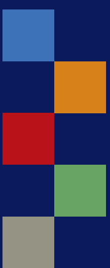

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The G20 Meetings: No Common Framework, No Consensus

MICHAEL PETTIS
Nonresident Senior Associate, Carnegie China Program

SUMMARY

- Participants in the recently completed G20 meeting in London agreed on a number of measures, some substantial and some merely symbolic, but they sidestepped the real issues dividing the major economic powers and, in so doing, failed to address the root causes of the global trade and investment imbalances. This was almost inevitable. China, Europe, and the United States have incompatible conceptual frameworks for understanding the causes of the global financial crisis; furthermore, their conflicting domestic political constraints make agreement on solutions hard to reach.
- Europeans believe that the root cause of the crisis was excessively deregulated financial systems, and they are skeptical about U.S. and Chinese calls for fiscal expansion, worrying that excessive spending would prolong the imbalances and make the ultimate adjustment more difficult. China also believes that the roots of the crisis lie within the structure of the global financial system, although Beijing insists that it was mainly the reserve status of the U.S. dollar that permitted imbalances to develop to unsustainable levels. China is particularly vulnerable to trade protection and seeks to maintain open markets for its continued export of domestic overcapacity. Like the United States, it is pushing for more aggressive, globally coordinated fiscal expansion. However, because of rigidities in its financial system and development model, its fiscal response to the crisis may exacerbate the difficult global adjustment and may, ironically, increase the chances of trade friction.
- In a time of contracting demand, the United States controls two-thirds of the most valuable resource in the world: net demand. Consequently, it is U.S. policies that will determine the pace and direction of the global recovery, along with the institutional framework that will govern trade and investment relationships for decades to come. The crisis puts the United States more firmly at the center of the emerging world order than ever. So far, the United States has not understood the need to consider the global outcomes of its recovery policies.
- Until the major powers can reach consensus about the roots of the imbalance and cooperate on policies to promote recovery, it is likely that the world economy will get worse before it gets better. The United States will drive the recovery process, but in order to do so effectively it will need to recognize its position of strength and negotiate the appropriate agreements with other major powers, especially China, on the pace and nature of the adjustment.

"Today, the largest countries of the world have agreed on a global plan for economic recovery and reform,…I think the new world order is *emerging, and with it the foundations of a new and progressive era of international cooperation."*

Prime Minister Gordon Brown,
at the conclusion of the G20 meeting

LONDON, APRIL 2009

Michael Pettis is a senior associate in the Carnegie China Program, based in Beijing.

An expert on China's economy, Pettis is professor of Finance with Peking University's Guanghua School of Management, where he specializes in Chinese financial markets. He has also taught, from 2002 to 2004, at Tsinghua University's School of Economics and Management and, from 1992 to 2001, at Columbia University's Graduate School of Business.

Pettis has worked on Wall Street in trading, capital markets, and corporate finance since 1987, when he joined the Sovereign Debt trading team at Manufacturers Hanover (now JP Morgan). Most recently, Pettis worked at Bear Stearns, where he was managing director-principal heading the Latin American Capital Markets and the Liability Management groups. He has also worked as a partner in a merchant banking boutique that specialized in securitizing Latin American assets and at Credit Suisse First Boston.

Besides trading and capital markets, Pettis has been involved in sovereign advisory work, including for the Mexican government, the Republic of Macedonia, and the South Korean Ministry of Finance.

He is a member of the board of directors of ABC-CA Fund Management Co., a Sino–French joint venture based in Shanghai. He is the author of several books, including *The Volatility Machine: Emerging Economies and the Threat of Financial Collapse* (Oxford University Press, 2001).

"Today, the largest countries of the world have agreed on a global plan for economic recovery and reform," British Prime Minister Gordon Brown said at the conclusion of the G20 meeting in April in London. "I think the new world order *is* emerging, and with it the foundations of a new and progressive era of international cooperation."

