



Global Imbalances

The Risks for the World Economy

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That which cannot go on forever, won't.

Herbert Stein, chairman of the United States Council of Economic Advisers under Presidents Nixon and Ford

1 Adam Smith, using the example of a pin factory, famously described the link between specialization and productivity in *The Wealth of Nations* (London, 1776). Today's global supply chain can be seen as an international version of Smith's pin factory.

Increasing globalization since the Second World War has transformed the global economic landscape. International trade in goods and services, migration flows, and cross-boarder capital flows have all risen inexorably over the past sixty years. The closer integration across countries of markets for goods, labour, and capital has brought enormous benefits to advanced and developing countries. In advanced economies, improvements in information and communication technologies have enabled firms to locate separate parts of the production process in different parts of the world, allowing them to reap the benefits of specialization and increasing competition. The resulting gains in productivity have boosted employment and standards of living.¹ In those developing countries, especially in Asia, that have become part of the global supply chain for goods and services, hundreds of millions of people have been catapulted from poverty into the middle classes. International capital flows have steered global savings to their most productive use, raising the level of world income. But increased global integration is not without risks. While international trade flows have exploded, in some countries exports and imports have expanded at very different paces. The result has been a marked — and in some cases, a worrying — widening of trade imbalances around the world. For example, although US exports to the rest of the world have risen

on average at a double-digit rate over the past decade, they have been outpaced by US imports from abroad. As a result, the US trade deficit — the gap between the level of imports and exports — has reached unprecedented levels. Deficits of this size are not sustainable. Put simply, the US is living beyond its means. To finance its ongoing trade deficits — to pay the bills for spending more on imports than it earns on exports — the US must borrow from the rest of the world. At some stage, the amount that it owes to foreigners will become unsustainably large.

Contrastingly, in China, booming exports have helped produce an enormous trade surplus; Japan has also run large trade surpluses for many years. Oil-exporting countries too are registering huge trade surpluses at present, reflecting the jump in the world price of oil over recent years. These trade-surplus countries are currently happy to lend the revenues generated by running these surpluses to the US, but there will almost certainly come a time when they will no longer want to lend any additional funds. At that stage, the US deficit will have to decline. This adjustment may be sudden and disorderly, involving a sharp fall in the value of the US dollar and a collapse in the prices of stocks and other financial assets in the US and elsewhere. The challenge for policymakers will be to avoid a disorderly adjustment process.

Cargo ship. Photograph: Michael Wells/Getty Images.

Chart 1 US External Balances**Chart 2 US Real Effective Exchange Rate**

Evolution of Global Current Account Imbalances²

For several decades after the Second World War, the US recorded balanced trade, roughly speaking, with the rest of the world. The US current account balance — the broadest measure of a country's international balance of trade — fluctuated within a narrow band of +1 to -1 per cent of Gross Domestic Product (GDP) during the 1960s and 1970s (Chart 1). A substantial deficit emerged in the early 1980s, as an

overvalued dollar (Chart 2) and robust economic growth in the US relative to the rest of the world boosted its imports and depressed its exports. However, by the end of the decade the US external position had returned to around balance, aided by a sharp fall in the dollar, a pick-up in economic growth in the rest of the world which boosted the demand for US exports, and a drop in oil prices, which lowered the value of US imports of oil. Interestingly, the unwinding of the large current account deficits of the late 1980s was smooth

2 Parts of the discussions below are drawn from Alan Ahearne and Jürgen von Hagen, 'Global Current Account Imbalances: How to Manage the Risk for Europe', Bruegel Policy Brief, December 2005, and Alan Ahearne and Jürgen von Hagen, 'European Perspectives on Global Imbalances', paper prepared for the Asian-Europe Economic Forum conference European and Asian Perspectives on Global Imbalances, Beijing, July 2006.

