China & World Economy

China & World Economy / 15–33, Vol. 24, No. 4, 2016

Macroeconomic Rebalancing in China and the G20

*Jeffry A. Frieden**

Abstract

The principal challenge facing the world economy is the risk of recurrent financial crises. Global macroeconomic imbalances create the conditions for boom-and-bust cycles that are extremely costly for the countries that experience them, and that can affect other nations and the entire world economy as well. The G20 recognizes the importance of these trends, and has committed itself to cooperative measures to reduce imbalances. However, progress has been limited and halting. There are major political obstacles to global macroeconomic policy cooperation, both within countries and among countries. China's attempts to rebalance its economy are crucial to broader international financial stability. Its G20 presidency gives China the opportunity to demonstrate that it is willing and able to advance its cooperation with economic partners, and to help lead the rest of the world in this direction.

Key words: G20, global imbalances, international policy coordination
JEL codes: E02, E61, F33

I. Introduction

The world economic order today seems quite different than what prevailed before the crisis that began in 2008. There is, today, a widespread recognition that many of the circumstances taken as given, and desirable, before 2008, are now open to question.

The pre-2008 consensus was roughly as follows. International financial markets provided the world with a tremendous set of opportunities to move capital from where it is less needed to where it is more needed. Financial institutions had become sophisticated at managing risk, and governments had reformed financial regulation to streamline financial flows and to provide financial stability. China and other emerging markets were on an encouraging upward growth path, drawn forward by international commercial and financial flows. European integration was proceeding apace, with more and more countries on the periphery of Europe joining the club, and the euro establishing itself as a stable, reliable currency. Through it all, international economic cooperation, largely in the Group of Seven, was appropriate to the needs of the world

*Jeffry Frieden, Professor, Harvard University, USA. Email: jfrieden@harvard.edu.

economy.

This consensus was shattered by the crisis of 2008–2009, and by events that followed it. International financial markets turned out to be just as effective at transmitting bad news as they were at good; in fact, they came close to shutting down completely and bringing the world economy to a grinding halt. While few doubt the general desirability of international capital flows, there is now much more cognizance of the potential dangers inherent in today's financially integrated world economy.

Other components of the pre-2008 consensus have also suffered. Chinese economic growth has slowed considerably. Perhaps more importantly, despite continued discussions of the need to "rebalance" the Chinese economic order (i.e. to focus it more on domestic than foreign demand), the country's economy remains heavily oriented toward the export sector. The slowdown of Chinese growth has contributed to a dramatic collapse in commodity prices, which has driven some of the emerging markets previously regarded as the most dynamic to stall or fall into serious crisis. Rather than a rapid upward trajectory on the part of both China and other emerging markets, the prospects include recurrent financial crises and political instability.

And then there's Europe. The high point of euro-triumphalism was probably 2006. However, the tenor of European discussions has changed utterly. The crisis in the eurozone, which began in 2008 and shows no real sign of ending, has become the most serious crisis in the history of European integration. The inability of the member states to deal productively with the sovereign debt crisis, in particular, calls into question the very integrity of Europe's political institutions. This failure has now been compounded by the eruption of a refugee crisis that threatens to divide the member states even more bitterly. The implications for the rest of the world are serious, on many dimensions. One of the most important, especially for the work of the Group of 20, is that a region that has traditionally been at the forefront of attempts to strengthen global governance is now completely absorbed in its own problems. Another important consideration is that one of the principal concerns regarding global macroeconomic imbalances is the persistence of German current account surpluses, a problem that remains central both to Europe's tribulations and to global economic worries.

Through it all, the previous complacency about global cooperation now seems seriously misplaced. Whether at the regional level (such as within Europe) or at the international level, cooperative efforts would appear both very desirable, and sorely lacking.

Some have referred to the situation that has come to prevail since the end of the Great Financial Crisis as the "new normal." In this view, growth will be slow, monetary policy will be increasingly ineffective, fiscal policy will be politically infeasible, and financial and currency instability will continue to exercise a drag on national economies and the global economy.

Whether this pessimistic vision is accurate or not, there seems little doubt that the world of 2018 will be fundamentally different than the world of 2008. This raises a series of questions about the desirable policies that might be pursued by national governments, about the demands likely to be placed on international cooperation, and on whether these demands are likely to be met. All these questions are central to the challenges faced by the Group of 20, and by China as it steers the group in 2016.

This paper surveys the problems faced by the world economy, and the world's major economic powers, as they look toward the aftermath of the Great Financial Crisis. The paper starts with a summary of the principal economic issues confronting the world, then goes on to discuss some of the political obstacles that stand in the way of their resolution. Then the paper turns to how China might be involved in addressing these questions. It should be clear that the author is no expert on China, and looks at the role of that nation from the standpoint of the rest of the world, not on the basis of any expertise about China itself. In this context, this paper assesses the prospects for the future.