Gordon Brown is partly right. A new world order is certainly emerging, but whether it will represent a new era of international cooperation is far from clear. G20 participants agreed on a number of measures, some substantial and some merely symbolic, but sidestepped altogether the real issues dividing the major economic powers, thereby ensuring that the meeting will have little impact on the crisis.

The reason is not found in notions of relative U.S. decline. Washington is more than ever in the driver's seat. Because of its social and economic flexibility, the United States will probably be the first country to put the crisis behind it. Early (and deceptive) appearances of recovery in countries like China notwithstanding, the full brunt of the contraction in U.S. demand has yet to be felt around the world, and the more rigid economies of Asia in particular—wedded as they are to a development model that is now out of date—are going to experience great difficulty in adjusting.

Even more importantly, the United States effectively controls more than two-thirds of the world's most valuable resource: net demand. The pace and timing of the rest of the world's adjustment will therefore be driven largely by the pace of contraction in U.S. net demand. Most policy makers, however, not least those in the United States, seem not to have grasped this point.

Europe, being less flexible than the United States, will slowly follow the United States out of the crisis. In Asia, however, the impact of the crisis is likely to last much longer. During the past twenty years or more, and particularly in the decade since the 1997 Asian financial crisis, economic growth in Asia and especially in China has been largely based on a development model that generated savings by constraining consumption, poured investment into manufacturing capacity, and accumulated foreign reserves. For this model to work, someone—and that someone could only be the United States—had to run up large trade deficits to absorb the rising overcapacity produced by Asian exporters. Those days are now over.

It's 1933 Again

The economic crisis of the 1930s sheds some light on the nature of the changes taking place today. The G20 meeting itself can best be understood in the context of the 1933 London Conference, when representatives of 65 of the world's leading nations met in London's Geological Museum to coordinate a response to the spreading global economic crisis. For all the pomp surrounding the conference, the real action, as everybody knew, was taking place on nearby Threadneedle Street at the Bank of England offices, where English, French, and American representatives met to discuss currency stabilization and the resolution of international debt issues.

The Bank of England meetings achieved nothing, and the 1933 London Conference ended in failure. Any chance of cooperation was scuttled with Franklin Delano Roosevelt's "bombshell" announcement on July 3 condemning the gold-standard "fetish" of international bankers. With this, the new U.S. president signaled American support for trade-enhancing currency policies and expressed his frustration with growing European nationalism.

Most analysts subsequently blamed the failure of the conference on the United States taking the dollar off gold in the midst of the meeting. But University of California–

Berkeley economist Barry Eichengreen sees a far more fundamental problem: incompatible conceptual frameworks and conflicting domestic political constraints. In his magisterial work *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (Oxford University Press, 1992), Eichengreen writes,

> In fact, more systematic obstacles to co-operation lay behind the conference's failure. French, British, and American policymakers were unable to negotiate an exchange-rate stabilization agreement because they perceived the nature of economic crisis in radically different ways. Lacking a shared diagnosis of the problem, they could not prescribe a cooperative response. Roosevelt's decision to devalue the dollar in the midst of the conference was merely symptomatic of these deeper disagreements.

Nearly 76 years later, a sudden flurry of proposals by Chinese officials just before the meeting commenced, which sharply criticized Western financial regulations and the U.S. role in the crisis including People's Bank of China governor Zhou Xiaochuan's March 23 essay attacking the reserve status of the U.S. dollar, is being likened to Roosevelt's "bombshell" of 1933 as having sabotaged any chance of a substantial agreement. But the reality is that no agreement was ever in the offing.

As in 1933, it is obvious that the major countries do not share a conceptual framework in their understanding of the roots of the crisis. And now, as then, it is increasingly clear that domestic political considerations will create vast—and difficult to bridge—chasms between policies that resolve the global imbalance and those that address domestic employment concerns.