- 3 A billion is a thousand millions.
- 4 Yu Yongding, 'Global Imbalances: China's Perspective', paper prepared for the Asian–Europe Economic Forum conference European and Asian Perspectives on Global Imbalances, Beijing, July 2006.

and caused few problems for the global economy. The first half of the 1990s saw the US run moderate current account deficits. But since 1997 the deficit has ballooned. US imports have outpaced exports in response both to a stronger dollar and to faster growth in income in the US than in the rest of the world. Although the dollar reversed some of its previous gains after 2002, the depreciation was not enough to prevent further widening of the trade deficit. By 2005, the current account deficit had widened to nearly \$800 billion, equivalent to about 6.5 per cent of GDP. The deficit increased further to \$850 billion in the first half of 2006.³

Data on the evolution of global current account balances, shown in Table 1, show that the counterpart of the large and growing US current account deficit are the large and growing current account surpluses in Asia and in the major oil-exporting countries. Over the past decade, the nearly \$700 billion increase in the US current account deficit was accompanied by a roughly \$330 billion increase in Asia's surplus and a \$360 billion increase — most of which happened since 2002 — in the oil-exporters' surplus. For 2005, the US current account deficit of nearly \$800 billion is almost entirely accounted for by Asia's roughly \$400 billion surplus and the \$375 billion surplus of the oil-exporting countries in that year. Europe contributes very little to current global imbalances. Despite some euro-area countries having sizeable current account imbalances, the euro area's current account swung into deficit last year, after three years of moderate surpluses. Germany, for example, has recorded annual surpluses of around \$100 billion in recent years. As an aggregate, however, the euro area runs generally balanced trade with the rest of the world. The United Kingdom current account deficit continued to widen, reaching \$58 billion (about 2.5 per cent of GDP) in 2005. The fact that trade balances in Europe are not far from zero suggests that the eventual

rebalancing of global current accounts should primarily involve the US, Asia, and the oil-exporting countries.

What explains the very large current account surpluses in Asia? In part, the surpluses reflect deliberate policy measures by governments in Asia to promote exports in order to increase employment in export industries.⁴ This policy strategy centres on the use of undervalued currencies to boost exports. In addition, many Asian economies run large surpluses because their demand for imported investment goods remains relatively subdued in the aftermath of the Asian financial crisis in 1997–98. Economies that were hard hit by the financial crisis, such as that of Indonesia, Korea, Malaysia, and Thailand, ran large current account deficits for a long time prior to 1997. Only since then have these economies begun to run current account surpluses. Running current account surpluses has the added benefit of allowing Asian economies to rebuild their foreign exchange reserves in order to protect themselves against future financial turbulences and dependence on International Monetary Fund (IMF) support. One implication of this motive for running current account surpluses is that it is highly unlikely that they will continue to build up their foreign exchange reserves after the reserves have reached a certain level.

Japan has run current account surpluses persistently since the early 1980s, and over the past decade and a half the annual surplus has been above \$100 billion. Even when the Japanese economy was booming in the late 1980s, a time when one might have expected Japanese imports to exceed exports, Japan registered a trade surplus. To be sure, part of Japan's chronic surpluses over the past fifteen years reflects the depressed state of the Japanese economy following the bursting of the stock market and property bubble in the early 1990s. Japanese households, and especially Japanese firms, have recorded very high

savings rates since 1990, while investment has remained weak. The fact that Japanese households and firms are accumulating large savings instead of spending their incomes and revenues on imported goods has depressed other countries' exports to Japan. In turn, Japan's high propensity to save may reflect demographic factors associated with the ageing of the population. Households are also saving for precautionary reasons, concerned about the weak — albeit evidently improving — condition of the Japanese economy and poor prospects for future income. In addition, the desire to pay off debt and strengthen corporate balance sheets after the damage done by the asset price boom and bust explains some of the savings by firms.