II. The Core Problem: Global Financial Instability

Contemporary international economic reality has been characterized by a great deal of financial instability, which has given rise to significant concern about how international cooperation might serve to address the problems caused by this instability. This is, indeed, why the G7 and then the G20 were created in the first place.

To be sure, there is a broad consensus that international financial integration is a good thing. Capital should move from countries and regions in which it is abundant and where productive uses are not readily available to where it is scarce and productive. There are many countries, especially aging developed ones, that have substantially more savings than they want to spend; and there are many more countries, especially developing ones, that have massive investment needs.

However, the past 30 years give ample evidence of the fact that international financial flows create risks, in particular the risk of financial crisis. We have, in fact, gone through many instances of capital flow cycles that ended badly. This suggests that there are features of the contemporary international economic environment that are at the root of financial distress. Indeed, there has been a wide variety of experiences with a common theme.[1]

---

[1]The points made here are related to the more specific arguments made by Hélène Rey and co-authors about the global financial cycle, as, for example, in Miranda-Agrippino and Rey (2015).

Current risks are a function of three interrelated trends. The first is the extremely high level of financial integration, which allows capital to move from place to place with great speed and efficiency, even in response to relatively small differences in rates of return. The second is that since the late 1980s, the advanced industrial countries (and, to a certain extent and eventually, much of the world) have experienced great macroeconomic stability. This has come to be known in some circles as the Great Moderation. Inflation has been extremely low in all the rich countries, and many of the emerging markets have had inflation rates that are also very low by historical and comparative standards. The resultant expectation of stable monetary conditions has encouraged a trend toward low nominal interest rates. Finally, there has been a virtually universal monetary loosening in response to the Great Financial Crisis. Much of the world has lived in an environment of a zero interest rate policy (ZIRP).

Financial integration and very low interest rates make it possible for relatively small differences in macroeconomic conditions to lead to large-scale capital movements. These financial trends magnify the initial differences, as capital inflows stimulate economic activity and raise asset prices. This, in turn, encourages further financial flows, so that the process can be self-reinforcing. Eventually, especially if unchecked by macroeconomic or regulatory intervention, expansion leads to a boom, which turns into a bubble, which eventually bursts.

Boom–bust credit cycles fueled by capital flows are certainly nothing new to the developing countries: the problem of pro-cyclical borrowing is long standing. What is new is that the developed countries now seem equally susceptible to the cycle. To a large extent, this is, indeed, a function of the factors mentioned: high levels of financial integration along with very low interest rates. Financial integration makes enormous, rapid capital flows easy; very low interest rates lead investors (including fund managers with defined return obligations) to scour the world in search of yield. The result has been a continuing series of capital flow cycles: large-scale financial inflows creating booms and bubbles, which eventually burst, leaving behind a debt overhang that causes economic and political distress.

The damage done by the downswing in the capital flow cycle is both economic and political, and the effects of such debt crises can last a very long time.[2] Economically, such financial crises leave the affected countries with a debt overhang that severely restricts recovery. The weight of problematic debts leaves both creditors and debtors constrained. Creditors need to restore their balance sheets, and have little incentive to engage in further lending, especially to riskier borrowers. Debtors need to find ways to

[2]A now-classic presentation of the data is in Reinhart and Rogoff (2009). See also Funke et al. (2015) and Mian et al. (2014).

service their existing debts, and have little incentive to take on further liabilities, which will only eat up the benefits of any recovery they might experience. The debt overhang impairs both lending and borrowing, exerts downward pressure on economic recovery, and dampens output growth.

Politically, debt crises typically degenerate into bitter battles over how the adjustment burden will be distributed.[3] Creditors work to get as many of their obligations recognized and serviced as they can; debtors fight for a restructuring of their debts. Each side has weapons: creditors can cut off future supply, while debtors can default. The battles also often implicate powerful groups within creditor and debtor countries, further inflaming social and political controversy. In debtor nations, conflict revolves around who will bear the burden of the austerity measures necessary to service outstanding debts. In creditor nations, conflict implicates domestic financial institutions, investors and taxpayers, as they jockey to limit the costs to themselves of whatever debt restructuring may take place.

Recent instances of capital flow cycles have given ample evidence of how pernicious and longlasting the effects of a financial crisis can be. In Europe, in particular, economic recovery has lagged dramatically: economic activity in the eurozone remains below its pre-crisis level, and political strife has ratcheted upward with every passing year of economic stagnation.

Capital flow cycles of this sort also create dilemmas for national monetary, and especially exchange-rate policy.[4] Many or most of these capital flow cycles lead to substantial currency misalignments. As capital starts flowing in, the real exchange rate typically appreciates. This could be due to nominal appreciation as demand for assets in the borrowing-country currency rises. It could also be a real appreciation, as economic expansion raises the price of non-tradable goods and services. In either case, the real exchange rate and asset prices usually bubble upward together, confronting the monetary authorities with a dilemma. They can try to counteract the real appreciation, inasmuch as a major misalignment (and its inevitable reversal) can be disruptive and costly. Or they can allow the process to take its course, resolving to try to clean up after the fact. Most of the evidence indicates that prevention is more effective than cure, and yet political-economy factors (of which more below) make it unusual for national macroeconomic policies to attempt to dampen a capital flow cycle.

