form of long-term Treasuries. In September 2012, the Federal Reserve announced a new program or (QE3) totaling \$40 billion in mortgage-backed securities per month on a continuing basis until there is "substantial improvement" in labor market conditions. While QE1 and QE2 involved the purchase of specific types of securities within a defined time period, QE3 has no limits - meaning the Fed can buy unlimited amounts of mortgages, Treasuries or other securities "indefinitely" - meaning, for as long as they see fit.

The U.S. Federal Reserve's activism has pushed other advanced economy central banks to also rely increasingly on quantitative easing measures, besides requiring their banks to buy up their own government's debt by implicitly allowing banks not count the sovereign debt against their Basel capital requirements. For example, the European Central Bank (ECB) has implemented three asset purchase programs since 2011 providing more than €1 trillion in low-cost financing to Eurozone banks. Between March 2009 and January 2010, the Bank of England purchased some £200 billion of assets, mostly UK government bonds or gilts. Japan's new Prime Minister, Shinzo Abe has long blamed the yen's appreciation to the easy monetary policies of the United States and the Eurozone.

To counter this “unfair practice,” he instructed the Bank of Japan (BOJ) to ease up on monetary policy by doubling its inflation objective and expanding its asset purchase program. With its benchmark interest rate already close to zero, Japan's central bank has little choice but to engage in the purchase of government bonds to inject liquidity into the economy and hopefully push Japan out of its persistent deflation. In April 2012, the BOJ announced the purchase of \$61 billion of assets to inject more liquidity in the economy, besides maintaining interest rates between 0 and 0.1%. In September 2012, the BOJ added \$128 billion more to its program of asset purchases, and in December 2012 increased its quantitative easing program by another ¥10 trillion (\$118 billion). By year end 2012, the BOJ's easing program had pumped an estimated \$L2 trillion (¥101 trillion) in the economy. Yet, this still was deemed insufficient. In early-January 2013, Tokyo approved an “emergency” stimulus of ¥10.3 trillion (\$116 billion) to create demand and boost the moribund economy, and on January 22, the BOJ set a 2% inflation target and agreed to open-ended asset purchases. However, already burdened with a public debt which is twice the size of the country's economy (and the largest in the OECD) such loose monetary policy has the real potential to trigger the buildup of asset bubbles and inflation - similar to what happened in late 1980s.

Although, the U.S. Federal Reserve has long claimed that its rationale for injecting liquidity in the economy and maintaining low interest rates is aimed at encouraging investment and job growth, and the BOJ claims that its central goal is to stem the persistent deflation (and there is no reason not to believe either's justification), one of the consequences of the Fed's actions is that it also pushes down the value of the dollar, just as the BOJ's aggressive actions farther devalues the yen. In the end, the worsening competitive position of major currencies could very well force a new round of competitive devaluations as each weaken their currencies to boost exports. Hardly surprisingly, Bernanke's (2012) plea that “this policy not only helps strengthen the U.S. economic recovery, but by boosting U.S. spending and growth, it has the effect of helping support the global economy as well” has fallen on deaf ears. Rather other countries see his actions as a continuation of Washington's destructive “beggar-thy-neighbor” policy. Brazil's Finance Minister Guido Mantega dubbed the policy “selfish” as it negatively impacts emerging markets by undermining their exports and overall growth by destabilizing capital and currency flows. He warned that “Brazil, for one, will take whatever measures it deems necessary to avoid the detrimental effects of these spillovers.” Similarly, Russian finance minister Anton Siluanov noted that “everything is getting done, from my perspective, blindly, without regard to the consequences it could have.” For his part, Bernanke rejected these criticisms. Without naming China directly he argued that countries can prevent asset bubbles and inflation by allowing the value of their currencies to rise in response to capital flows in. The problem, Bernanke noted is that some emerging market economies have deliberately kept the value of their currencies low to gain unfair trade advantages (Ahmann 2012).

Justifiably, Brazil, Russia and other countries remain deeply concerned about their ability to respond



to inflows which will inevitably drive up their exchange rates and threaten their exports. In addition, G-20 economies have every reason to be concerned about the rising levels of public debt in the United States. They also know that the United States aggressive monetary easing vividly illustrated by Washington's willingness to print new money (to cover its deficits and hide the real value of its debt), is laying the foundations for inflationary pressures, both nationally and globally. This explains why a number of countries, including Brazil, China, India, Indonesia, South Africa, Japan, Malaysia, Taiwan and Thailand, among others, had to put in place capital controls on foreign investments in their bond markets to curb currency appreciation. For example, Brazil deeply concerned that foreign investors were pushing-up the prices of securities has limited capital inflows by taxing investors' purchase of the country's stocks and bonds. Brazilian authorities are also concerned that massive influx of foreign capital would inflate the value of its currency, the real (in fact, Brazil's flexible exchange rate was fast rising against both the dollar and the euro), making Brazilian exports uncompetitive and dampening the country's economic growth. It is not unreasonable to suggest that this growing discord and acrimony between leading G-20 countries has the potential to unleash a destructive currency and trade war.