China's trade surplus has expanded markedly over the past decade as it has integrated itself rapidly into the global economy. Its exports have boomed over recent years, especially since it joined the World Trade Organization in December 2001. Exports have far outpaced rapidly growing imports of food and raw materials needed to fuel the country's phenomenal economic growth. China's vast pool of underutilized labour and low labour costs give the country a large comparative advantage in the production of labour-intensive products. In addition, China's government continues to pursue deliberate export-promotion policies, including tax incentives for exporters and its exchange-rate policy. China offers tax incentives to foreign investors who build plants in China that produce goods for export. Many multinational corporations, especially from Japan, Taiwan, and the US, have set up production units in China. These plants operate mainly in labour-intensive assembly activities and the output is mostly exported from China. As a result, China is an increasingly important player in international production networks. China's growing role in the global supply chain is reflected in the rapid growth in processing trade in China. Of total exports of about \$750 billion in

2005, more than one-half was accounted for by processing exports and the bulk of those exports was produced by foreign multinationals located in China. In addition, China's exchange-rate policy is favourable to exporters and therefore helps create a trade surplus. China continues to maintain a *de facto* fixed exchange-rate régime aimed at keeping exports competitive in international markets. Until July 2005, the Chinese currency, the renminbi, was firmly pegged to the US dollar. Since then, the renminbi has been allowed to appreciate moderately against the dollar by about 2 per cent but, by most measures, remains significantly undervalued against the US currency.

The very high current account surpluses registered in oil-exporting countries in recent years highlight an important effect of the elevated level of world oil prices on global imbalances. High oil prices have shifted some of the rest of the world's (that is, non-US) current account surplus away from Asia towards net oil exporters. To the extent that the oil-exporting countries have a lower propensity to save than economies in Asia, this shift may bring about a faster decline in savings in the rest of the world. That said, Asian economies also have higher investment rates than those in oil-exporting countries. Therefore, it is not clear whether the shift in surpluses from Asia towards oil exporters will slow down or speed up current account adjustment. Moreover, because oil-exporting countries have lower savings and investment rates than economies in Asia, recent developments imply a shift in global demand away from investment goods and towards consumption goods. This might well benefit US exports (which are more heavily concentrated in consumer goods and services) at the expense of German exports (for which capital goods are more important).

Turning to Europe, Table 2 shows the bilateral trade balances that underlay Europe's current account deficit for 2005. Europe's trade surplus of nearly \$100

- 5 The Japanese Ministry of Finance reported record levels of foreign exchange market intervention during 2003 and 2004, with total intervention amounting to the equivalent of \$183 billion in 2003 and \$136 billion in the first quarter of 2004. No official intervention by the Japanese authorities has been reported since the first quarter of 2004.
- 6 Martin Feldstein, 'Why Uncle Sam's Bonanza might not be All that it Seems', *Financial Times*, 10 January 2006

billion in 2005 with the US was similar in magnitude to the trade surpluses of Japan and the oil-exporting countries — separately, not combined — against the US, and roughly half the size of China's surplus with the US. Like the US, Europe recorded large bilateral trade deficits *vis-à-vis* China, Japan, and the oil-exporting countries. Although the configuration of bilateral trade positions reflects many factors, one can imagine a global rebalancing scenario in which Europe imports more US-produced goods and services and exports more goods and services to Asia and the oil-exporting countries. This would leave Europe's current account largely unaffected, even as the US current account deficit shrinks, but it presupposes a decline in the Asian current account surplus. The alternative rebalancing scenario is one in which Europe imports more from the US and exports less to Asia, or imports more from Asia, allowing the US current account deficit to decline, while the Asian surpluses remain the same.

