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Summary of the Discussions

by
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Currency blocs, exchange rate regimes and the RMB

The meeting's location may have partly contributed to spirited discussions on the stability of China's present exchange rate arrangements. In an early intervention Yu Yongding provided some interesting historical background as to the thinking that led the authorities to peg the RMB to the US dollar. The decision largely reflected concerns about currency instability in the wake of the Asian financial crisis. With a vulnerable financial system the authorities wanted to sharply limit the risks associated with a possible devaluation of the RMB. There was also worry about the regional implications of currency instability in China, such as the likely collapse of the Hong Kong peg to the US dollar and the risk of Asian countries entering into a phase of competitive devaluations. He also noted that the high share of dollar-denominated imports as inputs in Chinese exports would probably have greatly mitigated whatever competitive benefits might have resulted from a weaker RMB. Finally, a peg to the US dollar—at a time when Chinese inflation had not yet converged to international levels—had been seen as a disciplining mechanism to boost productivity in the tradables sector.

China remained committed to a more flexible exchange rate regime in the longer-term, but the authorities had thought it better not to give a timetable to this particular policy undertaking. A peg to a basket of currencies of China's main trade partners with a 10-15 percent fluctuation band might possibly provide a measure of that "greater flexibility" now being called for. Over a longer time horizon he thought that the authorities faced three choices: managed floating, free floating, and participation in a common currency area for the Asia region. Due to fragilities in the Chinese financial system he thought that free floating in the short term was "out of the question." However, as a transitional arrangement, a BBC regime (basket, band, and crawling) had many features worth supporting, addressing in a more flexible manner some of the concerns that had driven

the authorities to peg against the US dollar in the first place. Over the longer-term a common currency in East Asia was certainly worth considering, particularly given the considerable gains made in recent years as regards trade and financial integration—a point made persuasively by Masahiro Kawai—and the patterns of production in the region which have greatly deepened the regional nature of production processes and are quickly leading to the emergence of a highly integrated international production process in the region. Kawai argued that because of much greater intra-regional interdependence in Asia, it might be desirable to have more formal exchange rate coordination arrangements; for instance, the introduction of an anchor G3 currency basket, thus diminishing the risks associated with dollar/euro/yen bilateral volatility.

Yongding—as other speakers in Rome and Amsterdam—noted that the operation of the present international financial system implied enormous implicit gains for the United States which, with unlimited access to the capital markets, enjoyed the full fruits of seigniorage, buying goods abroad without selling an equivalent value of its own goods; an arrangement akin in spirit to a “free lunch”. He thought that, as a direct response to the increasing degree of trade and financial integration in Asian markets, the creation of an Asian currency side by side with the euro was politically desirable. In due course, it would diminish the influence of the US dollar.

There was some concern expressed in the audience about the state of the Chinese banking system, with some arguing that it was important to enhance its efficiency to boost levels of financial intermediation and to stimulate domestic demand. Its glaring inefficiencies (banks dominated by the state, with little capacity to price risk and suffering from considerable moral hazard) had created a situation where financial intermediation was taking place outside of China and coming back into the country in the form of foreign direct investment. A not insignificant share of this was Chinese flight capital coming back through Hong Kong, taking advantage of various tax incentives.

As regards the role of the IMF in Asia, he agreed that the institution occasionally played the useful role of scapegoat for policy makers, who were otherwise given cover for tough policy decisions. However, there was a view that the continent was not fairly represented in the IMF’s governing structures. Senior officials in the region saw value in the organization but the degree of support which governments would be willing to give it could obviously not be de-linked from fair shareholder representation. In the absence of changes to ensure appropriate representation by Asia in the decision making bodies—which, in practice, meant a reduction in the voting share of European members—Asian governments would take their own measures to ensure financial stability in the region, without unduly relying on assistance from the IMF as had been the case in the second half of the 1990s.