The reasons are largely political. Governments have trouble reining in economic expansion: taking away the punch bowl, in William McChesney Martin's memorable

[3]Frieden (2015b) is one summary of the problem.

[4]Frieden (2015a) covers the general issue; chapters 4 and 6 deal in part with the European and Latin American experiences with financial crises.

phrase, just as the party gets started. The average constituent has little or no way of knowing if the governments' warnings are accurate, and if the austerity measures imposed are necessary; and in any case, slowing economic growth is never popular. There are also specific interest groups that can swing into action to resist measures to slow or unwind a capital inflow and real appreciation. In the recent European peripheral and emerging-market cases, these have prominently included economic agents with substantial foreign currency liabilities.[5] Any depreciation of the currency raises the real debt burden of those with foreign-currency debts, and is resisted.[6]

Whatever the reason, the reality is that we can expect the contemporary international economy to be faced with successive rounds of these capital flow cycles and subsequent financial crises. This then raises the question of whether something can, or should, be done about the prospect of recurrent crises of this nature.

III. Financial Globalization and Global Cooperation

A traditional view is that national macroeconomic distress is a purely national problem: bad government policies punish the country whose government pursues them, and nobody else. From this perspective, the costs of a financial crisis are fully borne by those who created it, creditors and debtors alike, and there is no need for anything other than national government attention to the problem.[7]

The experience of the past 25 years would appear to contradict this view.[8] Contemporary levels of international financial integration mean that financial distress is transmitted rapidly, often with devastating effect, from country to country and region to region. The extent of financial interdependence creates substantial scope for externalities and spillovers. Mexico's 1994 debt crisis, whose origins were almost entirely domestic, had broad regional and even international effects. Distress in the subprime portion of the US mortgage market ended up spurring the gravest financial and economic crisis since the 1930s: in part as it became clear how exposed European financial institutions were to risky investments in to the US real estate market.

The potential contagion of financial crises is not the only way in which capital flow cycles create externalities for countries other than those that are directly involved. To

[5]This, of course, does not apply to those countries that had already adopted the euro, but as Walter (2013) makes clear, it was an important consideration for countries in Eastern and Central Europe that were not in the eurozone at the time the crisis hit.

[6]Walter (2013) addresses these and related issues in detail, both theoretically and empirically.

[7]Frankel (2016) surveys the state of the literature, on both (or all) sides of the problem.

[8]Frieden (2016) summarizes the arguments and experience.

take just one example, a substantial currency appreciation in a country experiencing a major capital inflow often creates powerful domestic political pressures for trade protection (see e.g. Broz and Werfel, 2014). This can, in turn, provoke countermeasures (including explicit retaliation) by trading partners, threatening to generate controversy over trade policy. Indeed, currency misalignments have arguably been a greater irritant to international trade over the past decade than explicit trade policy. In this sense, there are substantial international implications of national experiences with the macroeconomic consequences of capital flow cycles.[9]

The G20 appears to recognize the broad global implications of these trends. The group's 27 February 2016 Shanghai Communiqué began with a reference to "[d]ownside risks and vulnerabilities … against the backdrop of volatile capital flows." It went on committing the members to "better monitor capital flows, including more timely identification of risks, and take stock of and review policy tools and frameworks as appropriate to address challenges arising from large and volatile capital flows."[10]

There have been substantial efforts to monitor the "global macroeconomic imbalances" associated with major international capital movements. These efforts have not been particularly successful, but the fact that the problem has been recognized at the highest levels of the world's major economic powers is at least a step toward addressing the issue.

It is not difficult to construct a compelling normative case for global cooperation. Macroeconomic policy cooperation can be welfare-improving for all concerned.[11] Harmonizing financial regulation almost certainly is similarly a Pareto improvement over fragmented standards that invite regulatory arbitrage. Some common agreement on when financial flows might be destabilizing, and how instability might be combated, would help establish a set of expectations about global capital movements that would in itself be stabilizing. On the other hand, every normative justification of greater global cooperation can be, and has been, challenged.[12]

However, this need not detain us overly, for our concern is not whether a particular form of global cooperation is a good thing, but rather whether and under what circumstances it is likely to be feasible. In other words, whether standard theory can be interpreted as justifying the sorts of global cooperative efforts mentioned above, and

[9]Frieden et al. (2012) develop the arguments and evidence in more detail.

[10]See http://www.g20.utoronto.ca/2016/160227-finance-en.html. Similar points were made by Raghuram Rajan in Rajan (2016).

[11]Again, however, Frankel (2016) warns that this is not a universal view, and even in optimistic scenarios is not necessarily universally positive.

[12]Frieden et al. (2012) assess a variety of these views.

discussed by the G20, is not that important; what is important is to understand whether these efforts are likely to bear fruit, and whether they are politically feasible at the international and domestic levels.