To finance a current account deficit — to pay the bills for spending more on imports than it earns on exports — a country must borrow from abroad. Similarly, a country running a current account surplus must lend to deficit countries the excess that it earns on exports over the amount it pays on imports. In other words, there is a financial counterpart to the large current account imbalances that takes the form of large imbalances in net international capital flows — that is, international borrowing and lending. Another perspective on global imbalances can be gained from exploring what role countries have played in generating the observed patterns in financial flows. A striking feature of recent capital flows has been the substantial rise since 2001 in so-called 'official' net capital flows — that is, lending by foreign governments as opposed to lending by foreign private institutions such as private banks and pension funds. These inflows peaked in 2004 at \$390 billion as governments and central

banks in Asia intervened heavily in foreign exchange markets by buying dollar assets in an effort to restrain the appreciation of their currencies, before moderating some last year.⁵ The step-down in net official inflows in 2005 to \$220 billion, as well as the sharp increase in net private inflows, meant that the bulk of the overall net inflows needed to finance the US current account deficit in 2005 was accounted for by net private capital inflows. By contrast, in both 2003 and 2004, net official inflows were the predominant source of financing, accounting for 60 per cent of total net inflows in 2003 and 65 per cent in 2004. Most of these flows came from Asia.

Interestingly, some commentators argue that in reality foreign governments continue to provide overwhelmingly the share of financing for the US current account deficit, and that a substantial chunk of inflows that are classified as 'private' in the balance-of-payment data are purchases of US securities by private institutions acting on behalf of foreign governments.⁶ Whatever the truth, there is little doubt that official inflows have become a significant source of financing for the US current account deficit. The sight of the US relying heavily on loans from governments in Asia — and in particular on loans from China — to finance its trade deficit is a source of deep concern. Commentators are worried about a situation in which China exports massive quantities of cheap goods to the US and then lends back to the US the dollars earned from those exports, so that Americans can purchase even more goods from China. To the extent that cheap Chinese exports are destroying jobs in the US manufacturing industry, trade with China on this scale looks to many like a bad deal from a US perspective. Moreover, some are worried that by being essentially a banker to the US, the Chinese government is accumulating leverage over it. Being a large debtor to China puts the US in an uncomfortable political position.



Trading floor, Chicago
Options Exchange.
Photograph: Paul Chesley/
Getty Images.

The rise in net private inflows in 2005 in part reflected the continued recovery in the demand for claims on the US private sector from their recent lows in 2003. Private foreign purchases of US securities (excluding US Treasury securities) jumped last year, largely reflecting a marked increase in private foreign purchases of US corporate bonds, though purchases of US equities and US agency bonds also rose. Foreign purchases of US debt (including corporate bonds, agency bonds, and Treasury securities), relative to purchases of portfolio equities and direct investments, have become an increasingly important source of financing of the US current account deficit in recent years. Private foreign purchases of US Treasury securities also rose in 2005. The increase in purchases in that year was broad-based across foreign regions. The largest private purchasers of US Treasury securities in 2005 were from Europe, followed by the Caribbean financial centres

and Asia; the large purchases by Caribbean financial institutions partly reflects their use by some oil-exporting states to channel funds. In addition, although private foreign direct investment in the US declined by \$23 billion in 2005 relative to 2004, US direct investment abroad plummeted from \$244 billion to \$9 billion, as foreign subsidiaries of US multinational corporations repatriated large amounts of funds back to the US in response to incentives associated with the American Jobs Creation Act of 2004. These incentives expired for most companies at year-end 2005.

Current Account Adjustment

Thus, to finance ongoing current account deficits, the US must borrow from the rest of the world. This adds to its net external borrowings, which have risen from less than 3 per cent of GDP in 1990 to an estimated

Interior of the Hong Kong Stock Exchange.
Photograph: Gary Cralle/
Getty Images.