Andy Xie said that large trading economies with fixed exchange rates had traditionally been perceived as “a problem” in the academic community—hence the focus on China and its exchange rate regime. In his view, however, the central problem confronting the global economy today was not China’s exchange rate regime but rather the implications of the failure of the US Federal Reserve to realize that inflation was no longer the

problem that it had been in past decades. Before the collapse of the Soviet Union a tight global labor market had been the source of inflationary pressures in most countries. This was no longer the case. Since 1997 the US current account deficit had tripled to some US\$660 billion (US\$770 billion if one added the deficits of the United Kingdom and Australia). The housing stock in the US had risen from 100 percent of GDP in 1997 to over 150 percent of GDP today, a huge increase over a relatively short period of time. The fall in interest rates in the US to historically low levels had contributed to the emergence of an asset market bubble. (In discussing the evolution of the Japanese economy during the 1980s Kawai said that the bubble was caused by a lax monetary policy which led to unsustainable growth in the stock and real estate markets.) In today's globalised economy the binding constraint on resources was no longer scarce labor but rather scarce commodities, with all the associated implications for massive income redistribution on a global scale. He therefore thought that there was an urgent need for a tightening of US monetary policy to cool asset markets and to bring the US economy down to a sustainable growth path that was consistent with external viability. A mere appreciation of the Chinese currency would not change things fundamentally.

For its part China would also need to shift the focus of economic policy. At the moment the savings rate was unusually high because of the need for the population to accumulate wealth due to the absence of adequate safety net mechanisms and the low return on capital, a point fully supported by David Dollar. Xie added that in China the lack of an efficient financial sector meant that financial resources were allocated by political criteria rather than economic efficiency, which created a potentially dangerous system.

US fiscal policy and a hard landing scenario

Nouriel Roubini suggested that the presence of a large and widening US current account deficit plus the accumulation of reserves at the central banks of China, Japan and other Asian countries meant that we were, de facto, back again into some form of Bretton Woods system. The fiscal deficit in the US was projected to be some US\$430 billion in 2005. If the tax cuts implemented by the Bush administration were to be made permanent, in his estimation, the budget deficit by 2009 would rise to US\$600 billion dollars and by 2015 would exceed US\$1.3 trillion, equivalent to 5.5 percent of GDP. There was thus a need for a "reality check" among US policy makers. At present 100 percent of the deficit was being financed by foreigners, indeed this had been the case during the last 4 years. The average maturity of the US public debt had fallen precipitously to around 55 months. In 2005 the financing needs of the budget would be in excess of US\$800 billion reflecting the issuance of new debt and the rollover of existing obligations. Roubini characterized public debt management by the US administration as "awful and reckless." The market for US government bonds was being manipulated both on the supply and the demand side. There were no issues of 30-year bonds; indeed the net issue of 10 year bonds was zero and there was manipulation of the demand as well because the central banks were providing the funding. So in fact there was no bond market per se. The current imbalances, in his view, were unsustainable. They were equivalent to a Ponzi scheme that would end in tears. Ralf Bryant agreed with Roubini that there would not be any fiscal adjustment in the US, essentially because there was no political will to do so. In fact, the

fiscal accounts in the United States were out of control and he thought that the Asian countries would do well to “take out insurance” against possible disorderly adjustment.

On the external side the outlook was actually worse than suggested by the latest current account figures, the deficit would likely exceed US\$ 650 billion in 2005 but it was necessary to add US\$ 200 billion to capture negative equity on the capital account. He also noted that although the dollar had fallen substantially in the last couple of years the current account deficit had, in fact, widened. He, therefore, was of the view that adjustment of the US economy would not come primarily through movements in the exchange rate of the US dollar but rather through a recession.

As regards the accumulation of reserves by the central banks of China and Japan and others in the region and focusing, in particular, on China he was of the view that China would suffer huge capital losses. By illustration, a 20 percent appreciation of the RMB would lead to something like a US\$ 100 billion capital loss. However, if reserves were to continue to accumulate at the pace of the last 12 months he expected that, within a 2 year period, a 30 percent appreciation of the currency would result in a US\$ 300 billion loss, equivalent to some 20 percent GDP. In addition, one would have to include the carry costs of the massive sterilization operations conducted by the central banks. More importantly, this policy was feeding an asset and credit bubble that would end in China in tears, given the glaring weaknesses of its financial system. Alexander Swoboda indicated that in addition to the exchange rate losses associated with appreciation of the currency noted by Roubini, that there would also be additional capital losses because of an increase in interest rates which would reduce the market value of the securities in Chinese reserves.

