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1. The world economy is in the grip of a dangerous downward spiral

Since the breakdown of Lehman Brothers in September 2008 the world economy has been affected by a dangerous downward spiral. It has all features of **Keynesian process** where the decline of demand cannot be adequately compensated by the self stabilizing properties of the market mechanism. Interest rates have declined but risk premia have increased so that debtors cannot benefit from the expansionary monetary policies. Inflation rates will come down but this entails the risk of **deflation**, above all if more and more companies try to stop the decline by lowering wages. Deflation would be an additionally destabilizing element as it increases the real value of debts, above all of the enterprise sector. Deflation is a very dangerous economic disease. Due to the zero bound of interest rates deflation cannot be cured by the traditional instruments of monetary policy. The experience of the Japanese economy shows how long it will take until an economy can successfully get out of a deflationary process. Thus, a widespread process of deflation would endanger the growth prospects of the world economy for a very long time.

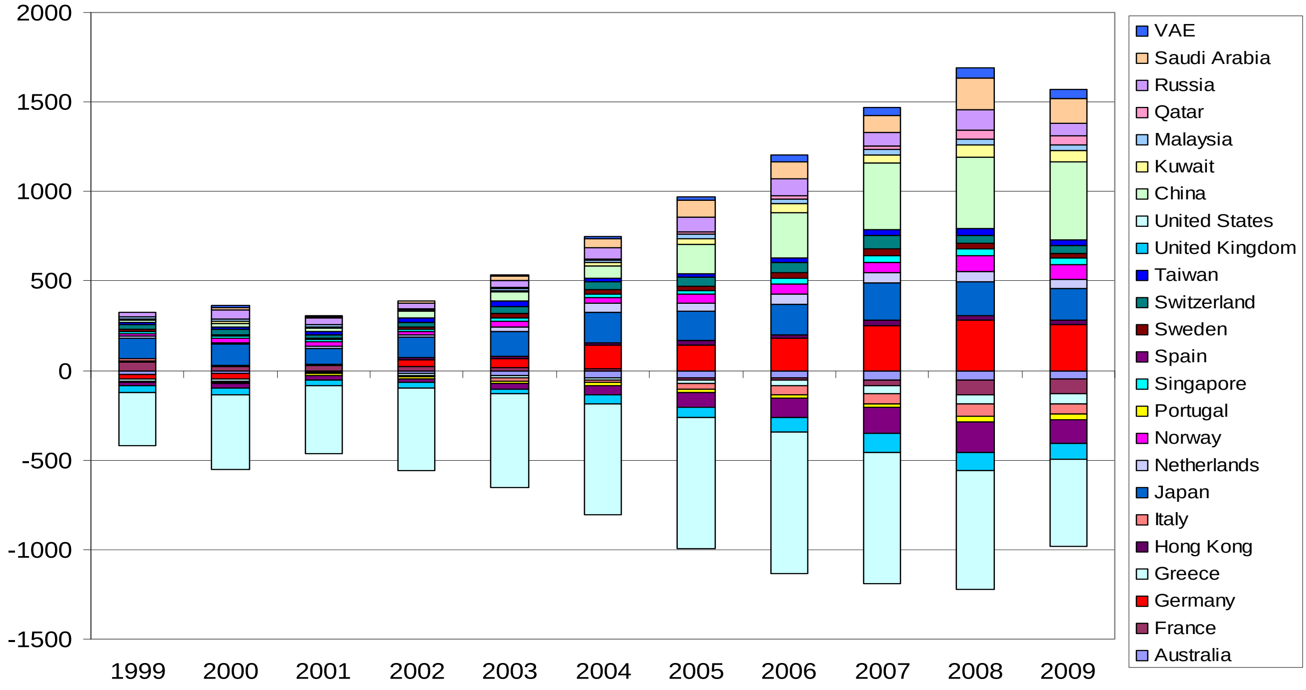
The only economic actor that can successfully stop a negative cumulative process is the government by increasing public spending or by reducing taxes. Fortunately, in many countries fiscal policy has now reacted forcefully to the threat of a global deflationary downward spiral. However given the severity of the situation, there is still an obvious lack of international macroeconomic cooperation.

But it is not only necessary to find an adequate short-term response to the crisis; it is at the same time very important to design a **new medium growth strategy** for the world economy. In my view, it depends very much on our two countries whether such a new formula for global growth can be implemented. Therefore I very much appreciate the initiative of the Friedrich Ebert Stiftung bringing together renowned economists from Asia and Europe in this conference at the right time.