- 7 A trillion is a million millions.
- 8 Alan Greenspan, 'Stability and Economic Growth: The Role of the Central Bank'; speech at the Banco de Mexico's 80th Anniversary International Conference, Mexico City, 14 November 2005

22 per cent of GDP today. This trend of rising US net external borrowings relative to GDP cannot continue for ever. Like any debtor, the US must service its liabilities, for example by paying interest on loans from other countries. The US currently owes a net amount of \$2.5 trillion to the rest of the world.⁷ Given the low level of interest rates at present, the US can easily service this debt. However, a continuously rising stock of external borrowings would eventually see the burden of servicing these borrowings become unbearably large. Anticipating this, foreign investors will grow increasingly reluctant to continue to lend to the US, even before this happens. The US can live beyond its means only so long as foreigners are willing to bankroll this overconsumption. At some stage, foreigners presumably will decide that they have extended enough credit to the US — as the former chairman of the Federal Reserve, Alan Greenspan, puts it: 'at some point foreign investors will balk at

further financing'.⁸ When this occurs, global current account adjustment will commence and the US deficit will begin to shrink to a more sustainable level.

Importantly, global current account adjustment will almost certainly involve a drop in the value of the dollar. Given the fact that the responsiveness of US exports and imports to changes in the exchange rate is relatively small, substantial dollar depreciation, perhaps in the range of 20–40 per cent, will be required to shrink the US trade deficit. Moreover, with US imports now twice as large as exports, exports need to grow at a rate nearly twice as fast as imports to prevent the trade deficit from widening further. In other words, the gap between imports and exports has grown so large that a dramatic acceleration in exports is necessary if they are to catch up. Worryingly, the longer current account adjustment is delayed, the more pronounced

the depreciation of the dollar will be. Perhaps, ironically, a weakening dollar is likely to have relatively benign effects on the US economy, at least if the correction is orderly. US exports will increase and the Federal Reserve will respond to contain any effects on inflation. The consequences of adjustment for the rest of the world, however, will be much more problematic. As one US official said to a foreign visitor: ‘It’s our currency, and your problem.’

For starters, if the adjustment started today, a narrowing of the US trade deficit to about zero would imply a contraction of US net imports of roughly \$850 billion at an annual rate. The flip side of this adjustment is that the rest of the world’s trade surplus with the US would necessarily shrink by \$850 billion. It is not clear if many countries are growing robustly enough to be able to withstand such a sizeable decline in exports. For example, let’s assume that the burden of adjustment is shared equally among Asia, Europe, and the major oil-exporting countries. This would imply a decline in European net exports of \$280 billion, equivalent to about 2.25 per cent of EU-15 GDP.⁹ For the currently anaemic European economy, this decline in exports would represent a significant blow, even if it were spread over several years. Current account adjustment will also affect the global economy through financial channels. When adjustment eventually occurs, holders of dollar assets in the rest of the world (that is, outside of the US) will suffer negative wealth effects. The rest of the world held about \$9,300 billion of gross dollar assets at the end of 2004. The euro area’s holdings amounted to nearly \$3,000 billion, equivalent to about one-third of its GDP. If adjustment started today, depreciation in the dollar of 30 per cent would imply a loss of wealth for the rest of the world equal to nearly 10 per cent of rest of the world GDP. The hit to euro-area wealth would be of a similar order, relative to GDP. These numbers assume an orderly adjustment. The wealth effect of a disorderly

adjustment would be even greater. Such a scenario would not only involve an abrupt drop in the dollar, but would also see surging US interest rates, falling US stock prices, and weaker economic activity in the US. The effects would probably spill over into financial markets in other countries, dragging down asset prices in Europe and elsewhere.

What Should Policymakers Do?