IV. Prospects for Cooperation: International Factors

Global financial stability is a global public good. Of this there is little doubt, although there may well be serious disagreements over exactly what should be done to try to ensure financial stability, and how best to move in that direction. We can abstract from some of the thornier theoretical questions about international cooperation generally, and macroeconomic policy coordination in particular, to focus on some of the issues that seem to be central to contemporary international economic relations.

The experience of the past 15 years indicates that a major threat to global financial stability (perhaps the major threat) is large-scale gross, and perhaps net, capital flows that lead to unsustainable expansions that eventually, inevitably, collapse. There are many interpretations of these experiences, and many approaches to how they might best be handled. For our purposes, it is useful to consider most closely the interpretations and approaches that appear to motivate G20 words and potential actions.

"Global macroeconomic imbalances" arise, as indicated above, from the confluence of tight financial integration and divergences in macroeconomic conditions. This leads to large capital flows, and often substantial exchange-rate movements: misalignments, to use a loaded term. Both the capital flows and the misalignments can impose externalities on others, which makes them fair game for cooperation. The enormous capital flows can impose externalities to the extent that they predictably are associated with boom–bust cycles that are quickly transmitted to other countries, with sometimes devastating, even global, effects. The misalignments can impose externalities, for example, to the extent that they may give rise to powerful protectionist pressures in countries that see their currencies substantially strengthened by the policies of others. To be sure, these are not so much purely economic arguments as they are political-economy ones, in the sense that political systems can have a hard time adjusting to the pressures placed on them by the actions of other nations.

High on the international economic cooperation agenda is managing and limiting global macroeconomic imbalances.[13] This requires action by both surplus and deficit nations. Deficit nations, the ones typically running up large foreign debts, can reduce the imbalances by limiting the incentives for foreign and domestic agents to chase yield so

---

[13]Frieden et al. (2012) make this argument in detail.

aggressively as to create booms and bubbles. This can include countercyclical policies, such as those that were most assuredly not in place in the run-up to 2008 in the USA, the UK or the European periphery, or in 2006–2013 in the emerging markets. Pro-cyclical macroeconomic policies exacerbate imbalances.

By the same token, regulatory policies that do not do enough to try to ensure that borrowing goes to productive purposes (or at least purposes that are likely to allow repayment) contribute to imbalances. Deficit countries can do their part by ensuring appropriately prudential financial regulation.

Surplus countries, too, must play a major role in reducing global imbalances and currency misalignments. There are a myriad of reasons why countries become net lenders, from demographic trends to monetary and exchange-rate policies. However, here, too, there is an international responsibility, especially on the part of large nations. As with deficit nations, macroeconomic and regulatory policies are pivotal. Surplus countries, too, can contribute to systemic stability with countercyclical macroeconomic policies: if domestic stagnation is leading to capital outflows, the government should be attempting to counteract this stagnation. Fiscal measures can do so, as can structural and other reforms. Depending on the environment, monetary measures can contribute as well, including exchange rate policies. In the same vein, financial regulatory policies in lending nations should be as responsible as those urged on borrowing nations. Surplus nations need to ensure that their financial institutions are not contributing to unwarranted credit booms elsewhere, even if only in their own self-interest.

This suggests two crucial dimensions of potential international economic policy cooperation: macroeconomic policy and financial regulation. While one might argue that it is in each country's interest to pursue appropriate countercyclical macroeconomic and regulatory policies, there are incentives in other directions. In the case of fiscal policy, for example, individual country policy-makers, especially of large countries, may worry that any fiscal stimulus will "leak" into trading partners. In financial regulation, there are always pressures to allow national financial institutions to maintain or develop advantages that will give them a competitive edge, or, similarly, to relax regulations so as not to put pressure on the balance sheets of financial institutions.

Ignoring for the moment any domestic considerations, national governments have reasons to avoid or limit cooperation with economic partners. The reasons for a shortage of cooperative efforts are well-known from the broader literature on collective action. Inasmuch as no one country can supply the public good of financial stability on its own, there is no reason for any one country to act unilaterally. In addition, if multilateral action is discussed and planned, there are powerful incentives to contribute less than fully to the provision of the public good. This may not take the form of explicitly refusing to contribute; it can show itself as a disagreement over the appropriate division of responsibilities or costs or over interpretations of agreements previously arrived at.

To understand how national leaders might encourage greater cooperative efforts among countries, it is valuable to look at the problem analytically, to understand the international and domestic conditions that make cooperation more or less likely. In addition, the extensive literature on cooperation does, in fact, have a number of suggestions that are relevant in this realm. The larger a country is, the more likely it is to internalize the externalities associated with the absence, or presence, of the stabilizing measures that cooperation might provide. The argument can be made somewhat more general, in both the positive and negative directions. A country more exposed to the negative effects of financial instability, or other international economic developments, has greater incentives to try to deal with the underlying causes. By the same token, a country more likely to benefit disproportionately from greater financial stability has greater incentives to attempt to find ways to ensure that it is provided. We can expect, then, that larger and more exposed countries are more likely to take the initiative in encouraging cooperation.