The Chinese economy was characterized by excessive overinvestment; at present equivalent to 45 percent of GDP. Furthermore high productivity growth in China would inevitably lead to an appreciation of the currency, sooner or later. Roubini noted in this respect that the Japanese exchange rate had been set at 360 yen per dollar in the 1960s and had moved eventually to 100 yen per dollar. He expected that the evolution of the Chinese currency would closely follow this pattern. Against this background, it would be much better to have a nominal appreciation of the currency than have higher inflation. He also noted rising protectionist sentiment against Chinese exports in the United States associated with the emergence of China as a global trading power with a weak exchange rate. There would be diversification away from the dollar which, of course, would lead to a weaker dollar and potential instability in the foreign exchange markets. Furthermore, he noted that while in his first administration president Reagan had implemented a fairly loose fiscal policy, in his second term there was a substantial retrenchment, now totally absent in the second Bush administration. He therefore thought that the risk of a hard landing for the global economy in the next couple of years was high and would be quite ugly.

External imbalances and the role of the IMF

Jack Boorman contrasted Roubini’s rather tough assessment with Richard Cooper’s far more sanguine views put forward during the July meeting in Rome, subsequently the

subject of an Op Ed piece in the Financial Times. He reminded the audience that Cooper had argued that the United States had a floating currency and that countries for their own mercantilist reasons were willing to invest in the United States. There were some US\$ 5 trillion of savings outside the US in search of an outlet for possible investment and it was not unreasonable to presume that investors outside would want to place 10-15 percent of their savings in the United States; an economy accounting for some 30 percent of global GDP and with an impressive pipeline of future technological innovation.

John Williamson reminded those present that during his assessment Cooper had noted that fiscal adjustment in the United States would be an essential precondition for the current account not becoming a source of instability both for the United States as well as for the global economy. Williamson noted that there would be an appreciation of the currency in China in due course and he agreed with Roubini that it would be better for this to happen through a nominal exchange rate appreciation rather than higher inflation.

Sumio Kusaka said that there was still trauma in Asia associated with the 1997 financial crisis. To avoid in the future the pain of 1997, countries had built up large cushions of reserves as insurance. There was, however, a sense that for the region as a whole, the IMF could still provide help in times of crisis, a view that was sometimes accompanied by the sense that the IMF might, nevertheless, run into resource constraints if sufficient funding was necessary to give confidence to the market that the appropriate policies were in place to stem the effects of the crisis. In his view it would be important to rethink the issue of the relative distribution of quotas, to enhance the effectiveness of the organization. Otherwise the IMF would run the risk of losing relevance in East Asia.

Rakesh Mohan said that the sharp changes in bilateral exchange rates in recent years, particularly the dollar/euro rate, had little to do with trade flows or other economic fundamentals. As a result of globalization the effect of exchange rate changes were sharply mitigated because the share of imported inputs in most countries' exports was high and there were growing volumes of hedging in the financial markets. There was, therefore, a need to deal with macro policies first, particularly of a structural nature and those aimed at addressing fiscal imbalances in the US and some of the other larger industrial economies. So, in a sense, there would have to be a shift in the content of policy coordination. A number of other trends in the global economy raised questions about the role and effectiveness of IMF assistance. For instance, there were some US\$ 25 billion per year in emigrant remittances to India, a sum that dwarfed in magnitude the size of any IMF package in a time of crisis. Swoboda agreed that coordination of policies should shift to structural areas. Roubini indicated that after 1997 there was a sense that it was necessary to have greater levels of self insurance but he thought that reserves in Asian central banks were now too high. Countries were running surpluses in the current account and levels of self insurance that were probably 10 times more than needed and the reason for this essentially stemmed from the particular development model that was being used, one mainly based on a weak currency which then was feeding the US current account deficit. But exchange rate adjustments—changes in relative prices—were important and, in conjunction with expenditure retrenchment, suggested ample scope for policy coordination. Mark Allen, likewise, thought that reserve accumulation had reached

“bizarre” levels and John Williamson thought that insufficient attention was being given to the opportunity cost of “resources being locked up in low-yielding reserves.”