2. The world economy needs new medium-term formula for growth

In this decade the growth of the world economy has relied on a "balanced imbalance". While a relatively small group of countries was saving increasing amounts of its export revenues and thus building up huge current account surpluses, another group was spending excessively and was thereby incurring huge current account deficits (Chart). Taken together this allowed an impressive growth of world trade and GDP. An important requirement for this growth model was an increasing transfer of financial funds from surplus to deficit countries via the international banking system. In other words, the global financial crisis is a direct legacy of this **balanced imbalance.**

Chart: Current account balances in US-Dollar Billion



Source: IMF

Today, it is obvious that this growth model has become obsolete. An adjustment of the imbalances is unavoidable. There are two different options for the adjustment process, a recessionary and a dynamic path. In both cases there is no doubt that the deficit countries are no longer able and willing to incur financial deficits, at least in the medium term.

- In the **recessionary adjustment** the surplus countries continue to try to maintain a high savings rate. This would to an adjustment of the payments imbalances via a strong global recession. The deficit countries have to reduce their imports and thereby the export revenues of the surplus countries decline.

- The **dynamic adjustment** requires the willingness of the surplus countries to increase their absorption significantly. This would increase their imports and thus also reduce their current account surpluses.

By the way, the need for and the advantages of an adjustment by the surplus countries was a main element of Keynes' ideas for a Clearing Union in the debate on the establishment of the Bretton Woods System.

3. The special responsibility of China and Germany as the world's largest surplus countries

Since several years Germany and China are the countries with the highest current surpluses of the world. Therefore, they share a common responsibility to contribute to a smooth adjustment of the world economy. In Germany, the Council of Economc Experts has recently called for a growth initiative of 1 % of the GDP (about 25 billion Euro). This would stabilize the domestic demand and at the same to contribute to a better adjustment of global imbalances.

In China an ambitious program for stimulating demand has been announced. In the medium term China needs an increase in private consumption. In order to reduce the high savings rate of private households the introduction of a comprehensive social safety net, above all a pay-as-you-go pension scheme would be very helpful.

In my view the present situation offers China a unique chance to implement an ambitious program for a comprehensive **ecological initiative**. For instance, huge amounts of energy could be saved if the government subsidies thermostats for private households, schools and office buildings. Statistics show that it takes about 22 kg of coal to heat a square meter in Beijing compared to 9 kg in Germany.

As I see the future perspectives of the US economy, the holding almost 2 000 billion of US dollars mainly in US bonds it is not a very good investment strategy. Even a relative fraction of its huge foreign exchange reserves, say 10 percent or about 200 billion dollars would allow a considerable improvement of the quality of your environment. By importing western technologies for such an initiative China could provide an important growth stimulus for the world economy and at the same time invest in the sustainability of its country and the global ecosphere. After the experience with financial crisis, investing in the own country seems to me a much safer strategy than try to find profitable and relatively safe investments abroad.

4. The need for a Bretton Woods II

In the last few months the G20 has been quite successful in addressing the need for a new global financial architecture. But so far the attempts are mainly focused on the more microeconomic issues of a better regulation for banks and financial intermediaries. There is no doubt that the global financial system needs a regulatory framework that provides much more transparency for regulators as well as for market participants, and the risk buffers have to be increased and improved to enhance the resiliency in situations with major shocks.

However in addition to a better regulatory framework, the world economy also needs a new framework for the **management of exchange rates**. There is no doubt that the system of flexible exchange rates which has been introduced in 1973 has become completely obsolete. In the last few years it has exerted a destabilizing impact on the global financial system. Above all, the technique of carry trade has contributed to the present instability of the financial system. By lending in low interest rate countries like Japan investment banks were able to finance risky transactions with a very high leverage. Temporarily this strategy was additionally rewarded by a depreciation of the yen vis-à-vis the US-dollar. Thus, Japan as a large surplus country was depreciating vis-à-vis the United States, the world's largest surplus country – a very absurd development.

China has never been a supporter of freely flexible exchange rates. Above in the Asian crises this has very much contributed to the macroeconomic stability of the whole region. In the last few years the Chinese exchange rate policy was criticized because of an insufficient appreciation of the renminbi. Astonishingly nobody criticized the Japanese authorities which at the same time did nothing to prevent the depreciation of the yen although they had bought hundreds of billions in the years 2003 to 2004 in order to prevent an appreciation of their currency.

All in all, while it makes no sense to allow a free float of currencies, it is also not acceptable that countries pursue exchange rate targets that are not coordinated internationally. This always entails the risk of competitive depreciations which threaten the global exchange of goods and services. This was already the lesson of the interwar period which led wise politicians in the 1940s to the idea of the Bretton Woods conference. It was able to develop a global framework for exchange rate policies which allowed an impressive growth of world trade and global welfare in the period after World War II.

In my view the time is now ripe for a Bretton Woods II. A stable global financial system can no longer rely on the chaotic dynamics of flexible exchange rates. It will not be an easy task to develop the design of such an architecture which needs to be sufficiently flexible and at the same time able to cope with huge and sometimes very erratic international capital flows. China and Germany are both countries which are very much export-oriented. They depend more than others on a well functioning and growing world economy. Therefore it is very much in the interests both countries that the plans for a Bretton Woods II will find strong political and academic backing.