Making Big Deals to Help the World

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Leaders at the upcoming G-20 Summit in Seoul should make two big deals to reduce the negative beggar-thy–neighbor policies of mixing debt fuel and money ease and create a strategy to enhance global economic development.

End Beggar-Thy–Neighbor Policies

Recent currency disputes endanger the global economic recovery. Indeed, this is rooted in the prevailing global financial system characterized by an imbalanced oligarchic market structure, where the U.S. Federal Reserve is the market leader of the main transaction means with the European Central Bank, Bank of Japan and Bank of England being the followers. The Fed's self-discipline is the sole implicit safeguard for this arrangement. Under this structure, if and only if the supply of U.S. dollars is predicable and stable, do current account flows of trading countries—so-called "market fundamentals"—determine exchange rates or prices of respective currencies against the dollar. Otherwise, the discretionary provision of the U.S. dollars governs exchange rate volatility and creates potential currency disputes. Any statement—regardless of official communiqué or editorial comments—that ignores this key feature but reiterates "insisting in principle of market-determined exchange rates" are hollow and meaningless.

Over the past two years, the U.S. Fed has injected billions of dollars to save the U.S. financial system. Meanwhile, the Fed has also kept printing more money to boost up the inflation expectation and stimulate the sluggish U.S. economy. But one should always remember that no government has the magic to create something out of nothing. Needless to say, the Fed's provision of global public goods—the stable and reliable U.S. dollar—is subordinated to U.S. domestic interests. In addition, short-term economic goals are most likely to be attained at the cost of international monetary stability in the longer term. Over time, the financial mess could eventually be cleared up through diluting U.S. greenback at best and defaulting it at worst. This may be the optimal option for the U.S. Federal Reserve, but the rest of the world will bear the negative externality as a byproduct—a breakdown of global financial order and the subsequent dwindling of international trade. As such, the easing of monetary policy by the U.S. Federal Reserve has again fueled the unfolding global financial unrest. This cure is illustrated by a Chinese proverb of "drinking poisonous liquid to quench thirst". History repeatedly shows us these bitter lessons, as exemplified by the collapse of the Bretton Woods system in the early 1970s.

To prevent the world economy from spiraling into an abyss, leaders of the G-20 must take their undeniable responsibility of maintaining global public goods through multilateral compromises. G-20 leaders can make the first big deal in Seoul by agreeing to do the following:

- The U.S. ceases random and discretionary money printing and slowly phases out its near-zero interest rate policy.
- Other major international money suppliers follow these practices and maintain basically stable bilateral exchange rates against the dollar.
- The economies with large trade surpluses, like China, align exchange rates against the

dollar to a certain level and maintain them intact for an intermediate period so long as the main reserve currency power is accountable.

This deal may buy the world some time to move out of the recession and redesign the global financial system.

World Savings for Global Development

Over the past decade, the world savings were mainly channeled to finance expenditure in the developed countries, especially in the United States. This situation has not reversed even when the financial crisis started in 2008. For example, the U.S. government transfer payment to persons amounted to $2,096.8 billion in 2009, creating a $1,271.9 billion budget deficit. To finance this huge deficit, the U.S. government issued $1,474.9 billion of Treasury debt, of which the rest world bought $614.5 billion, accounting for 42 percent of the total. This fact reveals that world savings are still fueling U.S. personal consumption indirectly via the U.S. government transfer payment. This is a distorted and unsustainable way of allocating resources.

World foreign reserves—a main part of world savings—are expected to approach $9 trillion in this year. Of the reserves, 34 percent is held by developed economies, 36 percent by emerging and developing countries and 30 percent by China. The majority of the reserves are invested in U.S. Treasury debts or debts of other OECD countries. By August 2010, foreign countries held over 50 percent of the $8,404.5 billion outstanding U.S. Treasury debt and East Asian countries alone had 26 percent of the total. World savings, at least part of them, can be turned into real business investment to promote global development rather than continuing to support extravagant over-consumption in the United States.

Leaders at the upcoming Seoul G-20 Summit can make the second big deal to tap into the vast and largely idle foreign reserves to boost global development.

A "debt-equity swap" strategy is able to serve this end. First, reserve-rich countries could allocate a portion of their reserve assets, say 10-20 percent, to set up a World Development Facility (WDF). Under this umbrella, an earmarked amount of U.S. Treasury debt is converted into equities of project investment and the funds are still owned and managed by their respective countries. Second, the WDF would mainly invest in capital-intensive infrastructure in countries of need, including India, Brazil and others. The WDF would also invest in projects of alternative and renewable energies to address issue of global climate change. Third, the WDF would transfer the Treasury bonds to invested companies, swapping the sovereign debt to private equities in the designated places. The bond-taking companies, in turn, may employ receivables as collateral to obtain liquidity in credit markets. The monetary authorities, especially the U.S. Fed, should facilitate the liquidity provision of the debt-equity conversion.

The debt-equity swap will immediately help to revitalize the credit markets of the U.S. and other developed countries. It also offers safe and profitable business to financial institutions, including banks and insurers. The most important advantage is that the WDF will mitigate funds away from consumption financing and channel them to business investment, which is crucial to restart the dynamics of the world economy. If reserve-rich countries converted $1.3-1.8 trillion of fixed-income securities into real investment equal to 15-20 percent of the total, world economic development would move out of bottleneck of financing.