What should policymakers around the world do to prepare for global current account adjustment? For policymakers in the US, the challenge is to reduce overconsumption by raising the savings rate. The proportion of national income that is saved in the US has fallen sharply over recent years and is low compared with savings rates in the rest of the world. In part, US households save very little because soaring house prices have made them feel considerably wealthier and many homeowners have withdrawn equity from the value of their houses to increase consumption spending. Recent interest rate increases by the Federal Reserve have put an end to the US housing boom and may slow consumption spending. However, additional interest rate increase would likely push the economy into recession. From the US perspective, this would not be an acceptable solution to the problem of current account imbalances. Total US national savings also include savings — or dissavings — by the US government. Over the past five years, the US fiscal balance has swung from a surplus of 2.5 per cent of GDP to a deficit of 3.5 per cent of GDP. By running such a deficit, the US government is reducing national savings by an amount equivalent to 3.5 per cent of GDP. Much of the swing in the fiscal balance from surplus to deficit over recent years reflected the tax cuts introduced by the George W. Bush administration. As a result, tax revenues raised by the Federal government as a share of GDP have fallen to post-Second World War lows, while government spending as a share of GDP has

⁹ The EU-15 are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Sweden, Spain and the United Kingdom.

remained largely unchanged. One course of action that US policymakers could take to facilitate an orderly reduction in the US current account balance would be to increase taxes and thus increase national savings. That said, the very large tax hike that would be needed to eliminate the US trade deficit altogether would risk plunging the US economy into a deep recession. Therefore, fiscal consolidation in the US should be seen as a complement to a depreciation of the dollar, not as a substitute for it.

The exchange-rate adjustment will require the reallocation of resources. In Europe, policies that increase the flexibility of its unusually rigid labour markets will be of crucial importance. Drawing on the example presented earlier, adjustment that would cause European net exports to contract by €280 billion, would result in more than three million job losses in Europe's export industries. If these displaced workers were not able to find new jobs in other industries, such as services, European unemployment would jump considerably. To keep unemployment from rising, significant resources would need to shift from the traded goods sector to the non-traded sector. In order to promote a smooth reallocation of resources, policymakers in Europe and elsewhere need to do more to liberalize credit and labour markets. These reforms would also help to boost potential growth in Europe. A lasting correction of global current account imbalances is likely to require an improvement in European potential growth, not just a cyclical pick-up of European growth above potential, and an associated temporary boost to imports from the US. Stronger domestic demand in the form of business investment should also contribute to higher potential growth. Rising net financial inflows into Europe, as net inflows to the US decline, would provide financing for this additional investment. Moreover, higher real consumption in Europe would have positive effects on European consumers.

Fiscal policy in Europe can cushion some of the shock to aggregate demand that will accompany adjustment. When adjustment begins and European exporters come under pressure from a falling dollar, governments in Europe should cut taxes and increase government spending to boost the economy and make up for the decline in exports. To facilitate this reaction, European governments should now be striving to improve fiscal positions by cutting fiscal deficits. Also, the European Central Bank (ECB) should make it clear that it would respond to the deflationary pressures that will stem from adjustment by easing monetary policy significantly, thus avoiding the risk of deflationary expectations that might raise the cost of adjustment even further.

When adjustment starts and the dollar begins to drop, investors and central banks around the world may view the euro as a safer currency in which to hold assets. Should Europe welcome the euro becoming an international reserve currency? A significant and lasting increase in the euro's share in the currency baskets that China and other Asian countries peg to, and in their asset portfolios, would certainly give a boost to the euro's position as a global reserve currency. A key question is whether Europeans are willing to let that happen, given that it would imply large and lasting current account deficits for the euro area in relation to Asia, as it absorbs the excess savings coming from that region. European reactions to a decline in Europe's current account balance will influence the attractiveness of euro assets for Asian investors. In the past, European governments have been quick to call for exchange-rate depreciations in the face of current account deficits, fearing that such deficits might result in the loss of jobs in Europe. Reserve currency status promises revenues resulting from the global use of a currency, but it would also expose the euro to potentially large and volatile shifts in the international demand for liquidity, which would result in

higher exchange-rate volatility. In the past, some national central banks in Europe were reluctant to accept that possibility. It is not clear whether the ECB will be more inclined to tolerate more volatility.