It was the willingness and (until recently) the ability of U.S. households to go on a debt-fueled consumption binge that permitted many countries, particularly those in Asia, to generate high growth rates. They constrained domestic consumption and poured resources into production, leading to large trade surpluses. As long as U.S. households were able to import large and increasing amounts of foreign goods, Asian policies aimed at expanding production did not need domestic consumption to justify the expansion.

A new world order is certainly emerging, but whether it will represent a new era of international cooperation is far from clear.

No longer. U.S. household consumption is declining rapidly as Americans rebuild their shattered household balance sheets. Given the size of the contraction in American demand (not to mention that of Europe and much of the rest of the world) and rigidities in Asian economies, there is almost no way Asian countries can expand domestic consumption quickly enough to make up the difference. The speed of the U.S. adjustment will be key to determining how Asian and other countries adjust. If the United States adjusts too rapidly, social and economic prospects in much of the rest of the world will be harmed.

But it is not clear that U.S. policy makers see the larger picture. Washington is struggling frantically to deal with its domestic banking crisis and is too worried about the immediate situation to consider what the post-crisis world might look like. This domestic focus, while understandable, is dangerous. If the resolution of the domestic crisis in the United States involves a too-rapid collapse of U.S. consumption and the trade deficit, it would force a brutal adjustment on countries, especially in Asia, that gambled their own economic futures on ever-expanding U.S. demand. Such a scenario could undermine Asian financial and economic systems, weaken the hand of reformers and internationalists in

local governments, and set the stage for decades of mistrust and hostility. This obviously would not be in the U.S. interest.

What Caused the Crisis?

Although much of the political focus in the United States centers on foolish or even fraudulent lending practices by domestic banks, U.S. policy makers believe that trade-surplus countries pursued policies that significantly exacerbated the monetary imbalances of the past decade. Fed Chairman Ben Bernanke's "global savings glut" hypothesis posits that Asian countries, especially China, responded to the 1997 Asian financial crisis by enacting industrial and trade policies aimed at encouraging production and suppressing domestic consumption. This led to a sharp rise in net Asian savings, which in turn forced balancing adjustments, primarily in the United States because of its open financial system and the status of the dollar as the world's reserve currency.

It is increasingly clear that domestic political considerations will create vast—and difficult to bridge—chasms between policies that resolve the global imbalance and those that address domestic employment concerns.

The recycling of the trade deficit brought about an explosion in U.S. liquidity, which among other things caused stock and real estate markets to inflate and pressured banks to expand lending. As the financial system accommodated this liquidity in the form of more and more consumer loans, the country locked itself into rising trade deficits. Before the 1997 Asian crisis, the normal range of the U.S. trade deficit was 1 percent of gross domestic product (GDP); afterward, it soared to 7 percent of GDP. *Financial Times* editor Martin Wolf explains in his book, *Fixing Global Finance* (Johns Hopkins University Press, 2008) what happened:

> The rest of the world's capital outflow supports the dollar. At the resulting elevated real exchange rate for the U.S., the output of the sectors in the U.S. economy that produce tradable goods and services shrinks, other things being equal. The Federal Reserve cuts interest rates to expand the economy, thereby preventing excessive unemployment. As it does so, a large excess demand for tradable goods and services emerges in the U.S. This, finally, appears in the trade and current account deficits.
>
> One consequence of all this is that U.S. domestic demand has had to grow faster than real GDP, to ensure that the latter grows in line with potential. The difference between the two is, of course, the increase in the current account deficit.

Another less widely discussed factor was the role of the Iraq war in fanning the flames of monetary expansion. Rather than finance the unpopular war with taxes, the Bush administration preferred to pay with loose money and government borrowing (another unpopular conflict, the Vietnam War, was also associated with domestic credit and stock market bubbles). In the U.S. view, loose monetary policies, coupled with the recycling of massive net Asian savings, resulted inevitably in a credit bubble.

The view from Europe is quite different. European policy makers tend to blame weaknesses in the global financial architecture for the crisis. They especially cite the regulatory framework, which they argue was weakened by a gradual withdrawal of governments from market control and intervention. For many European policy makers, the lesson of the crisis is the danger of deregulated financial markets, dizzying innovation, and the abdication by government bodies of their responsibility to monitor and manage brutal market processes.