Cooperation often involves policies that are not easily observable, or whose evaluation is open to interpretation. Successful cooperation on, say, financial regulation or macroeconomic policies can involve complex details of measurement and evaluation; this raises the possibility of disagreements over whether parties to an agreement are, in fact, carrying out their part of the bargain struck. This makes the monitoring and evaluation of agreements particularly important in the international realm, where there is no scope for third-party enforcement.

This means that cooperation is facilitated by the availability of reliable information about the behavior of other countries. This can come from the provision of trustworthy data. It can also come from the involvement of potentially independent (or at least not directly governmental) international institutions. The role of the IMF and the BIS in discussions over macroeconomic policy and financial regulation, respectively, illustrates the possibility that international institutions can play a part in facilitating international agreements. They are not a quick fix for the problems of interstate cooperation, but they may be part of a broader attempt to expedite cooperative efforts.

Theory and history demonstrate how difficult cooperation among states can be, in virtually every realm. In the absence of functioning governance structures at the global level, cooperation among national states is always difficult. It is more likely, the greater the stakes for countries large enough to make a difference, so that countries capable of making a difference have an incentive to take the initiative. It is more likely, the better information is about the behavior of states that have agreed, or might agree, to cooperate.

In addition, it is more likely, the more deeply involved are international institutions that are trusted by the major players. This last point highlights the significance of building, and reinforcing, both the broad credibility of international organizations, and the more specific faith on the part of important member states that these organizations are willing and able to reflect, and perhaps act upon, their concerns.

V. Prospects for Cooperation: Domestic Factors

One of the reasons why international cooperation can be difficult, and potentially unattractive to policy-makers, is that taken by themselves the measures required to contribute to global financial stability can be politically unpopular within the domestic arena. Virtually all policies have distributional consequences, and even if an argument can be made for the broad welfare desirability of a set of policies, there are likely to be those who gain more and those who gain less, or even lose, as a result of the policies. This is certainly true of international economic policies, including those generally relevant to financial stability. If the policies in question inflame the passions, and especially the opposition, of powerful domestic political forces, then there may be little reason for national policy-makers to undertake such policies. After all, national governments are answerable, first and foremost, to their constituents; and their constituents are at home, not abroad.

For example, the political incentives can be strongly unfavorable to the kinds of countercyclical macroeconomic policies that might help reduce the destabilizing effects of large-scale capital flows. When a country is experiencing a major capital inflow, as noted above, policy-makers have powerful political reasons to try to enable it rather than discourage it. In addition, there can be substantial pressures from financial institutions to relax regulation so that they can take full advantage of the new opportunities for intermediating now available to them. So it is hardly trivial for deficit countries to act in ways to limit these boom-and-bust cycles: it requires that the authorities meet booming conditions with restrictive macroeconomic and regulatory policies. This is hardly a formula for political success. To be sure, we know that in many, if not most, instances, the politically easy behavior in the short run can turn out to be disastrous in the long run. However, politicians have to win elections in the short run, and there are insistent pressures on them to satisfy their constituents. A government that tries to slow down a booming economy is sure to face the wrath of households that cannot buy the home they planned on, consumers who cannot buy the durables they wanted, and firms that cannot expand as they had wished. They are, to paraphrase William McChesney Martin, taking away the punch bowl just as the party reaches fever pitch.

The political obstacles to globally desirable behavior on the part of surplus-country governments are also substantial. The surplus countries are in surplus largely because their populations are content with macroeconomic conditions. In addition, they are creditors because financial institutions and investors appreciate the ability to obtain higher profits abroad. In some cases, especially in East Asia, surpluses are associated with purposive export-led economic strategies. In all cases, there are powerful interests in staying the course. Investors and financial institutions want access to opportunities abroad, savers want high returns, and exporters want a weak currency. As in deficit countries, the political incentives lead to behavior that can ultimately be disastrous. Investment in overseas assets may leave investors and financial institutions exposed to massive risks over which the national government has no control, other than bailing out the hapless lenders. Undervalued currencies impose burdens on consumers, limiting purchasing power and leading to charges that the public is not benefiting from the country's export success. However, as with deficit countries, the short-term political pressures usually outweigh these considerations.

A similar dynamic can be at work in financial regulation, and its currently popular expansion, macroprudential regulation. Almost by definition, effective regulators tell financial institutions that they cannot do everything they would like to do. This is justified by the expectation that regulation will provide the broader public good of financial stability, which the financial institutions appreciate, and that the monetary authorities will act as lenders of last resort as needed. When regulatory concerns extend to the entire state of the macroeconomy, it can be expected that financial institutions will be even less excited about restricting their activities on behalf of some vague notion of macroeconomic balance. To put it somewhat differently, inasmuch as the only politically relevant actors who care deeply about financial regulation are the regulated institutions, in normal times it is very difficult for regulators to impose sacrifices on their charges without a firestorm of opposition. When a crisis hits, the mass public comes to care about appropriate regulation; but memories fade quickly, and soon the regulators are sure to find themselves under pressure to treat financial institutions more leniently.