Perhaps the greatest fear for policymakers in Europe regarding global adjustment is that the dollar may depreciate excessively against European currencies. There are two reasons why an excessive appreciation of European currencies against the dollar would be a serious cause for concern in Europe. First, notwithstanding recent indicators that suggest an incipient recovery in the euro area may be under way, economic growth remains sluggish. Economic growth in the euro area has been very disappointing for a long time, dragged down by dismal real GDP growth in some of the larger European Monetary Union (EMU) countries such as Germany and Italy. Recent indicators on activity have been more positive, but it is not clear whether the recent pick-up in growth in domestic demand can be sustained. As a result, a sharp appreciation in the real exchange-value of the euro that would depress net exports carries with it the risk of deflationary pressures and of a severe recession.

In addition, an excessive appreciation of the euro would be a serious concern for Europeans because it could exacerbate the problem of economic divergences in growth and inflation between existing EMU members. A sharp appreciation in the euro would represent a common shock to countries in the euro area, but one that would probably have asymmetric effects on individual euro-area members. These asymmetric effects would complicate the response of policy to the rise in the euro, especially the response of the euro area's one-size-fits-all monetary policy. These effects could be alleviated, however, by a shift in demand towards the oil-exporting countries, if these countries buy primarily investment goods in Europe. In that case, a

large share of the extra demand would fall on Germany and help the adjustment.

Appreciation in the euro would probably have asymmetric effects on individual countries in the euro area for several reasons. First, the importance of trade with the US varies considerably across euro-area countries. Exports to the US in 2005 represented less than 1 per cent of GDP in Greece and Spain. At the opposite end of the scale is Ireland, where exports to the US accounted for a whopping 10 per cent of GDP in 2005. Ireland also imported a relative large share from the US, along with other countries such as Belgium and the Netherlands. In contrast, imports from the US were relatively small for Finland, Spain and Portugal. As a result, the size of the effect of movements in the euro on individual countries' real effective (trade-weighted) exchange varies considerably. In addition, some industries would be affected more than others by euro appreciation, so differences in industrial structure and the composition of trade with the US will cause asymmetric effects. More generally, in the context of a Chinese currency pegged to the dollar, the relevant trading partner is not just the US, but the wider 'dollar zone' of countries whose currencies would depreciate along with the dollar. All euro-area members have seen their imports from China rise markedly since the launch of EMU, with Belgium and the Netherlands importing the most from China. As well as different trading patterns, asymmetric effects of a sharp appreciation may arise because of differences across euro-area members in trade elasticities, initial conditions, investment patterns, and flexibility.

What role will China play in global adjustment? Given the size of China's trade surplus with the US, it is clear that an orderly unwinding of global imbalances will require a significant reduction in China's surplus. For Chinese imports to grow faster than Chinese exports over the next few

10 Jaime Marquez and John Schindler, *Exchange-Rate Effects on China's Trade: An Interim Report*, International Finance Discussion Papers 861, Federal Reserve Board, Washington DC (2006)

years, a substantial appreciation of the renminbi against the dollar will be required. Chinese policymakers have so far been very reluctant to allow a large rise in the value of their currency because they are fearful that the damage to international competitiveness could hurt export growth and lead to a politically destabilizing increase in unemployment. While the problem in the US is insufficient savings, China's difficulties arise because Chinese households are saving too much. Given rapid changes in the structure of the Chinese economy over the past few decades, it is not surprising that Chinese households are putting money away for a rainy day. In the past, state-owned enterprises (SOEs) provided secure employment for workers and guaranteed pension benefits to retirees. In addition, SOEs paid for the education of workers' children and took care of medical expenses for workers' families. The ongoing reforms of the SOE sector have done away with these guaranteed entitlements and prompted an increase in precautionary spending. Moreover, since markets for mortgages are still underdeveloped in China, prospective homebuyers must save the bulk of the purchase price of a new house. Financial sector reforms will eventually eliminate the need for such savings, although considerable time will be required for the effects of these reforms to be felt.