While American policy makers wanted the G20 participants to agree to more aggressive and coordinated fiscal stimulus, European policy makers had, and have, different objectives. They are less concerned with trade distortions as long as Asian currency and reserve accumulation policies do not result in the U.S. trade deficit migrating across the Atlantic. With rigid labor markets, its greater reliance on manufacturing that competes directly with Asia, and its less flexible financial system, Europe will be unable—politically as well as economically—to absorb trade deficits at anywhere near U.S. levels. Had Asian central banks tried to accumulate euro reserves as assiduously as they accumulated dollar reserves, and so force Europe into running large deficits, we would have quickly seen the limits of Europe's ability to accommodate Asian trade policies.

European policy makers worry that the U.S. rescue plan may simply replace one debt-fueled, binge-consuming era with another. Although everyone recognizes that rapid demand contraction could destabilize the world economy, many European leaders are reluctant to see excessive government consumption simply replace excessive household consumption. Angela Merkel made this view clear before the G20 meeting when she argued that spending more public money as part of a coordinated stimulus risked creating an unsustainable recovery. Global imbalances of the past ten years, the German chancellor and other European policy makers argue, must be resolved, and this will inevitably require a contraction of net demand among the large trade-deficit countries, especially the United States. There will be no escaping the pain, and too much fiscal spending today can only make the ultimate adjustment worse.

Although European skepticism about fiscal expansion is reasonable, European concern about financial re-regulation is probably less so. At the G20 meeting, European policy makers were eager to forge a new, far more regulated and far more restrictive global financial architecture. French President Nicolas Sarkozy called this demand "nonnegotiable" and insisted before the meeting that tightening up financial regulation was a "condition" for a return of confidence and an economic recovery.

History suggests a different view. After every financial crisis, analysts consistently confuse the underlying causes of the crisis with the specific triggers that set it off, and this may be happening once again. The triggers in earlier financial crises have varied greatly—investment trusts in the 1929 crash, crony capitalism and external debt in the Asian crisis of 1997, real estate in Japan's 1990 crisis, railroad speculation in the 1873 crisis, to name just a few—but the path and consequences of each of these crises are so similar that they must have had similar underlying causes.

The speed of the U.S. adjustment will be key to determining how Asian and other countries adjust. If the United States adjusts too rapidly, social and economic prospects in much of the rest of the world will be harmed.

Should We Re-regulate?

In fact, every financial crisis in history has been preceded by a period of intense liquidity growth. Excess liquidity inevitably causes asset prices to rise. Risk appetite also rises, as risk premia decline and previously risky investments become increasingly profitable. The perceived value of liquidity declines as trading volume in once-illiquid assets—whether developing-country bonds, high-tech stocks, or Florida real estate—surges. As economist Hyman Minsky presciently described more than 30 years ago, the financial system is forced to accommodate these changes by increasing leverage; funding foreign-currency,

illiquid, or long-term assets with short-term debt; and otherwise mismatching assets and liabilities.

Under these conditions, the increasing riskiness of the financial system is not a function of poor regulation. We saw this in Japan just two decades ago. The main reason the Anglo–Saxon model of financial deregulation enjoyed unparalleled prestige until now is that its greatest rival, the highly regulated and severely restricted Japanese financial system of the 1980s, went so spectacularly bust after 1990. During a period of surging domestic liquidity, and even without retreating regulators or dangerous derivatives, Japanese banks engorged themselves on very old-fashioned, highly regulated, and nonetheless very risky credit.

European policy makers worry that the U.S. rescue plan may simply replace one debt-fueled, binge-consuming era with another.