The broader point is that measures to create and sustain international cooperation, whether they involve macroeconomic policy coordination, financial regulatory harmonization or something else, impose costs on domestic actors. If they provided nothing but benefits, they would not be politically controversial, but some domestic values are almost always sacrificed in order to achieve a cooperative outcome. Those who are being asked to make the sacrifices are sure to resist.

VI. China and International Macroeconomic Cooperation

All of this leads to some observations about the role of China in the emerging international economic order. There is little doubt that China will play a large and increasing role in the international economy as it continues to grow, even if it grows at a slower pace. Understanding the dynamics of Chinese involvement in international cooperation may also help us understand the position and prospects for involvement of other large emerging markets, such as India and Brazil. In what follows, this paper focuses on macroeconomic policy coordination, which is almost certainly the most relevant issue in the case of China, and in particular on the prospect of "rebalancing."

China's development strategy has relied for many years on channeling resources into manufacturing for the export sector. The strategy has had many prongs, including exchange-rate policy, trade policy, financial and other subsidies, incentives to foreign investors, and the like. Whatever the character of the policy instruments, the target has always been clear: to expand manufacturing production for export, in order to modernize the economy and, not trivially, provide jobs for the tens of millions of people leaving the Chinese countryside.

China's export-oriented development strategy, and its extraordinary success, have implications for both the international and domestic politics of its involvement in cooperative measures to address international economic problems. They point, not surprisingly, in potentially different directions.

China's international position is dramatically different from what it was 40 years ago. And it is unique: China is the world's most populous country, by far the world's largest developing economy, and (depending on the measurement) either the world's second or third largest economy of any type. It is also, importantly, the world's largest exporter, larger even than the entire EU combined, and the second largest destination for international investment (when considering EU states separately). This gives China both a tremendous impact upon, and a tremendous interest in, the stability of the international economy, and of international finance. How might this affect the incentives for China to contribute to international cooperative measures in these realms?

China's outsized role in the world economy also means that it has a major impact, but also leaves it very vulnerable. So the Chinese Government is certainly aware that its economic aspirations are to some extent dependent on the maintenance of a semblance of international economic order. This gives the government an important stake in cooperation. In other words, the fact that China is susceptible to global economic trends means that it internalizes many of the externalities associated with the presence, or absence, of international macroeconomic and financial cooperation. This gives the government good reasons to participate in this cooperation.

However, as is well known, the Chinese Government is not fully satisfied with its position in the normal international economic forums. Certainly it does not have representation, or influence, fully consistent with its economic size and importance. In addition, the belief that it has too little influence over the course of at least some international economic discussions is likely to put a damper on its willingness to contribute to whatever emerges from these discussions. Finally, because China is still a poor developing country, it could legitimately argue that it should not be held to the same standards as the wealthy nations of Europe and North America.

So from a purely strategic standpoint, the implications of China's international position are contradictory. This contradictoriness is heightened by the fact that the country holds the G20 presidency in 2016. The country has a lot at stake in the global economy. However, its disproportionately small official or unofficial power is a disincentive to cooperate, as is its relatively low per capita income. This means that both the incentives to cooperate, and to free ride, are powerful, and likely to be operative. This, in turn, means that much depends on important groups within Chinese society weighing the costs and benefits of cooperative economic policies.

On the domestic front, the issue that has been at the forefront of discussions with, and about, China has to do with "rebalancing." This involves moving away from the export-oriented economic strategy that has characterized the country's policy mix for some 35 years (Blanchard and Giavazzi, 2006).

China's development strategy has international effects that put it at or near the center of some of the more important international economic policy debates. China would hardly play the role it does, of course, were it not for China's size. However, given the country's size, its massive export drive has had several effects that have drawn international attention. Imports from China have had distributional effects in most developed countries, and have been associated with everything from job losses in manufacturing to a worsening of the income distribution (Autor et al., 2016). Most of the developed world's governments are under substantial pressure to limit Chinese imports, or at least maintain flexibility to use such measures as anti-dumping to address the problem.

Conflict between China and its trading partners has been associated most prominently with concern about China's exchange rate policy, which has kept the renminbi relatively weak for most of the past 15 years or more. Critics charge that China's reserve holding can only be justified as attempts to avoid a currency appreciation, and there is substantial evidence that precautionary motives could not explain the size of these reserves (Aizenman et al., 2015). Again, were it not for China's size, such attention would be unlikely. However, China is so large that renminbi policy has become a prominent issue in many of the country's principal export markets, first and foremost the United States. It has been a source of great tension, which is, as yet, unresolved.

There has also been concern that China's financial system has been distorted enough in the service of the export drive that it faces substantial risks. Again, this is a global concern due to China's size: substantial financial difficulties in China could reverberate throughout the world. After all, the Chinese slowdown had major effects on the world's commodity markets and the world's major commodity producers, such as Brazil. Financial difficulties would almost certainly have similar, if not greater, repercussions.

For these reasons and more, the Chinese Government has been under substantial pressure to "rebalance"; that is, to shift the focus of the country's economic activities more toward the domestic market. It is not hard to make strong economic arguments for this, largely having to do with the desire of allowing Chinese consumers to benefit more fully from the country's extraordinary economic growth. The export drive has systematically privileged export producers over domestic consumers; after all, a depreciated exchange rate shifts resources away from domestic consumers and toward national producers of tradable goods. In addition to arguments about the domestic distribution of resources, this rebalancing could help reduce friction with trading partners.

Apart from any strategic considerations, discussed above, there are powerful domestic considerations that may make rebalancing difficult. Over the decades in which the export-oriented policy has been in place, the policy has created economic and political realities that are central to the structure of Chinese society. China is, to the best of our ability to understand, economically and politically dominated by the interests of the coastal exporting regions.[14] And the stakes are extremely high.

Reorienting, or rebalancing, a national economy is a daunting task: a complex modern economy cannot be turned around sharply like an automobile. The task is enormous when the economy in question is that of the world's most populous country, with massive differences among regions, in the train of 35 years of extraordinarily rapid economic growth.

The technical and economic challenges to rebalancing are daunting. To restructure an economy so as to reduce reliance on external demand and increase attention to domestic demand has many component parts. Factories producing for export have to

[14]The best analyses of the domestic political economy of these matters, limited of course by the availability of relevant data, are in the work of Victor Shih. See, for example, Shih (2008) and Shih and Steinberg (2012).

reorient toward domestic demand, or close. Household income has to rise, and where will that come from? The domestic infrastructure, including housing, health care, education and entertainment, need massive attention, and where will the resources to accomplish this come from? How can major new investments in nontradable services be undertaken without seriously degrading the quality of the investments? There are plenty of issues to address on the technical and economic fronts.

However, the political obstacles are almost certainly the most serious barrier to successful reorientation of the Chinese economy. The fact that after 15 years of talking about it, little has actually been accomplished speaks volumes about the political and policy problems associated with rebalancing.

A simple scenario, ignoring some of the technical issues mentioned above, would be as follows. The exchange rate is allowed to appreciate, as reserves are drawn down and spent on domestic social spending, and on social and economic infrastructure. Fiscal, credit and other subsidies to the export sector are eliminated. Wages are permitted to rise at an even faster pace than they have in the past 20 years, and profits are compressed. The financial system is liberalized to allow easier consumer credit and mortgage lending, and to reduce the outsized savings rate and encourage consumption.

Simply a listing of the sorts of changes that would, or could, be associated with rebalancing suggests both the scale of the changes necessary, and why they are likely to be politically difficult, if not impossible. Firms, entire industries, that have been built on the basis of fiscal and credit subsidies, and of a weak renminbi, will face disaster with these changes. Entire regions could face mass layoffs and firm bankruptcies, with resultant social and political difficulties.

To be sure, the rebalancing would also create winners: industries oriented toward the domestic economy, consumers and interior regions. However, the winners are largely winners in future prospect, rather than current reality, while the losers are losers very immediately and currently. It is hard to mobilize future, prospective winners to fight for the possibility of gains; it is easy to mobilize immediate losers to fight against the reality of losses (Olsen, 1965).

All this raises the central question about Chinese rebalancing: does the political leadership have the willingness and ability to undertake such a technically, economically and politically challenging task? Can the Chinese leadership credibly commit itself to a real reorientation of the Chinese economy? This is not about China’s position in international institutions, or the continued bargaining over its international economic role, but it is a much more important and far-reaching question about the future of China in the world economy. And the answer to the question will be given first and foremost in the cauldron of the Chinese domestic political economy. However, it has implications for the G20, and the actions of the G20 may affect the Chinese domestic scene as well.

Indeed, the domestic feasibility of the measures to rebalance the Chinese economy is also affected by the course of international cooperative measures. After all, one significant incentive for undertaking such difficult measures is the prospect that doing so will reduce tensions with the country's economic partners, and perhaps open up new international economic opportunities. If the international environment is hostile, important Chinese groups have little reason to make sacrifices in order to sustain access to that environment. This is true whether the environment in question is simply the broader international macroeconomy (a serious global downturn tends to lead countries to turn inward) or whether it is the strategic setting of relations with other major economic partners.

In other words, international economic cooperation can help motivate and mobilize domestic support for the measures necessary to restructure the Chinese economy in line with some of the concerns discussed here. This would be an instance of "linkage politics," in which potentially unpleasant policies are undertaken to the extent that they can be counterbalanced by more attractive policy options. The linkage is not technical but political: the pressures against change from the losers can be more than offset by the pressures for change from the winners.[15]

In this context, the future of Chinese participation in the workings of the Group of 20, and in international economic cooperation more generally, will be powerfully affected by both domestic Chinese and international factors. Domestically, Chinese policy depends on the evolution of domestic support for, and opposition to, the measures necessary to satisfy the country's international partners. Internationally, the domestic setting is more likely to be favorable, the more promising are the possibilities made available by the successful achievement of at least some global cooperation.