The other big player in the rebalancing game is China. To date, Beijing has shown no indication of backing down on its currency policy. Without this, external rebalancing will be impossible. Beijing can expedite external rebalancing by simply allowing the RMB to appreciate - which, to the United States and others is a prerequisite to resolving the problem. However, the fact that Beijing has refused to do this by continuing its well-worn strategy of relying on exchange rate undervaluation and intervention in foreign exchange markets to promote exports underscore how difficult rebalancing will be. Not surprisingly, Chinn, Eichengreen and Ito predicted that the economic imbalances between China and the United States will soon remerge (Chinn, Eichengreen, and Ito 2012). The current trends vindicate their prediction. Rather, concerned that the exploding U.S. government deficits have the real potential to lead to inflation and sharply reduce the purchasing power of its dollar-denominated financial assets, Beijing has repeatedly noted its concern regarding the safety of China's over \$1 trillion investments in American government debt. Not surprisingly, with so much at stake, former Chinese premier Wen Jiabao broke with protocol when he lectured Washington on financial management urging the Obama administration to keep focus on important matters such as providing guarantees that China's investments in the United States would keep its value. Wen unambiguously noted : "we have lent a huge amount of money to the U.S. Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried... the United States must maintain its good credit, honor its promises and guarantee the safety of China's assets" (Wines 2009).

With China's foreign exchange reserves heavily invested in U.S. dollar-denominated bonds, Beijing faces potentially massive capital losses if the dollar were to deprecate. Thus, confidently quoting

Keynes's famous aphorism: "when you owe the bank a thousand pounds you are at its mercy, when you owe the bank a million pounds, it is at your mercy," some find comfort in the fact that the United States has such a tight choke-hold on China that Beijing will have no choice but continue to buy U.S. dollars and government bonds in order to avoid a precipitous drop in the value of its already massive investments in U.S. securities. For example, Barry Eichengreen has noted that the United States enjoys "exorbitant privilege" (Eichengreen 2011), while Nobel laureate Paul Krugman has long claimed that Beijing is in an unenviable position vis-a-vis the United States because it is in a "dollar trap."<sup>5</sup> That is, in amassing a huge volume of dollars on order to keep its currency competitive, it now fears (correctly) that its paper dollars will depreciate in real value. This is the main reason why China is so keen to exchange its foreign reserves (denominated mostly in dollars) for the IMF's SDRs - which are based on a currency basket consisting of the U.S. dollar, the euro, the yen and British sterling.<sup>6</sup> Krugman cynically notes that this will not happen as the United States enjoys veto power in the IMF.

Although, in an unenviable spot, Beijing is not sitting idly by, but taking concerted action to reduce its dependence on U.S. assets, in particular, the low-yield dollar denominated U.S. Treasury Bills. It is important to note that Beijing ended-up purchasing such a large amount of Treasuries because it is not allowed to invest in other U.S. assets - such as when the Chinese state-run oil company CNOOC was denied the right to buy Unocal in 2005. Suffice it to note, Beijing has already noted its displeasure with this policy and warned it will no longer tolerate it. Furthermore, Beijing has been gradually diversifying its portfolio to make it less depended on the U.S. dollar. Part of this long-term strategy has been to increase its gold holdings. Although, common-sense informs that given China's massive investment in U.S. government bonds Beijing has a vested interest in maintaining the value of the Treasuries it holds, or at least do not do anything counterproductive to endanger its investments, it does not mean that Beijing will always stick to this policy.

Indeed, China has its own pressing problems which may eventually force policymakers to reconsider putting so much of their hard earned funds in low-yielding (and underperforming) U.S. securities. First, China's banking sector is dangerously leveraged as the result of the spending binge triggered by its massive 4 trillion yuan (\$630 billion) stimulus launched in 2008 to counter the ill-effects of the global financial crisis. The banking sector is not only heavily exposed to the country's highly speculative property sector but also to the off-balance sheet transactions conducted outside the formal banking sector by growing numbers of "shadow banks."