Kawai questioned the effectiveness of Article IV Consultations for non-borrowing countries and noted that maybe the IMF should do more regional surveillance. Gavin Bingham noted that cooperation in the European Union was about building a common market buttressed by strong institutional underpinnings, not about coordination of macro policies per se.

International policy coordination

Boorman hoped that during the discussions participants would not allow the belief that the United States would automatically oppose changes to the international financial system to curtail serious consideration of a number of critical issues affecting the present operation of this system. In his view, the need to complement processes of regional integration and cooperation with an overarching global framework was quite tangible. However, consideration of these issues would be facilitated if the underlying motivation was not the desire to undercut the IMF or “weaken” the United States, but rather a genuine wish to have a more effectively operating system.

Williamson made a number of interesting points in discussing the scope for international policy coordination. First, the depreciation of the US dollar that is necessary to secure some adjustment in the US current account deficit has to be mainly against the Asian currencies—other currencies have already appreciated significantly in real terms against the dollar. Indeed, Asian currencies have actually depreciated in effective terms, despite the fact that they are running current account surpluses. Second, revaluing of currencies is not favored by Asian authorities because large intra-regional trade has created a powerful constituency for stable exchange rates; this had been achieved by use of the dollar as the anchor currency. Third, the Asian countries thus face a collective action problem—any country that allows its currency to appreciate could lose competitiveness against its trade partners. This would suggest that there is ample scope for coordination, “to talk about the issue among themselves.” Fourth, Williamson noted that the solution to this problem is for all the countries involved to adopt a common basket peg, and to buttress this by active policy coordination since it is to be expected that, as a group, Asian currencies would need to revalue against non-Asian currencies. Fifth, the IMF could play a useful coordinating role in this process, a nice complement to the undue focus it has given to emerging markets in recent years, and perhaps assist in the calculation of equilibrium exchange rates, to shed some light on the issue of the sort of exchange rate adjustment that might be warranted. (This would take the IMF’s research capabilities beyond the World Economic Outlook exercise, a good thing.) Finally, he noted that the needed demand restraint in the United States was less likely to be the result of more cautious fiscal policies and more likely to be applied by the Fed as inflation accelerated. Nevertheless, there was also scope for demand stimulus in Japan and in Europe, which “had badly prioritized the competing objectives of controlling inflation and stimulating demand.” Roubini agreed that the central problems today were not the emerging markets but rather the global imbalances in the large economies, including reckless fiscal policies

in the United States and the slow pace of structural reform in the European Union and Japan. Ralf Bryant characterized US fiscal policy as being “out of control.”

Williamson also agreed that IMF surveillance had not been appropriately focused by putting too much emphasis on emerging markets and not enough on the G7. He thought that exchange rates mattered greatly, which is the reason why global corporations were outsourcing to low cost countries and why Argentina, at present, had a current account surplus.

The World Bank, aid, and knowledge transfer

David Dollar addressed the issue of why the World Bank was involved in China—a country with US\$ 600 billion in reserves.¹ The rationale for the Bank’s involvement had essentially to do with “knowledge transfer”, market failure in the knowledge market. He gave a couple of examples of the positive externalities associated with Bank involvement in China. The practice of competitive procurement had been formulated and implemented in the context of the country’s relations with the Bank. He also alluded to a project in reforestation, which had begun in a particular region of the country and had then been used as a model to be followed elsewhere. There had therefore been significant positive spillover benefits associated to a number of Bank projects in China.

Muhammad Al-Jassar agreed with David Dollar that the transfer of knowledge was key, playing an important catalytic role in the development process. However, X. P. Guma asked “Why, if countries were after knowledge, they would in that context also accept loans?” He noted that it was very costly from a bureaucratic perspective to do business with the World Bank.

Mohan raised the question of the real role of the World Bank in countries that have access to capital markets and the meaning of the World Bank operating as a “knowledge bank”, in the case of the much more widespread dissemination of knowledge in the world. He also indicated that governance, which often had been interpreted to mean voting power at the level of the Executive Board, also had its counterpart at the level of its management and staff. The international financial institutions were often training ground for public officials who returned to their countries to assume positions of responsibility. The fact that many IMF and World Bank programs had impractical conditionalities imposed on countries reflected lack of experience on the part of the staff who were largely inbred and had no understanding of political constraints and the practicalities of policy making. There was, therefore, a need to tap the whole world when hiring staff for these organizations in a transparent fashion, including the choosing of the organization’s top management.

