*State of the World Economy, 2011-2012:*

# Whither or Wither?

US·KOREA INSTITUTE AT SAIS

한국금융연구원 KOREA INSTITUTE OF FINANCE

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중앙일보

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On November 18, 2010, the U.S.-Korea Institute at SAIS and the Korea Institute of Finance, sponsored by the Asian Studies Program at SAIS and the *JoongAng Ilbo*, hosted the one-day conference, "State of the World Economy, 2011-2012: Whither or Wither?" at the Paul H. Nitze School of Advanced International Studies (SAIS) in Washington, D.C.

This volume contains the speeches and papers that were presented that day and subsequently further refined by the authors to reflect discussions during the conference.

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# Morning Keynote Address

# *Restoring Faith in the Economy, Repairing the Global Financial System, and Securing Sustainability for Emerging Economies*

**Duck-Koo Chung**
**Chairman**
**North East Asia Research (NEAR) Foundation**

Ladies and gentlemen, distinguished guests. It is my sincere honor to speak to you today. As we move forward after the G-20 Summit, it is critical to gather the latest insights and opinions on the key issues facing the global economy. Therefore, I am delighted to see so many prominent experts and leaders at today's event. I eagerly look forward to learning from your unique perspectives.

This morning I will discuss two of my recent experiences during the last month, one being my lecture trip this past year to Beijing, where I have taught Chinese students international finance at Peking University and at Remin University of China every fall semester since 2003. During this semester, I had a very special gathering with members of Chinese high society, who shared very conflicting views on the future of the world economy and the future of the U.S. and Chinese economies. There were two distinctive streams of thought on the future of the Chinese economy and society, one being a nationalistic view and the other being a progressive view. Both viewpoints worried about the potential threat of social unrest during the next three to five years.

The other experience was during my 80-minute-long phone interview in Beijing with the *New York Times* Tokyo correspondent. He tried to elicit some of my ideas on ways to restore confidence in American economics and any lessons I had learned from Korea's experiences during 1997 to 1999, a time of hard landings, of full-scale restructuring, and of addressing the structural roots of our weaknesses. My responses were negative on those issues. Actually, America is a different country from Korea with different political leadership and parliamentary systems, and a different type of people. Most importantly, unlike the Korean economy, the U.S. economy is the heart of the world economy and the main engine of a big aircraft. He continued to ask me how to overcome this peculiar type of global crisis, to which my answer was that we need more time and a political hero to gain new momentum to move out of the streams headed toward disruption.

On the issues of the future of America and China, I pointed out that America's innovation in DNA would eventually change the current stream of difficulties and weaknesses of the United States. I strongly advised him that we should make a cruel choice of whether to clean up lakebeds first or wait to draw a new stream of water from a nearby river after the lake has become totally dried up.

In terms of the G-20 Summit itself, there was a meaningful display of global coordination and cooperation at last week's summit in my hometown of Seoul. Yet we can still say that the world's major economies continue to act too much in their own interests. The U.S. and other advanced economies can be accused of looking inward, as politics are being tied down by domestic concerns; while in contrast, China and other fast-growing emerging economies can be accused of trying to increase their share of the global economic pie, rather than trying to make the whole pie bigger for everyone.

We have entered an era where China and other emerging markets have joined the already traditionally advanced countries in driving the global economy. This is why it is so critical that we have international economic forums to continue our discussion on the complications that arise from the inevitable differences that exist between them. We cannot let the differences among us keep us apart when we need to get together to overcome the enormous challenges that await us ahead.

## Conflicting Views on the Global Economy

Regarding the global economy as it stands today, we need a reform for resolution now, but we do not currently have a common ground for understanding the issues at hand. It will not be easy to reconcile China's and other emerging markets' government-centered approaches to the macroeconomic issues with the more open approach of the United States and other Western countries.

The West would like the world to be a single global market operating under just one set of standards, but that would bring severe growing pains to many still-developing nations with less than adequate market infrastructures. Additionally, that would ultimately translate to severe instability in the global economy. The IMF and World Bank have had their limitations exposed in terms of governing the global economy, and the mantra of "market discipline" has lost credibility due to the problems in the U.S. financial markets, which ended up turning into a global financial and economic crisis. The global economy right now is like a rubber band that has been pulled from both sides for too long. At this point, it is no longer elastic, and one small shock could cause the rubber band to snap. Without deliberate multilateral efforts to ease the current tensions through rebalancing, the pressure will be too much to bear for an already overly stressed global financial system.

Outside of the West, economies such as China, my country of South Korea, India, Brazil, and other nations have been growing rapidly. Yet these economies are not yet mature; although they hold great potential, the entrenched vulnerabilities and lack of requisite market infrastructures for an increasingly open environment imply greater uncertainties going forward. Another issue they face is that their globalization process still in many ways looks like a blank canvas, given a tortuous political agenda and an increasingly important multilateral review process. These countries are used to government intervention; due to immature markets, they cannot let their economies fly on autopilot. Instead, these economies need a social planning body that can navigate their economies manually against significant regulatory headwinds and pestilent tailwinds.

Therefore, advanced economies and large emerging economies are taking very different approaches to securing sustainable growth. Nevertheless, with increasingly interconnected and integrated financial markets, the long-term sustainability of the global economy demands that these approaches be reconciled. Thus, it is no surprise that discussions on global policy are being conducted at the G-20 rather than the G-7, to reflect emerging markets' increasing role. In short, it reflects the growing importance of controlling systemic risks in an increasingly integrated global financial network. With disparate individual financial systems, the integration requires enormous extra efforts to guard against the buildup of systemic risks so that they do not turn into a black swan!

Although the global crisis has calmed from its peak, there remain potential risk factors that present two pivotal challenges for the global economy. First, advanced economies, notably the United States, will need to address their internal and external imbalances to assure that their economies remain sustainable long-term. This is also critically important to maintaining their reserve currency status, if not global financial stability. Second, China and other rapidly growing emerging economies will have to reshape their financial and economic systems to correct the limitations shown by the recent global financial crisis. A paradigm shift toward a more balanced economy cannot be delayed further: serious reforms and social capital investments are urgently called for to revive consumption and strengthen the social safety net. Asia can no longer continue to simply outsource its financial system, which has been the traditional source of global imbalance.

We have seen important progress on both these issues, but not nearly enough. It is true that the United States has reduced its current account deficit from 6% of its GDP in 2007 to less than 4% of its GDP in the second quarter of this year, but the progress toward both internal and external rebalancing has been very slow. The Chinese are rather reluctant to increase their holdings in the treasuries this year, purchasing JGBs and KTBs on a larger scale instead. Unless the United States shows fiscal restraint, funding liquidity via foreign participation will become more difficult in the future. The reserve currency status of the U.S. dollar interferes with its role in achieving rebalancing, but multilateral cooperation headed by Asian countries would have been helpful in easing the pressure on the Fed to adopt a rather risky second round of quantitative easing. On another note, the United States also has attempted to comprehensively reshape its financial market system by passing the Dodd-Frank Act. However, whether these measures alone can restore market confidence and well-functioning markets remains to be seen.

Meanwhile, China and other emerging markets are taking steps to strengthen their economies, but there is still inadequate private-sector leadership to match the government's role. A few structural reforms have been undertaken to move the economy toward a sustainable path, and post-crisis developments have been largely characterized by temporary measures in the form of the extra-loose monetary policy of quantitative easing, rather than deep structural reforms that are necessary for sustainable growth. This necessary rebalancing has not been observed, and there are some concerns that imbalances will get even bigger with all of these policy efforts to sustain the recovery. It is the result of trying to keep a boat afloat without fixing its gaping holes.

In an ever more interconnected global economy, both advanced and emerging market issues will need to be discussed at the same time. For the West, this involves repairing its traditional way of doing things. This means addressing the heavy reliance on debt and making the social safety net more reliable and sustainable while also repairing the fundamental malfunctions in its economic and financial market governance structure. In short, the United States especially needs to save more and export more to get out of the "Triffin Dilemma." For this to happen, surplus countries in Asia need to be more flexible in allowing their currencies to appreciate further. To ease the tension on China, coordinated efforts by Asian economies can be effective to avoid the lengthy, painful, and speculative adjustment process toward a new equilibrium.

In East Asia and elsewhere, the key issue is how to make strong growth synonymous with sustainable growth. Such markets still do not have the fundamental conditions for becoming mature economies. They will therefore need to tackle the resource-level and societal-level limitations to achieving sustainable growth. So, as the new order emerges, we need to address both the factors limiting emerging markets and the weak points in advanced economies' growth models simultaneously.

Given the extended discussions among experts on the United States and other core vehicle currency countries, I would like to shift your attention to China, which has to be one of the subjects at the center of discussions on emerging markets and forming the new global economic order. China has become heavily relied upon as the engine for global growth, but its growth path and its role in the coming economic order are far from guaranteed. Right now, we have a country with a rapidly growing GDP, a country with robust exports helped by an undervalued currency, a country with a booming property market, and a country that some experts believe will overtake the U.S. economy in less than twenty years. Yet despite these successes, this is also a perfect description of Japan in the 1980s, right before one "lost decade" has become two "lost decades." For China's rise to be both sustainable and beneficial for the rest of the world, it must not fall into the same trap. In light of this, Chinese resistance toward a more open economy is well understood.

Fundamentally, China has fallen into a macroeconomic "trilemma." If it does not act, this will severely limit its growth long-term. In this context, China announced in its Twelfth Five-Year Plan that it intends to stimulate domestic demand, build up its social safety net, and restructure the financial and real estate markets. These measures are to be welcomed as they would do much to rebalance global demand and help China remain a sustainable growth engine for the global economy.

## The Four Key Bridges China Has to Cross

In this section, I shall further address China's global growth through a discussion of what I propose as the four key bridges China, along with most other rapidly growing emerging markets, will have to cross to secure a sustainable economy and assume a new role in the coming new global economic order. First, China will have to focus not only on building material wealth, but also on building social capital. Second, the Chinese government will have to let the market and civil society play a bigger role in allocating resources. Third, China must modernize its financial sector if it is to support an increasingly sophisticated sector. And fourth, China needs to show greater leadership in the international community to help steer the world away from protectionism and nationalism.

*Building Social Capital*

The first step in this process is that China must build social capital. China has been enormously successful at utilizing its physical and human resources to generate material wealth, but to fit in with the global economy and move to the next development stage, it must build the social capital necessary for a post-industrial knowledge-based society. This would be a better way to utilize its abundant human resources. This means emphasizing the rule of law, social trust, corporate and government transparency, and intellectual property rights. Only through addressing such vulnerable areas can China tackle its problems with corruption, social unrest, rural unemployment, and income inequality, among others.

In terms of social capital, China will also have to invest more in its social safety net. This will of course help in promoting social cohesion, or what Beijing has described as a "harmonious society," and it will be the right response to help overcome the "Four Un-s"—namely "*unstable, unbalanced, uncoordinated, and unsustainable"*—described by Premier Wen Jiabao in a press conference following the National People's Congress on March 16, 2007. But a strong social safety net also has another benefit. It will make its citizens feel they are freer to spend the money they earn, rather than save it excessively. This increase in consumption will serve as a growth driver both for China's private sector and for global companies eager to win Chinese consumers.

*Less Central Control of Economy and Society*

Secondly, China needs to cross the second bridge, one that focuses on less central control over the economy and society for a more balanced social governance structure. Helping the Chinese consumers in this manner also relates to the second bridge China must cross, which is to become less dependent on government controls, and more reliant on market and civil society mechanisms. Decisions on economic and other issues will need to be more responsive to citizens and less dependent on Beijing. Alhough the existing governance structure has worked well for China's rapid, capital-intensive growth phase, China will have to develop a more open and predictable mechanism for making key decisions on tackling the complex challenges facing Chinese society.

In terms of the economy, too much of China's growth is being captured by state enterprises and channeled into real estate and other nonproductive assets or capital-intensive infrastructure projects. To combat this problem, government authorities will need to allow a more market-driven private sector, which will create a more dynamic economy that balances capital spending, manufacturing, and service industry growth. This, in turn, will create many jobs, contribute to greener growth, and invigorate the Chinese consumers. If China continues to stick to its old paradigm, jobless growth would not be surprising, with the labor-saving capital-intensive growth strategy and the depressed service industry.

*Financial Innovation*

This type of fundamental structural change must be supported by change in the financial sector. This comes to the third bridge that we must encourage China to cross, which deals with the development of more sophisticated, innovative, and open financial markets. The global financial crisis exposed how financial sectors in many advanced economies became too large and risky. We are now seeing a move toward stricter regulation and supervision of financial institutions, and I think most of us would agree that some movement in this direction is necessary. In China and much of Asia, however, the financial sector is still far behind global standards, and governments still interfere with the financial markets too much. China must bring its financial markets closer to the global model to meet the demands of a twenty-first-century economy. It need not do so by blindly adopting global standards, but instead, should establish standards better suited to its local settings, without violating basic tenets, and with soundly operating market disciplines.

Over the past 30 years, China has built a remarkable manufacturing base on top of a cautious and relatively unsophisticated financial sector, which was under heavy government control. But as China and similar economies mature, they will need a much more flexible financial sector so that they do not fall into the middle-income trap. Beijing has understandably been slow to relax control over the financial sector, and over exchange rates. Its financial markets and currency are still very fragile.

In this respect, we should mention currency reserves. China and other Asian economies still sit on mountains of foreign reserves as a way of ensuring stable foreign exchange and financial markets, but it is very expensive for the domestic economy, and not sustainable long-term for the global economy. China and the global community therefore need to work on alternative ways of securing stability besides putting massive amounts of dollars under the mattress. In this respect, China needs to continue to promote the wider use of a new reserve currency, notably SDRs and a substitution account at the IMF. Also, a new reserve currency in the form of a regional currency unit (RCU) will be sought after in the intermediate run. That is one key step to get China and other economies away from stockpiling foreign reserves and towards the more market-driven exchange rates and capital flows that Western leaders have been calling for.

*Leadership Rather Than Influence in the International Community*

This brings me to the fourth, and final, major bridge China will have to cross, which involves showing greater leadership in the international community. Present tensions over monetary and trade policies are a perfect opportunity for China to show that it can be a responsible leader in the new economic order. This will mean not allowing such disputes to fall into nationalism, counterproductive rhetoric, and blame games. No country stands to benefit from conflict between China and other countries on economic or other policy issues.

It is true that China's interests and other countries' interests do sometimes clash. Yet we all know that China will be a key engine of the future global economy and a key in whether the world can peacefully coexist. Therefore, we all have an interest in China maturely taking on the responsibilities of a global power. For this to happen, China will have to face the demands, responsibilities, and sacrifices that come with being a true global power. China is expected to play the role of a global leader by approaching formidable issues such as exchange rate conflicts and the like in a multilateral manner to seek national interests within the context of improving the welfare of everyone.

## Conclusion

To conclude, the new global economic order requires that three pivotal, yet very different issues be addressed for sustainable and coordinated global growth: restoring faith in the economy, repairing the global financial system, and securing sustainability for emerging economies. Political leaders, presidents, and prime ministers of the G-20 have been too inwardly focused, and worried about criticism from domestic citizens. Perhaps we need a certain type of hero to overcome the current situation right now.

We must now adamantly adhere to a multilateral approach to meet the serious challenges we face. Even though discussions seem to revolve around the G-20 for the time being, other countries need to be more actively involved in this adjustment process. We are indefinitely seeking "multilateral efforts" to resolve the unprecedented global financial crisis. By construction and definition, coordination would be difficult in a multilateral setting, but a coordinated solution is a better way to control systemic risks in this integrated network environment. If we are not able to come to a solution, we are all back to a protectionist movement with a significant reduction in the welfare of everyone.

This is the single most important reason that the G-20 is such an important step toward resolving the issues we face now. To fix system-level problems, we need a system-level approach, and therefore multilateral efforts will remain the key to any effective outcome. Even the seemingly visible bilateral issues such as the exchange rate need to be cast in a multilateral framework, which will call for unprecedented cooperation before we expect any real progress.

In conclusion, the four key bridges that China must cross are also issues that apply to many other rapidly growing emerging markets. It is in the interests of the entire global community to address the vulnerabilities of emerging economies since they will be the drivers of the majority of global growth for the near future. Of course, in an interconnected global economy, any discussions about China and sustainability should be accompanied by discussions about the challenges advanced economies must face as well. This means getting the traditional economic powers healthy again by attaining much-needed rebalancing, as well as addressing flaws in their financial and economic systems. Advanced economies must tackle their own internal imbalances and governance malfunctions, and avoid acting only in their own interests. This is vital to avoiding any serious systemic repercussions from the derailed global financial system that hinges on key reserve currencies. As we saw at the past G-20 summits in Washington, D.C., and London, a coordinated action plan is what will really set the global economy on a sustainable development path.

With genuine efforts towards coordination by advanced economies, as well as by China and other emerging economies, I am confident that the new global economic order will serve as a rising tide that lifts all boats. However, do not forget that we are all on the same boat but with different dreams!

Thank you very much for your attention.

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