In the near term, the key to reducing national savings in China will be a cut in government savings through tax cuts and increases in government spending. It is clear that the economic well-being of Chinese citizens would benefit from higher government expenditures directed at improving China's infrastructure, health and education systems, social safety net, and public housing. One concern is that greater government spending would cause the already rapidly expanding Chinese economy to overheat. The answer, therefore, is for the Chinese government to let the renminbi appreciate. The resulting loss of

competitiveness will slow the growth of exports and thus will offset the expansion in domestic demand and prevent overheating and a pick-up in inflation. China's economy will come to depend more on domestic demand as a source of growth and less on exports. In the end, China's economy is simply too large relative to the rest of the world for China to rely indefinitely on export-led growth. How much China's currency will have to appreciate will depend on the sensitivity of China's exports and imports to changes in the exchange rate. Recent estimates suggest that a 10 per cent appreciation of the renminbi lowers the share of aggregate Chinese exports by half a percentage point — in other words, China's exports are not particularly sensitive to exchange-rate changes.¹⁰ The same appreciation lowers the share of aggregate imports by about one-tenth of a percentage point. The upshot is that a large appreciation in the value of China's currency may be needed to put a dent in China's massive trade surplus.

Elsewhere in Asia, Japan has also been running large current account surpluses. Like China, Japan also records very high household savings rates. To a large extent, high savings rates in Japan reflect the depressed level of household confidence about future employment and income prospects. In turn, consumers' anxiety about the future reflects the country's fifteen-year-long economic slump that followed the bursting of the asset price bubble in the early 1990s. Weak investment has also contributed to the poor performance of Japan's economy. To facilitate smooth global adjustment, Japan, like China, faces the challenge of boosting domestic demand to compensate for the drag on economic growth that will come from slowing exports. Unlike China, there is little room in Japan for additional government spending. Japan's fiscal deficit is already large at 6 per cent of GDP and its national debt has reached 150 per cent of GDP, the highest

level among industrial countries. Demands on government spending, stemming from the ageing of the population, will put further burdens on the country's fiscal position as expenditures on pensions and health care rise. With the option of a large fiscal expansion off the table, much of the heavy lifting will have to be done by monetary policy. The Bank of Japan, the country's central bank, recently ended its five-year-old policy of zero interest rates by raising interest rates to a still low 0.25 per cent amid signs that the economy may be recovering and a decade-long period of deflation (that is, falling prices) may be coming to an end. The trick for the Bank of Japan will be to make sure that in its efforts to gradually return Japanese interest rates to more normal levels it does not inadvertently snuff out the economy's nascent recovery. Global adjustment will require that the Bank of Japan displays patience and keeps interest rates low for the foreseeable future.

As in the case of China, global adjustment calls for an appreciation in Japan's currency. The yen has recently weakened considerably against both the dollar and the euro. After adjusting for price developments, the drop in the yen is even larger, as prices have been falling in Japan. The resolution of global imbalances will require that this depreciation be reversed. In addition, Japanese policymakers can take steps to increase domestic demand by accelerating the pace of structural reforms. In particular, measures to strengthen the still-troubled banking system and further liberalize product markets should improve the economy's potential rate of growth and eventually boost consumer and business investment spending.

How will the Burden of Adjustment be Shared?

When the dollar depreciates sharply, as it will have to do to boost US exports and contain US imports, the key factor

determining how the burden of adjustment is shared across countries will be movements in bilateral exchange rates. From a European perspective, policymakers in Europe are fearful of an unfair distribution of the adjustment burden, because, unlike some other major players, their exchange rates are flexible and are determined by market forces. In contrast, China has a pegged currency régime and limits the amount by which the renminbi moves. Tellingly, the bilateral dollar–euro and dollar–sterling nominal exchange rates have moved much more over recent years than the US trade-weighted exchange rate, suggesting that a large amount of the effective dollar depreciation since 2002 has been borne by Europe. