Against the Consensus

Reflections on the Great Recession

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WHAT CAUSED THE GLOBAL CRISIS

The global imbalances and Global Financial Crisis

- The global financial crisis was preceded by the global imbalances
- A commonly accepted view is that the global financial crisis was caused by the global imbalances
  - The surplus countries accumulated huge amount of foreign reserves denominated in US dollars
  - The reserves were used to purchase US treasury bills, which repressed interest rate
  - The low interest rate resulted in a housing bubble in the US
  - The burst of housing bubble caused the eruption of financial crisis

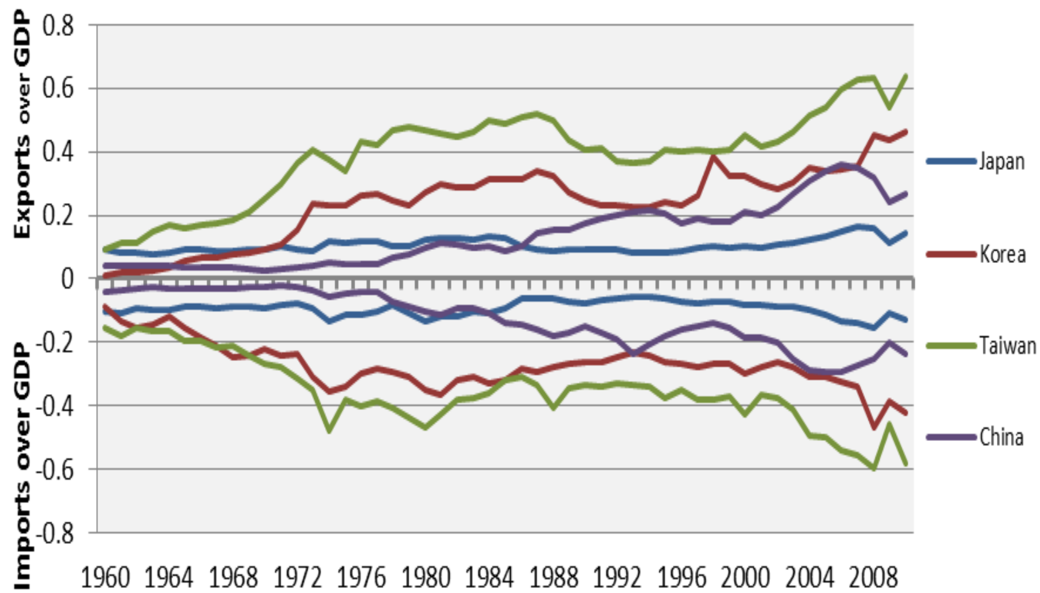
The causes of the global imbalances

- Commonly accepted hypotheses behind the large global imbalance are:
  - East Asian economies' export-led growth strategy.
  - The self-insurance motivation after the East Asian financial crisis.
  - China's exchange rate policy.
- The above hypotheses are all theoretically plausible. If they are valid, the East Asian economies were responsible for the global imbalances and crisis and they have to change those policies to avoid the recurrence of such imbalances and a crisis.
- However, are they consistent with the empirical evidence?

East Asia's export-led growth strategy ?

- The trade surpluses in East Asian economies increased dramatically in recent years.
- However, the East Asian economies have adopted an export-led growth strategy since the 1960s and before the 2000 , their trade accounts were basically balanced.
- Therefore, an export-led growth strategy cannot be the root cause for the emergence of large global imbalances in 2000 and thereafter.

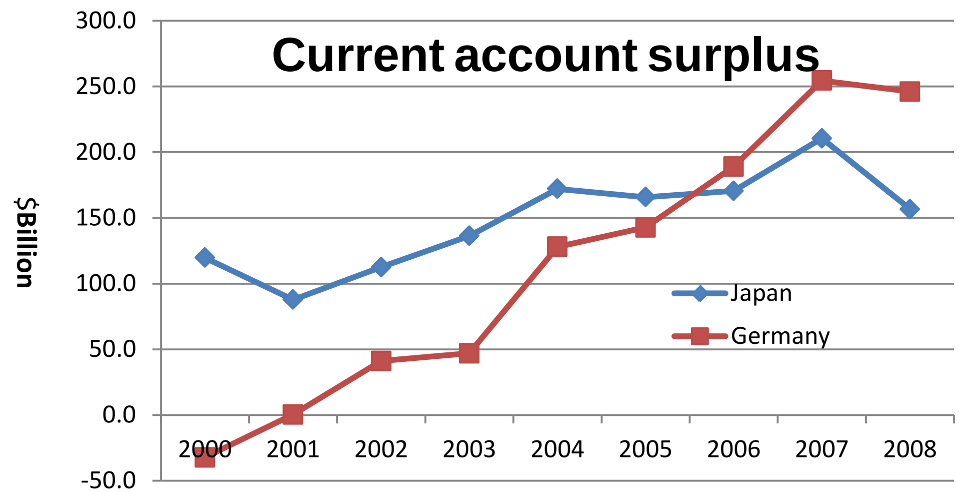
Decomposition of the trade balance (exports and imports as a percent of GDP)

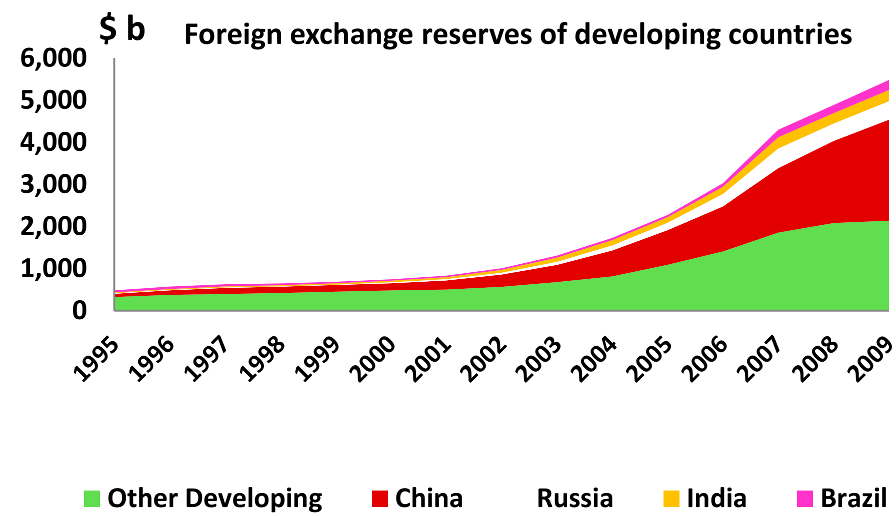


Sources: International Monetary Fund, World Economic Outlook database; Organization for Economic Co-operation and Development National Accounts data files; Taiwan Statistical Databook; and World Bank national accounts data.

The self-insurance motivation?

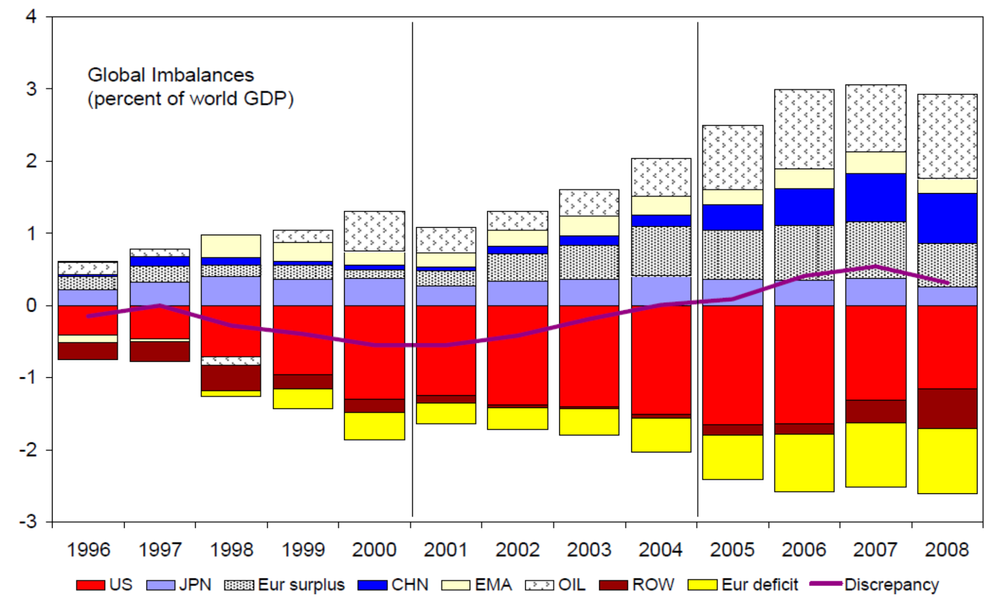
- After the financial crisis in the late 1990s, East Asian economies increased their trade surpluses substantially, as the hypothesis suggests.
- Japan and Germany also have large trade surpluses, but as hard-currency countries, they do not have the need for self-insurance.
- Other developing countries also increased their reserves substantially
- Moreover, the surplus and reserve accumulation in China after 2005 are too large to be justified by the insurance motivation.

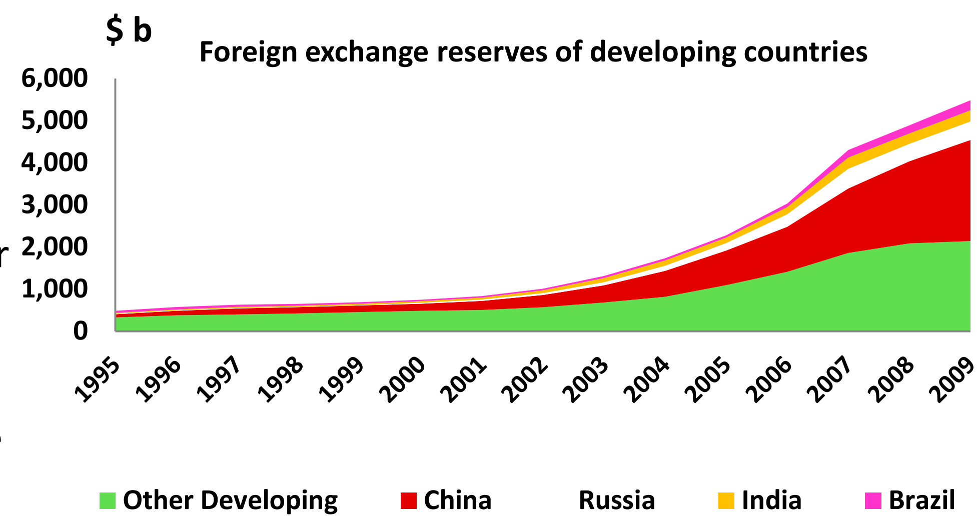




China's exchange rate policy?

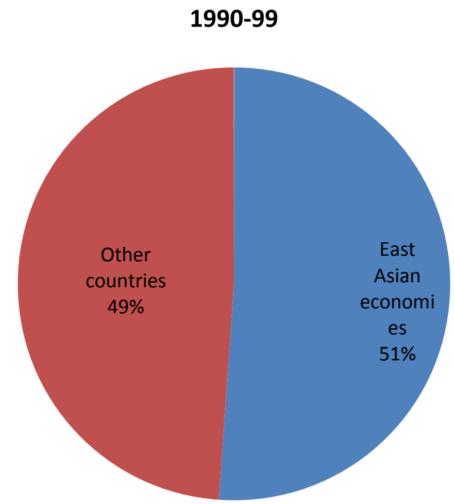
- The global imbalances started to grow in 2002, and China has been accused of causing the imbalance by a large undervaluation of its exchange rate since 2003.
- However, consider the following facts:
  - –China's trade surplus did not become large until 2005, and its trade surplus in 2003 was smaller than it was in 1997 and 1998. It was commonly believed that the Chinese currency was substantially *over*valued in the late 1990s.
  - –When China's trade surplus with the US increased after 2005, China's trade deficits with other East Asian economies also increased.
  - –China's currency appreciated against US dollar by 20 percent in 2005-2008, but the global imbalances, especially the US-China imbalance, continued to grow.
  - –Most other developing countries also increased their trade surpluses and reserves substantially in the same period. If China's exchange rate were the cause, then the other developing countries that compete with China in the global market would have experienced declining trade surpluses and declining or relatively stable reserves.

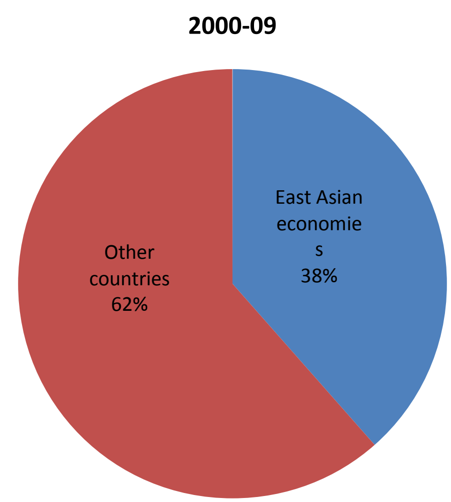




The need for an alternative hypothesis

- The above three hypotheses all imply that East Asia economies are driving global imbalances.
- However, while US's trade deficits with China increased substantially,
- ……the share of the US's trade deficits due to East Asian economies as a region were declining significantly.
- The above evidence indicates that the three commonly accepted causes cannot be the root cause of the global imbalances.





A new hypothesis that is consistent with all the evidence….

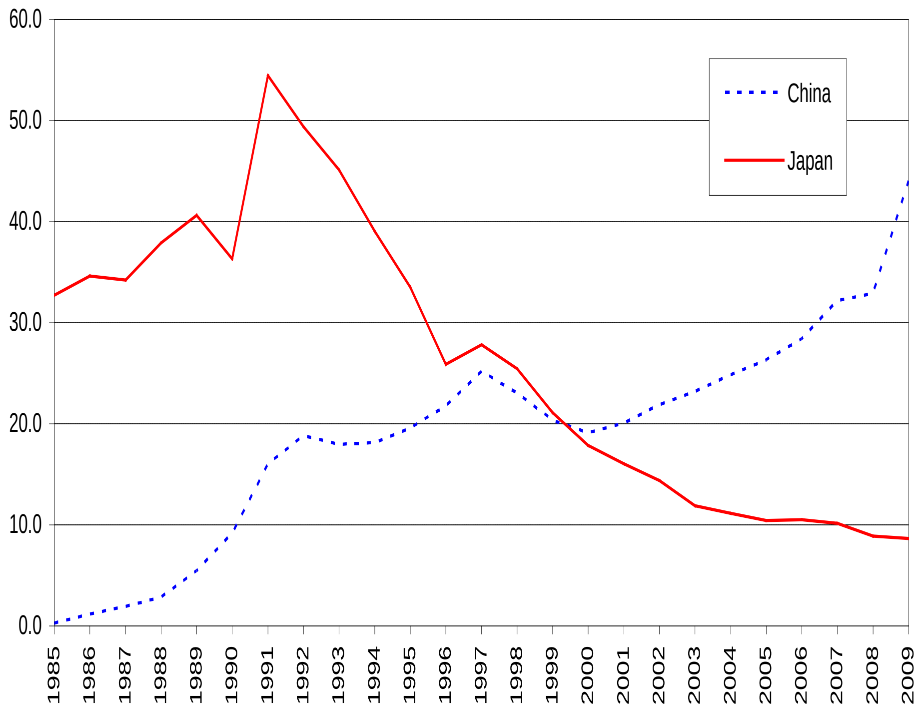
- The global imbalances were a result of the status of the US dollar as the major global reserve currency,
- …….combined with the following two policy changes:
  - The high leverage in financial sector made possible by deregulation in the 1980s.
  - The Fed’s low interest rate policy following the burst of the “dotcom” bubble in 2001.
- The above policy changes led to excessive risk-taking and higher leverage, resulting in excess liquidity, and “bubbles” in both housing and equity markets in the US.
- The wealth effect of these bubbles enabled US households to over-consume, which together with the public debts arising from the Afghanistan and Iraqi wars, increased the US current account deficits,
- Such a large rising US current account deficits could be sustained for a long time only because the US dollar is the main global reserve currency

A new hypothesis-continued

Chart 2

Share of US-Japan and US-China deficits in total merchandise trade deficit of the United States, 1985-2009

(Percentage)



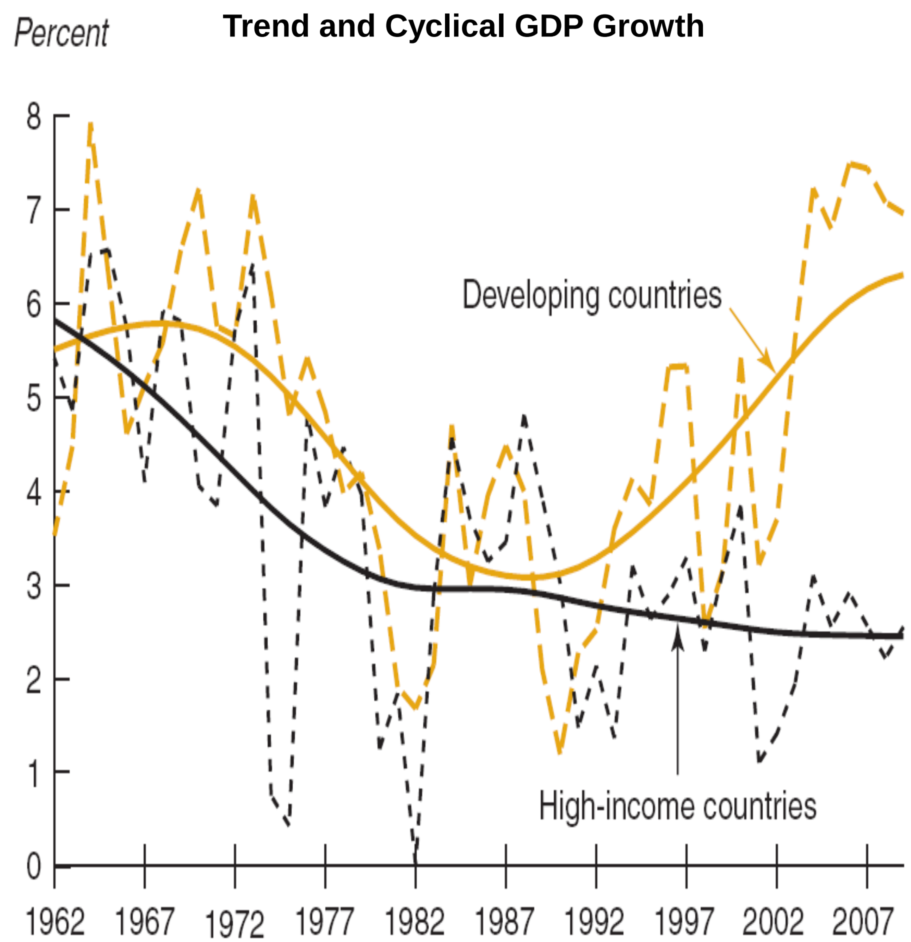
Source: UN Comtrade database.

- The increase in the US's trade deficit with China reflected the relocation of light manufacturing production from East Asian economies to China and regional integration through production networks, as shown in the changing patterns of US's trade deficits with Japan and China from 1985 to 2009.

A new hypothesis-continued

- The above excess liquidity also led to the large outflow of capital to developing countries, rising from $200 billion in 2000 to $1.2 trillion in 2007, contributing to investment-led growth in many developing countries in the same period. The growth rate of developing countries as a whole in 2002-2007 was a historical record.
- The investment-led growth in developing countries in turn resulted in large trade surpluses in many advanced capital-goods exporting countries, such as Germany and Japan.
- The accelerated growth in many countries resulted in a sharp increase in demand for (and prices of) natural resources, as well as trade surpluses in natural resource exporting countries.
- Since the US dollar is the reserve currency , the central banks of other countries will invest the foreign reserves accumulated through their trade/ capital account surpluses back to the US by purchasing treasury bills or other financial assets.

Trend and Cyclical GDP Growth



A WIN-WIN PATH TO RECOVERY

A Protracted New Normal

- The global economy, especially the advanced countries, has not fully recovered from the global crisis
- For the sovereign-debt crisis-hit Southern European countries, without structural reforms any rescue package is just a pain killer
- Structural reforms are contractionary and politically infeasible due to the existence of high unemployment rate
- Devaluation is a conventional measure for creating the space for structural reforms in a crisis-hit country. Such measure is not feasible in Southern European countries
- The devaluation of Euro may cause a competitive devaluation in the US, Japan and other high-income countries
  - They all need spaces for structural reforms
  - Their products are competing in the global market
- The high-income countries may encounter a protracted “new normal” or even Japanese-style “lost decades” due to the lack of space for structural reforms

A Global Infrastructure Initiative

- A bottleneck-releasing, productivity-enhancing infrastructure investment can create demand, job and growth and is self-liquidating.
- The opportunities for a bottleneck-releasing, productivity-enhancing infrastructure investment are limited in advanced countries but abundant in developing countries
- A coordinated global infrastructure initiative, funded by reserve-issuing countries, reserve-rich countries, pension funds and sovereign wealth funds, is a global win-win
  - Creating the required space for structural reforms in advanced countries, enabling them to regain competitiveness and normal growth
  - Enhancing the growth potential in developing countries
  - A new asset class for private and institutional investors
- The G20 can be a platform to push for a coordinated global infrastructure initiative and the multilateral development banks can be the agencies for implementing the initiative

CAN POOR COUNTRIES GROW DYNAMICALLY

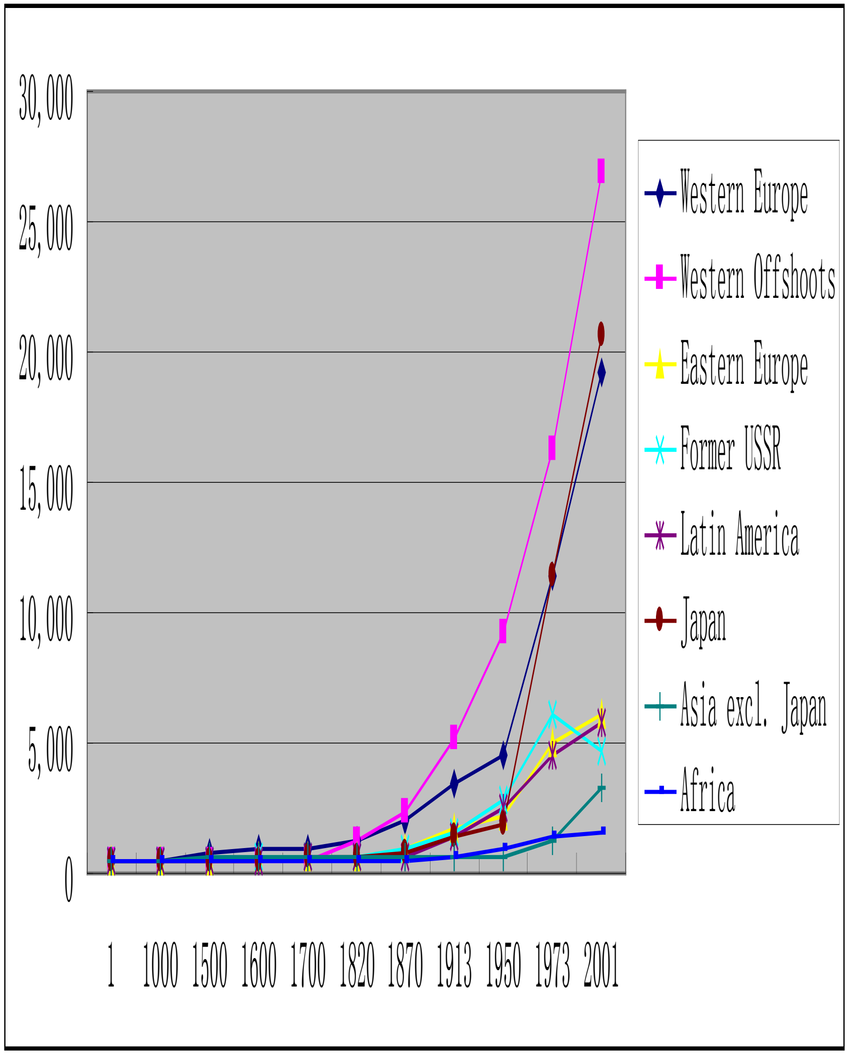
Growth and Self Liquidation

- The self-liquidation of an infrastructure project depends on, among other factors, the intensity of use, which is a function of economic growth
- Can poor countries grow dynamically?
  - Most developing countries were trapped in low-income status and middle-income status since WWII
  - Poverty is not a destiny. The new structural economics, drew on the experiences in China and other successful economies, provides the intellectual basis for guiding developing countries to achieve dynamic growth
  - China's rising wages and pending relocation of labor-intensive manufacturing industries provide a golden opportunity for poor countries

Let's go back to Adam Smith

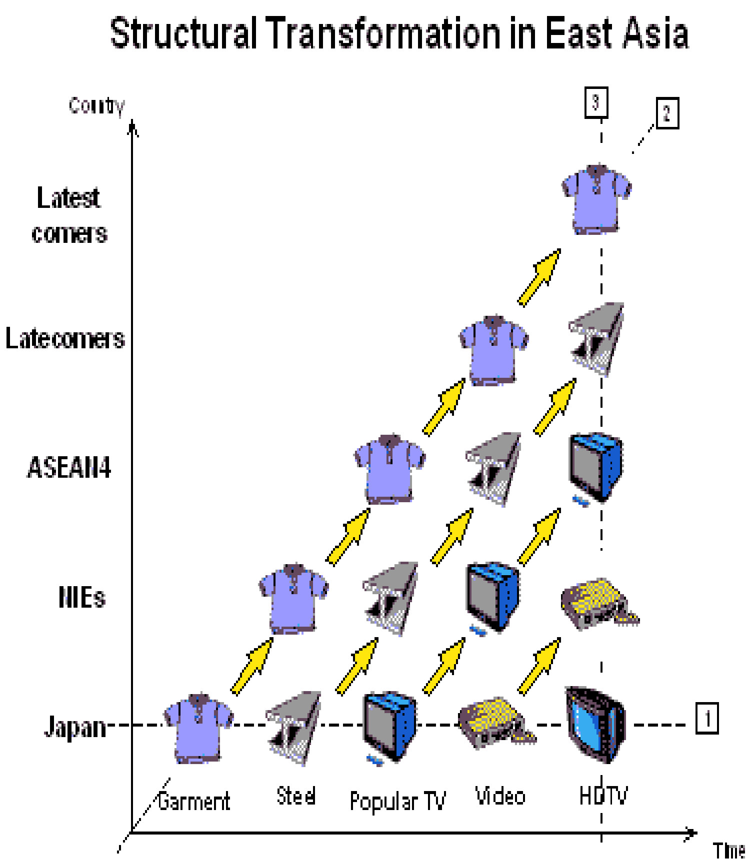
- The new structural economics proposes to the study of economics to go back to Adam Smith
- But not to ***The Wealth of Nations***, which reflects findings of Adam Smith's research
- But to go back to Adam Smith's methodology, that is, ***An Inquiry into the Nature and Causes*** *of the Wealth of Nations*

The Nature of Modern Economics



- The rapid, sustained income growth is a modern phenomenon
- The nature of modern economic growth is a process of continuous technological innovation and industrial upgrading, appeared after the Industrial Revolution
- Advanced countries rely on inventions to achieve technological innovation and industrial upgrading. Empirical evidence shows that advanced countries grew at about 3 percent annually since the mid-19th century.
- The experiences in East Asian economies show that if a developing country knows how to utilize the advantage of backwardness in technological innovation and industrial upgrading in its catching up stage, it can grow at 2 or 3 times faster than the high-income countries.

Flying-geese pattern and dynamic growth in developing countries



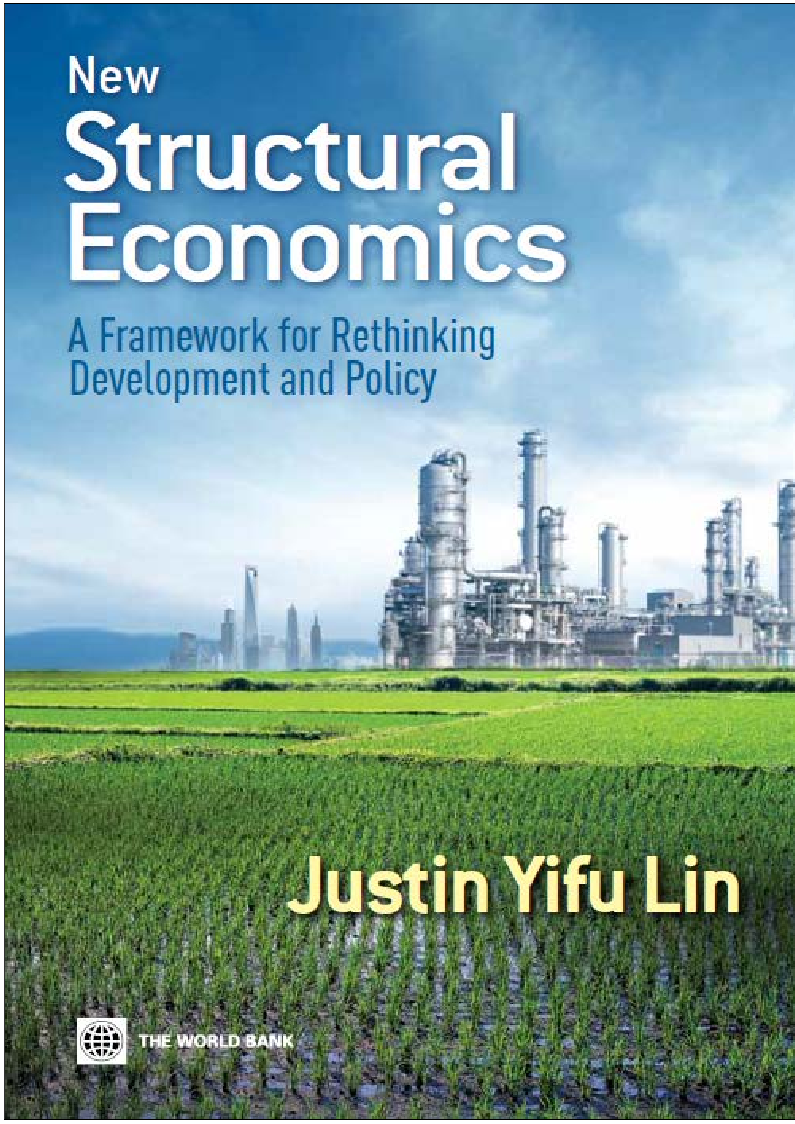
- Historical evidences show that successful countries in their catching-up stage used industrial policy to facilitate the development of industries existing in dynamically growing countries with a similar endowment structure and moderately higher per capita income in a flying geese pattern. This is because
  - Industrial upgrading is based on changes in comparative advantages due to changes in endowment structure.
  - Countries that have a similar endowment structure should have similar comparative advantages.
  - A dynamically-growing country's industries should be consistent with the country's comparative advantages. Some of its industries will lose comparative advantage as the country grows and its endowment structure upgrades. Those "sunset" industries will become the latent comparative advantage of the latecomers.

The opportunity of China's pending relocation of labor-intensive industries for other developing countries

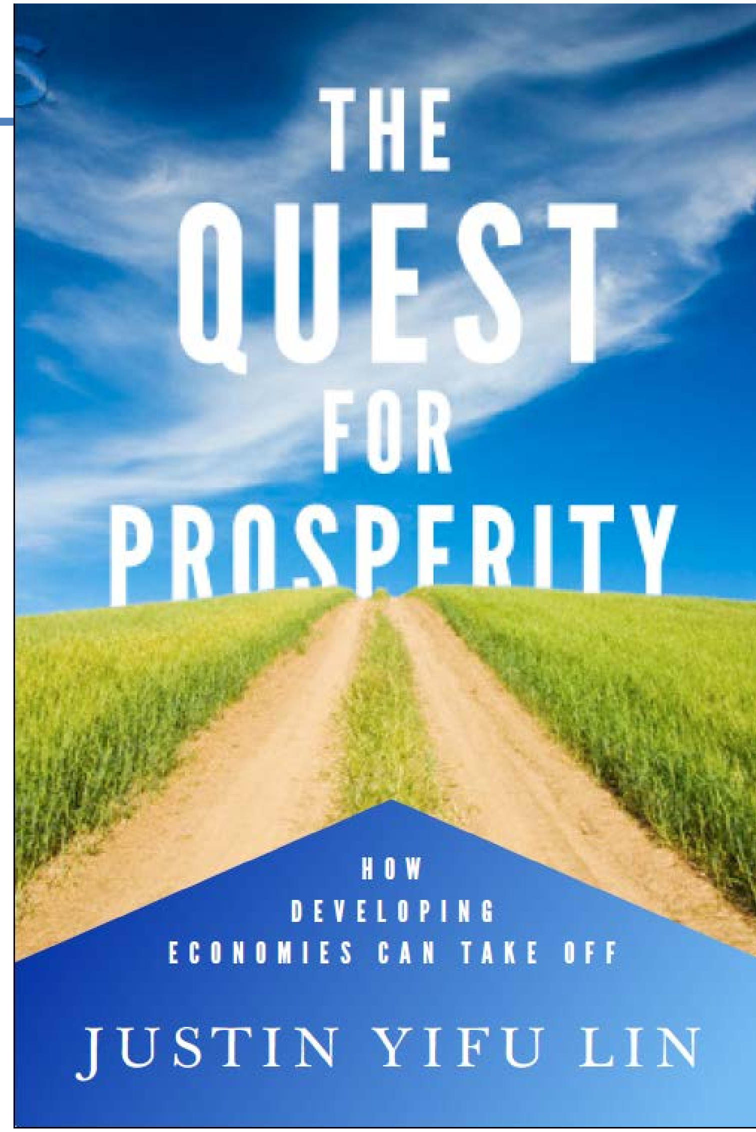
- China has reached the same stage as Japan in the 1960s and the East Asian Dragons in the 1980s. The wage increase in the coming years will force China to give up the labor-intensive industries and move up the ladder to more capital-intensive and technology-intensive sectors.

		GDP per capita, constant USD		Manufacturing		
	year	2000 USD	2005 USD, PPP	as % of Total Value Added	as % of Labor	employment in millions
China	2009	2206	6200	43%	17.7**	85
Japan	1960	5493	6976	35%	20**	9.7**
S.Korea	1982	3709	6123	25%	14.6	2.3
**In 1963						
*In 2002						

- China's upgrading to higher industries will leave a huge space for MANY low-income developing countries to enter a labor-intensive industrialization development phase. This new phenomenon can be referred as a leading dragon pattern.
- If India, Brazil, Indonesia and other large MICs continue their current pace of growth, a similar pattern will arise.
- If the governments in developing countries play the right facilitation role to capture the above opportunities, there will be a golden age of industrialization and dynamic growth in developing countries



This book can be downloaded for free from the World Bank:
http://go.worldbank.org/QZK6IM4GO0



The book was published by the Princeton University Press in September 2012 and is available on Amazon.com.

TOWARD A BRAVE NEW GLOBAL MONETARY SYSTEM

The role of the reserve currency in global imbalances

- It is only because the US dollar is a major reserve currency that it is possible for the US to run such a large current account deficit for so long.
- The status of the dollar as the global reserve currency, combined with the financial deregulation of the 1980s and the low interest rate policy of the 2000s, led to the emergence of global imbalances.
- To prevent the recurrence of global imbalances, the ultimate solution is the replacement a national currency as a global reserve currency with a new global currency.

Is the Special Drawing Right an Alternative?

- The IMF's special drawing right is a basket of national currencies.
- It does not solve the issue of using national currency as a reserve currency

The Paper Gold

- I propose a supranational reserve currency-the Paper Gold
  - It can avoid the conflict of national interest and global interest, which is inherent in using a national currency as the reserve currency
  - It has the advantage of gold as a reserve but can increase its supply to meet the need of growth of the global economy
  - It can avoid the current troubles in Southern European countries, caused by the lack of national currencies
- This proposal may become acceptable if the emerging multiple reserve currencies system is inherent unstable

COMING
INTO
FOCUS

What really caused the Great Recession?
How best to recover?
How to avoid another?

从西潮到东风

我在世行四年对世界
重大经济问题的思考和见解

林毅夫◎著
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