Unregulated (but, with government connivance) shadow banks operating under the guise of "banks," "investment and finance companies" and "trusts" raise funds via non-transparent means to provide loans to businesses and local governments at high interest rates.<sup>7</sup> It has been estimated (see Rabinovitch 2014) that loans from the formal banking system "which used to account for more than

90% of total credit, fell to little more than half of new financing last year [2012]. Lending by shadow banks now totals Rmb47 trillion, or 84% of gross domestic product" (Rabinovitch 2014). The real concern is that since the majority of these unregulated lenders' (who are not licensed to raise deposits or make loans) have made speculative (indeed reckless) loans it could easily set-off a destructive chain-reaction of defaults triggering a broader financial crisis. The case of China Credit Trust (CCT) one of the country's largest "trust" companies is illustrative. In early 2011, CCT began marketing a "wealth management investment" product grandiosely named "Credit Equals Gold No.1," which it then sold via the Industrial and Commercial Bank of China, the country's largest bank. Among other ventures, CCT's prime purpose was to raise money for an unlisted coal mining venture called the Shanxi Zhenfu Energy Group for which it guaranteed investors a whopping 10% annual return. However, in early January 2014, it became public that Zhenfu Energy had filed for bankruptcy soon after receiving the loan and that CCT was close to defaulting as it could not honor its obligations it made on its "Credit Equals Gold No.1" product - now valued at some 3 billion-yuan (\$490 million). At the very last minute, CCT was saved from collapse by an unidentified entity (most suspect the Shanxi government), which bailed out investors principal and a percentage of their interest - and in the process creating a moral hazard problem. In early February 2014, it was reported that "six Chinese trust firms have lent more than 5 billion yuan (\$824.6 million) to a delinquent coal company... raising the prospect of further defaults" (Wildau 2014). Of course, the option of bailout may not be available in the future, because as Rabinovitch notes "in all, there are about \$660 billion of trust products up for repayment or refinancing this year.... Chinese shadow banks, by definition, have been focused on customers - miners, property developers and local governments - that regulators have deemed too risky for banks, so more problem loans are a certainty."

China's shadow banks have also fueled an alarming buildup in the debt owed by local governments. It has been estimated that local government's using various financing vehicles (LGFVs) to get around prohibitions on excessive borrowing have accumulated some 10.7 trillion yuan (about \$1.65 trillion) in bad-loans by the end of 2010 - a figure equivalent to 25% of China's annual economic output. If China's real-estate bubble bursts, local governments default on their debts, and the balance sheets of Chinese banks to deteriorate and non-performing loans pile-up, Beijing will have much less to lend and may be forced to repatriate its funds back home.

The United States should know from its own history that creditor status gives a sovereign much power and influence. Kirshner persuasively shows that creditor countries have constantly sought to influence other states by strategically targeting the stability and value of their currencies through interventions in the foreign exchange market - as the United States did so effectively against Great Britain during the 1956 Suez crisis.<sup>8</sup> Friedberg notes that China "uses commercial relations for its strategic advantage... The fact that such an action would probably do at least much damage to the Chinese economy does not guarantee that in the heat of a crisis, Beijing would not attempt it"

(Friedberg 2012). In fact, Beijing did try to impose sanctions on Japan via its large position in Japanese government bonds during Diaoyu/Senkaku islands dispute in September 2012. Clearly, Beijing has the capacity to use currency as a "weapon" to advance its strategic goals. Contrary to conventional wisdom, Beijing does not have to take extreme action to have a consequential impact on the American economy. Even if China reduces its purchases or sells even a modest portion of its position, Treasury prices would fall and yields would sharply rise resulting in higher borrowing costs for the U.S. government and slowdown in economic activity. This underscores that Beijing's current mercantilist policy of using exchange rate undervaluation and intervention in foreign exchange markets to promote exports could trigger a "disorderly unwinding" of the global imbalances.

### **The G-20 and challenges to rebalancing**

At a minimum, fixing the global imbalances will require cooperative, coordinated and sustained policy response - which not only includes the United States and China but also the other important players. Yet, the key deficit and surplus countries continue to pursue and engage in economic policies that are in direct conflict with each other, with China, arguably, engaging in a particularly insidious race to the bottom (Ferguson and Schularick 2011). This seemingly zero-sum actions carry huge risks because it can trigger a "disorderly unwind-mg" of the global imbalances. That is, if and when global markets are no longer willing to continue financing U.S. debt, it could trigger a sell-off of dollar assets and a sharp rise in U.S. interest rates with grave implications for the global economy as the spillover effects would be huge and disastrous.

At this critical juncture, the G-20 in its current form is simply not up to the task to effectively diffuse this simmering conflict and advance multilateral economic cooperation. Rather, even as competing national interests push against genuine multilateral cooperation, the G-20 has no effective levers to override this. Indeed, even in the midst of a rapidly deteriorating situation in the Eurozone and dire warnings of another global crisis, the G-20 leaders at their 17-19 June 2012 summit in Mexico failed to do anything substantive (besides issuing a joint statement that "we will act together to strengthen recovery and address financial market tensions") to ease market worries.

In other words, the current decentralized and fragmented international monetary and financial system lacks an effective mechanism or a "neutral" arbiter (like the United States during the Bretton Woods era) to manage what each country does to advance its own self-interest does not hurt them as a collective. A cursory review of the G-20's attempt to deal with the problems underscores the wide gulf between intentions and outcomes.

In November 2008, the G-20 held its first summit in Washington D.C. to address the financial crisis

swirling in their midst. In a show of solidarity and resolve, the G-20 unanimously agreed that it was now time for a "new Bretton Woods" capable of stabilizing financial markets and jump-starting global economic growth. To boost confidence, the G-20 cut interest rates, increased liquidity in the financial system and agreed to increase financial resources for the international financial institutions, in particular the IMF.

Yet, even as the G-20 knew that boosting confidence in the financial markets was critical, the member states were also cognizant of the fact that shielding national and global financial systems from the recurrent bouts of speculative excesses and sharp economic contractions were not going to be easy given the internationalization of financial markets. After all, the crisis had painfully underscored that not only were the existing international regulatory and supervisory agencies lagging far behind market innovations, these bodies had to be significantly strengthened if they were to be effective. For example, in order to reduce market distortions and improve transparency and risk management, the supervisory and regulatory frameworks not only needed more transparent disclosure and reporting rules but also had to be coordinated at the global level to ensure effective macro-prudential supervision. Only such comprehensive harmonization of national and international regulations and the consolidation of surveillance and supervision would make implementation and enforcement much easier as it would reduce incentives for banks and financial institutions to move their operations off-shore to more lax jurisdictions.

To this effect, the G-20 unveiled an ambitious regulatory reform agenda complete with a detailed plan for immediate and medium-term action. These included among others: (1) strengthening transparency and accountability, (2) enhancing sound regulation, (3) promoting integrity in financial markets, (4) strengthening international cooperation, and (5) reforming the international financial institutions. At their April 2009 London Summit, the G-20 agreed to "empower" international bodies, including the IMF, the Bank for International Settlements, and various "standard setting" bodies such as the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions, the International Association of Insurance Supervisors and the International Accounting Standards Board. Specifically, the G-20 pledged some \$5 trillion in fiscal stimulus spending over 2 years and to increase funding for the IMF and the other multilateral development banks by \$1.1 trillion, including tripling the IMF's lending capacity to \$850 billion. In a bold move, the G-20 also agreed to transfer about 6% of voting power within the IMF to "dynamic emerging-market and developing countries" by end-2012. This meant that China would become the IMF's third-largest shareholder - behind the United States and Japan. The BCBS was assigned responsibility for reaching agreement on new capital and liquidity standards, and the Financial Stability Forum (renamed as the Financial Stability Board (FSB) was expanded to include all G-20 members) was made into a permanent institution with the powers to report directly to G-20 finance ministers on issues pertaining to regulatory reform and implementation. The FSB was

also given primary responsibility for coordinating the actions agreed upon by the G-20. Finally, the G-20 adopted the "Declaration on Strengthening the Financial System" or KG-20 Action Plan" consisting of "47 concrete measures designed to reform all systemically important financial institutions and instruments based on five principles": strengthening transparency and accountability; enhancing sound regulation; promoting integrity in financial markets; reinforcing international cooperation; and reforming international financial institutions.

At the G-20 Summit in Pittsburgh (24-25 September 2009), the host - an enthusiastic President Obama - boldly declared that "from now on the Group of 20 will be the primary organization responsible for coordinating global economic policy." British Prime Minister Gordon Brown was even more ebullient noting that "the old system of international economic cooperation is over. The new system, as of today, has begun ... the G-20 is now the premier economic organization for dealing with economic management around the world."<sup>9</sup> With these lofty endorsements, the G-20 formally took over the responsibilities that had been for decades the purview of an elite club made-up of the world's wealthiest countries: the G-7 and more recently, the G-8. Viewed as a far more representative body as it includes countries from all regions of the world (and which together constitute some 90% of global gross national product, 80% of world trade, and over two-thirds of the world's population), the G-20 was seen as better equipped to resolve common challenges in the global age.

Indeed, in Pittsburgh the G-20 unveiled, yet another plan to promote growth by launching the "Framework for Strong, Sustainable, and Balanced Growth" The core of this framework is a multilateral process through which G-20 hopes to identify objectives for the global economy, the set of policies needed to reach them, and the progress toward meeting these shared objectives - the so-called Mutual Assessment Process (MAP). At the Seoul Summit (November 2010), the G-20 committed to work with "greater resolve" in addressing global imbalances and reached broad agreement on a set of indicators and guidelines to identify what constitutes "large and persistent imbalances," At the November 2011 Summit in Cannes, the G-20 announced the "Cannes Action Plan for Growth and Jobs," reiterated their support for measures to deal with the Eurozone debt problems, strengthening financial regulation, and better managing capital flows and reducing the global imbalances.

Certainly, the sense of collective purpose and unity the G-20 has demonstrated in responding to the financial crisis and post-crisis developments, including coordinating stimulus programs to jump-start the global economy, synchronizing regulatory reforms to correct distortions in their financial systems, reforming IMF's governance to include more emerging economies in decision making, and rejecting protectionist policies in favor of balanced and sustainable growth based on free-trade, underscore the organization's coming of age and commitment to collective purpose. However, much of these bold measures are yet to be implemented. This is because the G-20 has no formal

adjudicating and enforcement mechanism. All agreements passed by the G-20 are done via consensus and all agreed-to commitments are non-binding. In fact, the G-20 does not even have a formal voting system. Therefore, it is very difficult to gauge members' views on particular issues. Given the fact that the G-20's recommendations depend on solicitous peer-pressure and voluntary implementation, governments can cherry-pick what they want enforced and what to be left alone. Hence, Truman (2011, 1) correctly concludes "that the G-20's journey involved some useful mutual education, but not much in terms of concrete accomplishments" (Truman 2011).

### **G-20: the divide hardens**

With contentious issues left to fester, it did not take long for the simmering divisions within the G-20 to manifest itself. When the G-20 met in Seoul, the unity and bonhomie so much at display in Pittsburgh had all but disappeared. Instead, the old rifts and the fault-lines among the world's major economies, including between the advanced economies and between the advanced and emerging economies resurfaced with a vengeance (Wittrock 2010). Despite the rhetorical consensus by G-20 leaders to put a positive spin, the Summit ended on a sour note. That is, in acrimony with heightened divisions over issues of trade, currency and global imbalances.<sup>10</sup> The failure at Seoul was particularly stinging rebuke to President Obama who had hoped the Summit would vindicate his "shared jobs agenda."

At the heart of Obama's ambitious "jobs agenda" was to create a "level playing-field<sup>11</sup> for U.S. exporters. However, according to Washington, there is two ways to achieve this. First, Beijing must stop its policy of deliberately keeping its currency, the RMB (renminbi also called the yuan), artificially undervalued, and second, a number of G-20 members, in particular, China must work harder to "rebalance their economies" or limit their trade surpluses with the United States. Indeed, Washington even went to the trouble of proposing specific targets regarding how much a country's current accounts of trade and capital could go into either surplus or deficit - noting that excesses of one or the other could lead to economic instability.<sup>11</sup> However, the first consideration was particularly critical to Washington, and it was well-known that Obama wanted to make the issue of the undervalued yuan and global imbalances the focal point of G-20 deliberations. This is because the United States (as well as other countries) has long accused Beijing of manipulating the yuan at an artificially weak rate to give China an unfair trade advantage.

To Washington, Beijing's neo-mercantilist "cheap yuan" policy costs American jobs because production moves to China to take advantage of the low-labor cost, while the deliberately undervalued yuan helps Chinese exporters by making their products less expensive in the United States, thereby eliminating thousands of American jobs. This, the Obama administration found unacceptable at a time when U.S. unemployment was stuck at 9.6%. Indeed, the President made no

secret his frustration with the slow pace of Beijing's moves to strengthen the value of its currency. If to the White House, the pace of the yuan's appreciation has been too slow and the extent of appreciation too limited, to a growing number of congressional critics, Beijing is not serious about fixing its overvalued currency - reflected in the fact that the yuan increased in value by about 1.5% since Beijing stopped tying its currency to the U.S. dollar in July 2009. Moreover, Beijing's critics have long pointed out that a stronger or market- determined yuan would encourage Chinese firms to sell more to their own consumers (instead of unduly relying on American and other foreign consumers to buy low-priced Chinese goods), besides helping reduce the U.S. trade deficit with China.

Yet, contrary to expectations, leading G-20 economies, including Germany and Japan refused to back Washington's demand to cajole (if not pressure) China to boost its currency's value by transitioning to a market-based system. Instead, the G-20 only pledged to refrain from "competitive devaluation" of currencies and not the wording "competitive undervaluation" preferred by the Obama administration because it would explicitly mean pointing a finger at China's currency policy. To add salt to the wound, Beijing charged that the United States was itself engaging in a subtle form of currency manipulation via the U.S. Federal Reserve's easy-money policy. Specifically, Beijing claimed that the Fed's announcement on 3 November 2010 that it was planning to phase-in the second round of "Quantitative Easing" (QE) by pumping an additional \$600 billion into the U.S. economy was implicitly designed to weaken the dollar to boost the competitiveness of American exports. Germany's finance minister Wolfgang Schauble backed Beijing by accusing the Americans of hypocrisy noting that "It's inconsistent for the Americans to accuse the Chinese of manipulating exchange rates and then to artificially depress the dollar exchange rate by printing money" (The Economist 2010).

Clearly, these concerns resonated with most G-20 members (The Economist 2010). Predictably, there was no progress regarding how to reduce the widening gap between nations running large trade surpluses and those running deficits. In other words, on the question of how to rebalance the "persistently large imbalances" in current accounts, especially, correcting the huge trade deficits the United States has with major exporters like China, Japan and Germany, all the G-20 could agree to was to set "indicative guidelines" to measure the current account imbalances (in consultation with the IMF), but left the details to be determined later. Put more bluntly, the G-20 rejected the "binding targets" called for by the United States.<sup>12</sup> Emboldened, Beijing once again rejected the use of real exchange rates and currency reserves to measure global economic imbalances. Rather, Chinese Finance Minister Xie Xuren bluntly stated that the G-20 should use trade figures rather than current account balances, real effective exchange rates and reserves to assess economic imbalances. Zhou Xiaochuan, the governor of China's central bank reiterated that Beijing alone would decide the pace of the yuan's appreciation, noting that "external pressure has never been an important factor of



consideration and we have never paid special attention to it,"<sup>13</sup> At Cannes · Beijing, once again · rejected the idea of monitoring real effective exchange rates and foreign exchange reserves. Suffice it to note, without an agreement over how to define economic imbalances, how does the G-20 prescribe effective solutions?

During the meeting of finance ministers and central bank governors from the G-20 in Paris (18-19 February 2011), Treasury Secretary Geithner once again criticized China stating that the yuan was still "substantially undervalued" and that the measures taken by Beijing to adjust the value of its currency by allowing it to appreciate against the dollar was not enough. As noted earlier, for its part, Beijing remained defiant noting that currency reform was an internal matter. Although, Geithner correctly noted that the real effective exchange rate is the best measure to evaluate a currency against its trading partners, China vociferously disagreed (Alderman 2011). Rather, Beijing reiterated its usual complain that "hot money" inflows (an indirect reference to U.S. Federal Reserve's \$600 billion bond purchase program), risk destabilizing the economies of emerging countries. At Beijing's insistence, the final G-20 communique made no mention of the real effective exchange rate or foreign currency reserves (Flynn and Neogy 2011). Instead, the G-20 agreed on only board references to exchange rates and the current account as a measure to assess economic imbalances, but with emphasis on indicators such as public debt, fiscal deficits, private saving and borrowing, trade balance, and balance of payments such as net investment flows. Again on Beijing's insistence, the indicators were not binding targets, but guidelines for coordinated economic policies to reduce distortions, in particular, disruptive fluctuations in capital flows. At its Ministerial Meeting (April 2011), the G-20 finance ministers reached an agreement on a set of indicators to monitor global economic imbalances. Specifically, the IMF was given responsibility to identify imbalances by drawing on a wide range of indicators, including internal factors, such as public debt and fiscal deficits, private savings rate and private debt, and external factors, such as trade balance and net investment income flows and transfers. Needless, to say the indicators are broad and convoluted enough to give China the necessary wiggle room. It is, therefore, not surprising that despite the stated committed by all key players in the global economy to enhanced exchange rate flexibility and reforms in the international monetary system to avoid disruptive swings in capital flows and exchange rates, competitive devaluations continue unabated.