When the financial system is forced to accommodate excess liquidity, attempts by regulators to prevent risk-taking cause the financial system to evade these constraints either by innovating around them, channeling money into unregulated parts of the financial system, or simply concealing exposure that violates the regulatory constraints. The highly regulated and constrained world of U.S. banking in the 1970s did not avoid foolish lending to less-developed countries following the liquidity surge caused by petrodollar recycling. Instead, with domestic restrictions in place, lending simply migrated offshore to the unregulated international banking center in London; by the mid-1980s, when the dust finally settled, nine of the top ten banks in the United States were insolvent. In China, too, regulatory constraints in 2007 and 2008 on loan growth in a period of rising domestic liquidity caused banks mostly to push lending off balance sheet and forced a huge expansion in the unregulated informal banking sector. When liquidity is ample, credit will expand.

Nonetheless, Chinese officials strongly support European efforts to enhance the regulatory framework. Beijing has become increasingly eager to heap scorn on deregulated markets and "Anglo–Saxon" market ideology, although a recent publication on the People's Bank of China website by its governor, Zhou Xiaochuan, stressing countercyclical measures, rather than pure regulation, is a more promising direction than the knee-jerk re-regulation frenzy of continental Europe. Beijing, however, sees very different causes of the crisis than do the United States and Europe, and it set very different—and much more parochial—objectives for the G20 conference.

The View From Beijing

China believes there is only one possible culprit in the creation of the global imbalances: U.S. overconsumption. Chinese policy makers are aghast at any mention of China's contributory role and consider Chinese overproduction to be nothing more than a response to U.S. demand. Curiously, Chinese authorities have failed to understand the link between their criticism of the dollar's reserve status and U.S. complaints about the distortionary impact of Chinese trade policies. Bernanke's "global savings glut" hypothesis is simply a corollary to Beijing's own well-founded criticism that the reserve status of the dollar allows the United States to borrow almost without limit (and, in the process, run limitless trade deficits).

Along with formal recognition of its global status as a major financial, economic, and political power, China wanted the G20 participants to agree to two major policy goals. The first goal is an enhanced commitment against protectionism, which to Chinese

policy makers does not mean free trade (most of Beijing's production-enhancing, consumption-constraining fiscal policies, after all, have distortionary trade effects) but rather means no changes that might impede China's ability to export its overcapacity to the United States and Europe. With China's domestic production exceeding domestic consumption by an astonishing 10 percent of GDP, any limit on the country's ability to export the excess would have a contractionary impact on local production and employment. Because it is virtually impossible for China to raise domestic demand quickly enough to compensate for the severe drop in U.S. consumption, protectionism threatens to harm China more than it would harm any other major country. Understandably, signs of rising trade tensions around the world are worrisome to Chinese policy makers.

China's second policy goal—much like the U.S. goal—was to demand more fiscal stimulus spending around the world, but here there was an almost insoluble conflict. With their mantra that China's best contribution to the global crisis is stabilizing its domestic economy, Chinese policy makers ignore the distinction between fiscal expansion that leads to an increase in net demand and fiscal expansion that leads merely to an increase in domestic employment.

Like the insistence of Herbert Hoover and Franklin Roosevelt on enacting measures to generate domestic employment regardless of the impact on U.S. trading partners, China, now the leading trade-surplus country (just as the United States had been in the 1920s), is engineering policies aimed at generating domestic employment, even at the cost of exacerbating the country's export of overcapacity and locking into place its export-based and capital-intensive development model. It should be remembered in this context that the 1930 Smoot–Hawley tariffs were also aimed at expanding demand in the United States, but they only exacerbated the export of U.S. overcapacity, which led, ultimately, to trade war—thus defeating the purpose of the tariffs.

Net Demand Versus Total Demand

Why are Beijing's policies making the global imbalance worse? Net demand is the excess of demand over supply—the residual consumption a country provides over and above its own total production, which is equal to the trade deficit (or the trade surplus, in the case of countries providing negative net demand). In the United States and among the trade-deficit countries of Europe, fiscal stimulus spending is aimed at slowing the contraction in domestic consumption. This inevitably means slowing the rate of contraction in net demand—in other words, slowing the contraction in the trade deficit. As a necessary corollary, trade-surplus countries must enact policies to contract negative net demand in line with the contraction of net demand among trade-deficit countries. Global trade, after all, must balance.