Kusaka indicated that there remained in middle income countries some 2 billion people living on less than US\$ 2 per day. In his view this meant that there would be a role for

¹ He noted that at present the bank had a portfolio of some US\$ 12 billion in outstanding loans, involving disbursements of some US\$ 1.5 billion per year. For the Bank this represented a gross profit of some US\$ 85 million per year; about a third of this was returned to China as part of the Bank resident mission’s administrative budget and other operations in the country.

the World Bank in this area for some time to come. Roubini noted that the division of labor between the IMF and the World Bank was important to bear in mind. In financial crises lending should come from the IMF, although there was a need to conceive better facilities than those used in the past, such as the Contingency Credit Line which failed because countries that needed the money could not qualify for it. Andrew Large said that the lender of last resort function was a difficult idea, both conceptually and practically even at a national level with a single monetary and fiscal policy, more so at the global level.

Luiz Pereira said that aid fatigue in many of the developed countries was emerging as a major problem, particularly against the background of lack of concrete results and evidence of success. Major volatility in financial markets and herd behavior among investors had created problems for the low income countries. Furthermore, large swings in the evolution of ODA over time, the rather large costs of coordination with donors, and inadequate levels of aid more generally suggested that the time had come to “make aid more attractive”. There was also a need to better understand the impact of development projects on the incidence of poverty, the conditions of women, against the background of weaknesses in the absorptive capacity of recipient countries. He also thought that maybe it was important to begin thinking about permanent sources of funding for aid, perhaps through some form of international taxation, partly also to avoid political cycles. He added that it was tremendously important to improve governance of the international financial institutions, in particular, the issues of voice, representation and voting power.

The IMF’s “business model”

Angel Ubide asked whether the current business model of the IMF was still valid. The IMF did surveillance, crisis resolution and poverty alleviation; these were its primary tasks. On the surveillance front it was widely acknowledged that no one was very happy. There was privileged access to data associated with the surveillance process but these days there was huge access to the authorities in individual countries in any event, particularly on the part of the financial community, with investment banks having developed substantial internal capacity to do country analysis. It was therefore not clear whether the value added provided by the Fund in this area was that great. Perceptions of an independent assessment by the IMF of the situation in countries might have potential value for the market. However, to the extent that, for instance, coverage of topics in the World Economic Outlook were “negotiated” with the major shareholders, with many of the more “sensitive” ones essentially taken out to deflect direct criticism, fundamental questions about the independence of the organization were inevitably raised, giving some credibility to those critics who argued that the IMF was simply the voice of some of the most important treasuries of the largest shareholders. In the absence of such independence, the value to the outside world associated with the surveillance function was thus correspondingly reduced. A move towards giving the IMF greater independence would certainly nurture the accuracy of the country assessments that it made, including those made in the context of the World Economic Outlook.

On the discussion of the relative merits of grants versus loans, Ubide thought that to the extent that there was a shift towards grants this would mean smaller revenue streams for the IMF, whose administrative activities and expenses were financed out of the interest charges on its loans. Would this mean that the IMF would go out of business soon? (Pierre Jaillet asked if addition to grants might increase the cost of financing over the longer term.) Ubide added that, at present, we did not have a framework for preventing a liquidity crisis turning into a solvency crisis and argued that the large cushion of reserves in Asia were not necessarily bad, in terms of capital losses, if at some point, because of external developments, the currencies in these countries were to come under depreciating pressure. The insurance acquired by these countries in recent years through the build up of external reserves would encourage structural reforms in their economies. This raised further the question of the need to boost the independence of the Fund; he suggested that there was no need to have Executive Board approval of Article IV Consultations and that one possible step in terms of shifting the structure of governance in the fund would be to reorganize the chairs by regions.

