

# INSIGHT

## Losing power

Andrew Sheng says China's efforts to rebalance its own economy are hitting the fragmented world hard

I was in Jakarta this week for an IMF-Bank Indonesia conference on "The Future of Asian Finance". This is also the title of a book launched last week, in which experts at the International Monetary Fund provided useful analyses to help Asian policymakers navigate the current turbulence.

This weekend, the G20 finance ministers and central bank governors are meeting in Ankara, with the aims of strengthening global recovery, enhancing resilience and buttressing sustainability. Unfortunately, we seem to be heading in the opposite direction.

The IMF memo for the G20 meeting noted the slowdown in global growth for the first half of this year, and said financial conditions for emerging market economies have tightened and risks are tilting towards the downside.

Understandably, it is calling for strong policy action to raise growth and mitigate risks. The problem is that the G20 members are likely to pull in different directions.

On September 15, we will mark the seventh anniversary of the failure of Lehman Brothers, a landmark event that triggered efforts to prevent a global collapse, which consequently set us up for the greatest financial bubble in recorded history. In the first half of this

year, almost every country witnessed record peaks in their stock markets, bond markets and real estate prices. Given the fact that most countries are still slowing or having modest recoveries, the bubble has been pumped up by the activist monetary policy adopted by advanced economies known as "quantitative easing".

Indeed, the McKinsey Global Institute has warned that global credit and leverage is at its highest ever, and despite much soul-searching about the need for macro prudential regulation to prevent bubble risks, there has not been much deleveraging. We have the odd situation whereby the governor of the Bank of England, currently chairman of the Financial Stability Board, warns about real estate bubbles, but hasn't dared so far to raise interest rates in his own country.

The US Federal Reserve is also anguishing over whether to raise interest rates this month or in December. The polarity of the debate is astonishing. There are those who say the US economy is now strong enough to take a 25-basis-point interest rate increase, while authoritative figures like former Treasury secretary Larry Summers have argued that another round of quantitative easing may be necessary to prevent "secular

stagnation". When Chinese authorities intervened in the A-share market last month, the *Financial Times* and *The Wall Street Journal* revelled in China's debacle, only to see their own markets – the Dow, Nikkei and German Dax – suffer the largest drops since 2011 after the announcement of a renminbi devaluation of only 1.9 per cent. People in glass houses should not throw stones at each other.

The markets are not wrong to be nervous. The current global turbulence is not the fault of any single country, but the result of a highly fragmented international financial system being buffeted without a single regulatory authority. We have moved from a unipolar world to a multipolar casino where no one is fully in charge.

The system's fragility stems from the fact that its inherent trade and debt imbalances swing periodically to excesses without a coherent or single mechanism to control or moderate them. Remember, the IMF is not the world's central bank – that power was assumed by the leading sovereign central banks, particularly the Fed.

In 2005, then chairman Ben Bernanke complained that the Fed was losing monetary policy effectiveness because of excess savings by some countries, notably China and Japan. Thus the US runs ever

larger trade deficits, because the surplus countries are more than willing to hold dollars in their foreign exchange reserves.

The 2007 financial crisis erupted when the trade imbalances generated a second-order imbalance, when the US and European banks expanded credit both off their balance sheets and offshore. The complacency of their regulators allowed these banks to be exces-



**It was China's massive reflation in 2009 that ... pulled the world out of recession**

sively leveraged. Threats of raising interest rates then caused a market reversal and illiquidity, leading to a crisis of confidence and collapse.

Seven years after the Lehman collapse, advanced economies' central banks again crow that they have "fixed" the problems, but the markets are as fragile as ever. They are held together because the central banks have emerged as not only the lenders of last resort, but

also the buyers of first resort at any sign of market tantrums.

The stark reality is that it was China's massive reflation in 2009 that reduced its current account imbalances, increased commodity prices and pulled the world out of recession. But that was at a cost of a huge internal credit binge. Now that China has taken a pause in growth and attempted to correct its internal imbalances, the rest of the world is taking fright.

When underlying imbalances are being corrected, there is no excess savings or credit – only the prospect of higher interest rates. And higher interest rates mean the pricking of the global asset bubble.

In short, before 2007, the world was a four-engine jet, propelled by the US, Europe, Japan and the emerging markets, led by China. After 2009, when Europe and Japan slowed, it was a two-engine jet, with China helping the US sustain growth and currency stability. Since the US and Japan are hesitant to see China join the IMF's special drawing rights club, that second engine is being recalibrated.

The world is now flying on one engine, the US and US dollar. With a strong dollar and growing fiscal and trade deficits, small wonder that the markets are debating whether that engine is flying on empty.

Andrew Sheng comments on global issues from an Asian perspective