After every financial crisis, analysts consistently confuse the underlying causes of the crisis with the specific triggers that set it off, and this may be happening once again.

China argues that it has engineered a massive fiscal expansion as its contribution to global demand and that the rest of the world must match this relative contribution. As part of its contribution, Beijing announced a $586 billion fiscal stimulus package in November 2008 and forced banks to expand credit to anyone who needs it.

But instead of increasing net demand and reducing China's export dependence, the opposite is happening. China's trade surplus has risen—from an already high monthly trade surplus of just under $17 billion in the

Outsourcing Fiscal Borrowing

	Perceived root causes of the crisis	Policy objectives	Comments
CHINA	Excess U.S. household consumption supported by credit Unstable monetary policies based on dollar hegemony	Continued ability to export overcapacity Coordinated global fiscal expansion	Chinese calls for more fiscal expansion policies fail to distinguish between policies that expand net demand, which aid the global adjustment process, and those that contract net demand, exacerbating the global adjustment.
EUROPE	Failures in the financial regulatory framework Abdication of government responsibility in managing the economy	Rebalancing of trade, especially within Europe Significant reform of global financial system and rules framing financial activity	Europeans worry that too forceful a commitment to fiscal expansion will merely lead to different forms of unsustainable consumption.
UNITED STATES	Rapid monetary expansion exacerbated significantly by massive recycling of mercantilist Asian trade policies Foolish lending and securitization practices in the mortgage sector	Rebalancing of global trade Coordinated global fiscal expansion	Although the speed of the contraction in the U.S. trade deficit will determine the impact of the crisis on the rest of the world, U.S. policy makers seem too worried by the collapse in the domestic banking sector to consider global implications.

first half of 2008 to nearly $33 billion in the second half. Far from reducing its negative contribution to global net demand, China is actually increasing it. The stimulus is not working properly because the money is not going where it is needs to go—to household consumers and service industries, whose rising demand could absorb a greater share of Chinese production.

Why? Because the service sector in China is small, and boosting consumption directly is proving to be fiendishly hard to do. In its efforts to support domestic demand, Beijing is directing most spending to investment and the manufacturing sector, especially to the large state-owned enterprises that dominate the economy. The effects of these measures, in terms of boosting production, have so far outweighed Beijing's direct attempts to stimulate household spending. The policy has maintained employment and boosted total consumption, but it has done so indirectly, by boosting manufacturing capacity, rather than directly, by boosting demand.

As a consequence, although total exports are declining, imports are declining more quickly. Because it means that other countries must bear more than 100 percent of the contraction of global net demand, this will lead directly to an increase in trade friction or, eventually, when other countries can no longer bear the brunt of the contraction in global demand, it will cause a collapse in China's exports and trade surplus.

Therein lies the difference between stimulus spending in Europe and the United States and stimulus spending in China. The former addresses domestic employment concerns while lessening the impact of the global contraction in demand. In China, because the state has committed the bulk of its industrial resources to increasing manufacturing capacity, stimulus spending also addresses domestic employment concerns, but it exacerbates the adjustment process for the rest of the world—just as the U.S. trade policies did in the 1930s. This is not because of predatory intentions on Beijing's part. It is simply because China is locked into a development model that makes boosting net demand very difficult to achieve. Although Beijing is working to adapt, it will take years for a shift to occur.

Unfortunately, because of the role that trade and capital flows played in creating the crisis, domestic policies that do not improve the global balance will ultimately do little to improve domestic conditions either. With such fundamental disagreement among China, Europe, and the United States on the causes of the crisis, and with conflicting domestic policy needs, it is not surprising that the outcome of the G20 meeting was little more than a repeat of the 1933 London Conference. In fact, it is hard to see how the major powers can agree on anything substantial, what with the United States looking to craft an agreement on coordinated fiscal expansion but focusing so intently on domestic issues that it ignores the global context; with Europe reluctant to spend and far more concerned about re-regulating the global financial framework; and with China struggling to adapt its development model to a new world in which economic growth is no longer driven by out-of-control U.S. consumption.

With such fundamental disagreement among China, Europe, and the United States on the causes of the crisis, and with conflicting domestic policy needs, it is not surprising that the outcome of the G20 meeting was little more than a repeat of the 1933 London Conference.

As at the earlier London Conference, the occasional nationalistic bombshell, like the recent statements from the People's Bank of China bitterly attacking Western financial systems and U.S. dollar dominance, may prove

disruptive enough to be blamed subsequently for the collapse of the conference, but the truth is that there is nothing approaching consensus anyway. Beyond the obvious platitudes, there was no chance of any meaningful agreement at the G20. This was most evident in the meetings between Presidents Barack Obama and Hu Jintao. Beijing betrayed no recognition of its vulnerability to a continued contraction in the U.S. trade deficit. And Washington put forth no proposals about managing the contraction in an orderly way in exchange for Chinese commitments to force a necessary transition in its growth model.

Beijing betrayed no recognition of its vulnerability to a continued contraction in the U.S. trade deficit. And Washington put forth no proposals about managing the contraction in an orderly way in exchange for Chinese commitments to force a necessary transition in its growth model.

China's development model, based as it is on U.S. consumption continuing to exceed U.S. economic growth, will be forced into disarray by the tectonic shift in the global system. Yet because China does not see how vulnerable it is—indeed, it promotes that very shift in its call for an end to dollar hegemony—Chinese policy makers are in no mood to compromise or to accept anything smelling of foreign intervention. The United States, meanwhile, is too shell-shocked by the crisis to make its case forcefully.

As U.S. fiscal spending surges, increased attention will be placed on the way that U.S. fiscal spending leaks out through the current account to boost employment in China and elsewhere. And just as the Chinese complain bitterly, and rightly, that the West outsources polluting activity to China via the trade account, Washington will complain, as Martin Wolf pointed out in a March 31 editorial in the *Financial Times*, that China is outsourcing fiscal indebtedness to the United States, also via the trade account. Surplus countries, he argues, "relied on the private sectors of deficit countries to do their irresponsible borrowing for them." The U.S. government, in other words, borrows, and then it spends the proceeds in order to generate job growth in the United States as well as in China. That cycle won't go on forever.

As their economies worsen, Chinese, European, and U.S. policy makers will be forced increasingly to bow to domestic constituents. With the attendant rise in blame-seeking and nationalism that typically accompanies financial crises, compromise

will become more difficult to achieve. From the squabbling will arise the new institutional framework that is likely to be in no one's interest. To avoid this outcome Washington and Brussels should commit in negotiations with Beijing to continuing to coordinate fiscal expansion to slow domestic demand destruction over the next five or six years, while also committing to keeping American and European markets open to Chinese goods. Washington, Brussels, and Beijing would also refrain from enacting policies that favor production by local industries.

Although this comes with a political cost to the United States and Europe—rising debt and continued migration of employment to China in the short term—over the longer term, as China commits to managing down its trade surplus there will be a much healthier trade relationship between the three countries. In exchange Beijing would commit to policies that boost local consumption directly. These would include a schedule for liberalizing the domestic financial markets and interest rates, allowing greater worker autonomy in setting wages, raising the value of the currency, and taking steps to bolster the service sector and small and medium enterprises.

Many reformers in China have been arguing emphatically for these measures for years, but because powerful provincial and state-owned enterprise leaders have opposed these measures, China has remained stuck with its outmoded development model. The threat of a collapse in trade coupled with Washington's assurances would go a long way toward strengthening their position and ensuring a healthier political and commercial relationship for decades to come. ■

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1779 Massachusetts Avenue, NW
Washington, DC 20036

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