Chairs, shares and governance at the IFIs

Yung Chul Park suggested that maybe Asian countries could pull their quotas together, and argue in favor of an adjustment in voting power to better reflect the size of economies in the region, thus achieving a better position in the IMF governing structure. Caio Koch-Weser agreed that governance had to be recalibrated in a major way to build up legitimacy and boost ownership, especially in Asia. Not doing this would certainly threaten the independence of the international financial organizations. He thought that the G-20 was a good forum to discuss this particular issue but acknowledged, however, that it would be very difficult to shift weights and the power distribution within these organizations. The ratification of the European Constitution could lead to the European Union speaking with a single voice, which could then translate into a single foreign policy, including in the economic arena. Koch-Weser was not in favor of double majorities; that is a combination of voting shares and number of countries. He also thought that the G-20 could become a G-8 in some fashion in the matter of exchange rates and expressed some support for the idea that, in thinking about reform of the international institutions, it was better to “evolve” rather than to think of a brand new redesign. Many in the European Union shared the vision of one seat and one voice on the Boards of the World Bank and the IMF. He also was against the idea of merging the IMF and the World Bank, a project raising its head from time to time.

Randy Quarles agreed that an appropriate balance of representation in the international financial institutions was a key issue, in light of changes in the global economy. “Chairs and shares” issues could not be neglected indefinitely and their importance should not be underestimated. Governance of financial institutions clearly had to reflect the economic importance of members but the voting shares in these organizations had fallen out of step with economic realities in recent years. Asia as a whole, Turkey, Brazil and Spain were not fairly represented and there were also many countries of declining importance that were overrepresented. In particular European countries, at present, had one third of the voting shares in the IMF and the World Bank, a number that was out of proportion to the

relative importance of Europe in the global economy. If one were to exclude intra European trade the share of the EU would fall significantly. In his view there was no need to wait for the next quota increase which, in any event, was not needed to rebalance voting shares in these organizations. He then added that the United States was underrepresented in the IMF by any technical measure that was chosen and the Boards of the IMF and the World Bank were already unwieldy in size. Quarles therefore did not support an increase in the number of executive directors or chairs.

The consolidation of European seats was certainly the way to go; a single vote for Europe could be a more effective voice as well. Quarles was not in favor of the evolution of a G-20 into a Heads of State G8-like structure with many other issues not economic and financial—and thus not easily soluble—being brought in and traded off against other economic issues. Koch-Weser agreed that such a development would be undesirable and would be a good example of “form seeking substance” rather than the other way around.

Other participants made interesting remarks in the session on international financial institution’s governance. Swoboda asked how to organize regional representations at the Boards of these organizations against the background of countries with very diverse political interests. Jurgen Stark indicated that even if intra European trade was excluded from quota calculations the European Union would still have the largest share in the IMF, certainly larger than the United States, something that would presumably mean that Fund Headquarters would have to move somewhere in the European Union.

David Dollar proposed the decentralization of research and training at the World Bank, which at present was headquartered in Washington. He said that there was some support for the idea of moving it into the four most important geographic regions of the bank.

The issue of the legitimacy of the G-20 was also raised. To the extent that it brought together a limited number of countries for discussions on economic and financial issues, many countries felt left out. When the G-20 was first created Switzerland and the Netherlands took exception and felt disappointed at not being included. Beyond this the G-20 was essentially a club of official government representatives; its deliberations on important matters pertaining to the management of the global economy took place without formal input from the business community or civil society. There was some support for the idea of term limits for the managing director of the IMF who might thereby become freer from the impression that may be given that he would be unduly sensitive to the views of those who hold in their hands the renewal of his appointment. There was also support for the idea of entry examinations for employment at the IMF and the World Bank as opposed to the present system which is perhaps less than completely transparent.

Ralf Bryant had felt that China and other countries in Asia might wish not to be so patient, that the need to revise the formulas that are used to calculate the quotas should perhaps consider the introduction of population as a variable. Williamson and Boorman agreed that there was urgency to the issue of governance. Boorman, in particular, raised the question of whether the G-20 and other such configurations of countries were “idea factories” or “decision makers”; to the extent that they were emerging as the latter it

raised some questions about the credibility of the IMF Board. The serious lack of clarity about Fund lending operations was clearly harming the organization.