During their semi-annual talks in mid-April 2011, G-20 finance ministers again "chastised the United States for not doing enough to shrink its massive overspending and warned that budget strains in rich nations threaten the global recovery." Brazil's finance minister, Guido Mantega, offered sharp words in a thinly veiled attack on the United States [stating] "Ironically, some of the countries that are responsible for the deepest crisis since the Great Depression, and have yet to solve their own problems, ate eager to prescribe codes of conduct to the rest of the world." Suffice it to note, Geithner replied with his own veiled criticism of China and other countries on global imbalances by noting

they must adopt “greater exchange rate flexibility” (Wroughton 2011). In the meantime, despite the problems with the yen in the aftermath of the earthquake and the Eurozone (namely, the realization that Greece and others may have to restructure their debt obligations), the dollar has continued its steady decline against most major currencies. While, this is due in part to near zero interest rates in the United States (compared to higher rates elsewhere), other factors are also at play. On April 18, when Standard & Poor warned that the U.S. government's coveted triple A rating status was in jeopardy because of concerns regarding the Obama administration and Congressional Republicans failure to reach agreement on deficit reduction, including concerns about United States exploding budget deficit, the dollar experienced a sharp sell-off. Adding to the dollar woes, Beijing has continued to put pressure on Washington implicitly warning of a diversification away from dollars, besides allowing the yuan to gradually appreciate. Of course, this creates more challenges for the dollar. On one hand, a rising yuan means that Beijing needs fewer dollars to offset the yuan strength, on the other, China's competitors, in particular, other Asian exporters are also letting their currencies to gain strength against the dollar. Thus, Washington's long-held demand that Beijing must allow the yuan rise against the dollar (and other currencies), to boost U.S. exports, and thereby help reduce its massive trade deficit, the dollar's continued decline poses an unanticipated challenge further widening the divide between the United States, China and other G-20 member countries.

### **The risks of not rebalancing**

In the early 1970s, the problem of mounting current account mismatches was resolved with the collapse of the Bretton Woods system, while in the 1980s, international coordination of exchange rate movements such as the G-5 Plaza agreement of 1985 and the G-7 Louvre agreements in 1987, played the decisive role.

As in the past, today, fixing the global imbalances will require cooperative, coordinated and sustained policy response - which not only includes the United States and China but also the other important players. Yet, the key deficit and surplus countries continue to pursue and engage in economic policies that are in direct conflict with each other (Ferguson and Schularick 2011). This seemingly zero-sum actions carry huge risks because it can trigger a "disorderly unwinding" of the global imbalances. That is, if and when global markets are no longer willing to continue financing U.S. debt, it could trigger a sell-off of dollar assets and a sharp rise in U.S. interest rates - with grave implications for the global economy as the spillover effects would be huge and disastrous.

The inability of the G-20 to address the very issues it was established to do and coupled with the continuing acrimonious exchanges between the world's major economies is threatening to resurrect destructive protectionist policies like those that worsened the Great Depression in the 1930s. Specifically, given the surplus and deficit countries are pursuing economic policies that are in direct

conflict (that is, deliberately resisting the relative price changes that are essential for a successful rebalancing) the obvious danger is that the worst hit countries, including the United States, may resort to protectionism to facilitate rebalancing. Clearly, at this critical juncture, the G-20 in its current form is simply not up to the task to effectively diffuse this simmering conflict and advance multilateral economic cooperation. Rather, even as competing national interests push against genuine multilateral cooperation, the G-20 has no effective levers to override this. Indeed, even in the midst of a rapidly deteriorating situation in the Eurozone and dire warnings of another global crisis, the G-20 leaders at their 17-19 June 2012 summit in Mexico failed to do anything substantive (besides issuing a joint statement that "we will act together to strengthen recovery and address financial market tensions") to ease market worries. In other words, the current decentralized and fragmented international monetary and financial system lacks an effective mechanism or a "neutral" arbiter (like the United States during the Bretton Woods era) to manage what each country does to advance its own self-interest does not hurt them as a collective.

More fundamentally, the discord and acrimony at display at G-20 Summits and beyond is symptomatic of a much deeper trend in the international system -the unraveling of the liberal multilateral partnership that guided the global economy for much of the second half of the twentieth century. The American hegemon no longer towers over potential contenders, and no longer in the position to unilaterally dictate global economic policy. As "hegemonic stability theory" has long contended, the absence of a hegemon or even a concert of powers with the ability to exercise restraint and leadership in the global political and economic arena means that meaningful cooperation between large, divergent and competing economic national interests will be ever more contentious and difficult to resolve. Rather, with a growing leadership vacuum at the center of global economic policymaking, the world is entering a period that will be marked with unprecedented uncertainty and ambiguity. Whether the G-20 or a smaller bloc of powers be able to find a new equilibrium and fashion some sort of workable internationalist and multilateral compact in the form of pragmatic reciprocal partnerships or task-specific concerts, or will the widening polarization spins out of control in the form of protracted trade and currency conflicts, is the essential question of our time.

### **Postscript**

The modest decrease in global imbalances (in particular, the decline in China's surpluses and the narrowing of U.S. current account deficits) in the post-crisis period does not mean that the problem will magically "correct" itself. To the contrary, the decrease is due to reduced levels of economic activity in the advanced economies and China's current investment spending binge, rather than a fundamental rebalancing of the world's major economies. As noted, big export economies such as China (but also Japan and Germany) have hardly abandoned their export-led growth models, and not only China continues to engage in currency manipulation to maintain export advantages, the

lack of exchange rate flexibility in many emerging-market economies is a growing problem. In fact, the U.S. Treasury in its October 2013 "Report on Congress on International Economic and Exchange Rate Policies," not only once again accused China for its undervalued currency, but also explicitly blamed Germany for maintaining a large current account surplus in spite of the fact that such actions were exacerbating the Eurozone's financial woes.<sup>14</sup> On their part, deficit countries such as the United States have failed to rein-in spending and improve public finances, and China can hardly sustain its current investment rate (there is only so many highways and bridges it needs). In other words, the sources of the underlying problem that created the trade and current-account imbalances between the United States and China still remain in place. Given this, global imbalances will likely appear once a more sustained recovery takes hold. Clearly, there is not time for complacency. What is needed is concerted multilateral action to effectively address the problem. Arguably, fearful of complacency and that only limited progress has been made, the G-20 during their February 2014 meeting of Finance Ministers and Central Bank Governors, urged the member-states to redouble their efforts to rebalance their economies.

## Notes

1. Caballero, Farhi, and Gourinchas (2008); Cooper (2008).
2. Bernanke (2005) and Benjamin Bernanke, "U.S. Monetary Policy and International Implications" (speech delivered at the "Challenges of the Global Financial System: Risks and Governance under Evolving Globalization", A High-Level Seminar sponsored by Bank of Japan-International Monetary Fund, Tokyo, Japan, October 14, 2012). <http://www.federalreserve.gov/newsevents/speech/bernanke20121014a.htm>; Bernanke (2010).
3. For a good overview, see Borio and Disyatat (2011).
4. Baily and Bosworth (2014, 3-4); also see, Pierce and Schott (2012); Atkinson et al. (2012).
5. Krugman (2009). Of course, it was Robert Triffin who first identified the problem associated with the "dollar trap." Labeled as the "Triffin Dilemma," it argues that any international monetary system that is based on a national currency faces a structural problem - or the "dilemma". Namely, because the country issuing the international currency (the United States) is in charge of providing global liquidity, it invariably needs to run current account deficits. As a result, its external debt increases, but this in turn also erodes the "credibility" of that "international currency." This is what happened to the U.S. dollar in the early 1970s forcing President Nixon was forced to end the "gold standard" and the post-war Bretton Woods order. Triffin (1960).
6. For a good overview of the SDR, see Kenen (2010).
7. In large part, the proliferation of shadow banking in China is the result of "Financial repression." Specifically, Beijing's tight control of the formal banking system, via which it can maintain low interest rates and provide cheap loans to state-owned enterprises and those with connections, have forced investors, including small depositors to seek yield elsewhere, including shadow banks.
8. Kirshner (1997). Also see, Kirshner (2008).

9. "Leaders' Statement: The Pittsburgh Summit," September 24-25, 2009. <http://www.pittsburghsummit.gov/mediacenter/129639.htm>.
10. Joshi (2010). For details on the agreements reached at Seoul see, The G-20 Seoul Summit, G-20 Seoul Communiqué: Leaders Declaration, November 11-12, 2010.
11. The U.S. suggested that current account surpluses/deficits be capped or limited to 4% of GDP.
12. These guidelines are to be developed by the G-20 with assistance from the International Monetary Fund, including finance ministers and central bank governors. The G-20 agreed to meet in mid-2011 to discuss progress. For details, see International Monetary Fund (IMF) (2010).
13. Chinese Finance Minister Xie Xuren said that "the G20 should use trade figures rather than current account balances to assess economic distortions... "We think it is not appropriate to use real effective exchange rates and reserves." Flynn and Neogy (2011).
14. United States Treasury, "Report to Congress on International Economic and Exchange Rate Policy," October 2013, For a good overview, see Aizenman and Sengupta (2011).

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