VII. Conclusions

China will undoubtedly play a major role in international economic relations over the coming decades, beginning with its G20 chair in 2016. The nature of that role remains decidedly uncertain. China will undoubtedly be asked to make substantial changes in its economic policy, especially in the direction of reorienting its economic policies away from production for external markets and more toward domestic demand. These changes will be difficult on many dimensions. They require substantial economic transformations

[15]Drazen (2002) is the best single model of linkage politics, as applied to relations with the IMF, and is directly relevant to the issues discussed here.

that will affect firms, industries and regions. The changes will also be politically difficult, affecting as they will important and powerful socioeconomic groups with political power. The Chinese Government will be hard-pressed to satisfy its domestic constituents as it comes under increasing pressure from home and abroad to change the nature of Chinese economic policy.

International cooperation both depends on Chinese policies, and can have an impact on these policies. In addition, there are policies that can be mutually beneficial: after all, rebalancing should raise the real living standard of China's people, even as it reduces pressures on the living standards of workers in other nations. The more comprehensively the world's major economic powers and international economic institutions include China in their deliberations and decisions, the greater the incentives for the Chinese Government, and important socioeconomic and political actors within China, to participate constructively in international economic negotiations and international economic forums. Inasmuch as it is in the interest of both China, and the world, for the relationship between the two to be productive and mutually beneficial, we can only hope that China's participation in the Group of 20 will push both China, and its partners, in the direction of more fruitful cooperative measures.

References

Aizenman, J., Y. W. Cheung and H. Ito, 2015, "International reserves before and after the global crisis: Is there no end to hoarding?" *Journal of International Money and Finance*, Vol. 52, pp. 102–26.

Autor, D. H., D. Dorn and G. H. Hanson, 2016, "The China shock: Learning from labor market adjustment to large changes in trade," *Annual Review of Economics*, forthcoming.

Blanchard, O. and F. Giavazzi, 2006, "Rebalancing growth in China: A three-handed approach," *China & World Economy*, Vol. 14, No. 4, pp. 1–20.

Broz, L. and S. Werfel, 2014, "Exchange rates and industry demands for trade protection," *International Organization*, Vol. 68, No. 2, pp. 393–416.

Drazen, A., 2002, "Conditionality and ownership in IMF lending: A political economy approach," *IMF Staff Papers* 49 (November), IMF, Washington, DC.

Frankel, J., 2016, "International coordination," in R. Glick and M. Spiegel, eds, *Policy Challenges in a Diverging Global Economy*, San Francisco: Federal Reserve Bank of San Francisco, pp. 41–77.

Frieden, J., 2015a, *Currency Politics: The Political Economy of Exchange Rate Policy*, Princeton: Princeton University Press.

Frieden, J., 2015b, "The political economy of adjustment and rebalancing," *Journal of International Money and Finance*, Vol. 52, April, pp. 4–14.

Frieden, J., 2016, "The governance of international finance," *Annual Review of Political Science*, Vol. 19, pp. 33–48.

Frieden, J., M. Pettis, D. Rodrik and E. Zedillo, 2012, "After the fall: The future of global cooperation," *Geneva Report* 14, Center for Economic Policy Research, London.

Funke, M., M. Schularick and C. Trebesch, 2015, "Going to extremes: Politics after financial crises 1870–2014," *Centre for Economic Policy Research Working Paper 10884*, Centre for Economic Policy Research, London.

Mian, A., A. Sufi and F. Trebbi, 2014, "Resolving debt overhang: Political constraints in the aftermath of financial crises," *American Economic Journal: Macroeconomics*, Vol. 6, No. 2, pp. 1–28.

Miranda-Agrippino, S. and H. Rey, 2015, "World asset markets and the global financial cycle," *Working Paper*, London Business School, London.

Olson, M., 1965, *The Logic of Collective Action: Public Goods and the Theory of Groups*, Cambridge: Harvard University Press.

Rajan, R., 2016, "New rules for the monetary game. Project syndicate" [online; cited June 2016]. Available from: https://www.project-syndicate.org/commentary/new-monetary-policy-rules-needed-by-raghuram-rajan-2016-03.

Reinhart, C. and K. Rogoff, 2009, *This Time is Different: Eight Centuries of Financial Folly*, Princeton: Princeton University Press.

Shih, V., 2008, *Factions and Finance in China: Elite Conflict and Inflation*, Cambridge: Cambridge University Press.

Shih, V. and D. Steinberg, 2012, "Interest group influence in authoritarian states: The political determinants of Chinese exchange rate policy," *Comparative Political Studies*, Vol. 45, No. 11, pp. 1405–34.

Walter, S., 2013, *Financial Crises and the Politics of Macroeconomic Adjustment*, Cambridge: Cambridge University Press.

(Edited by Jing Qiu)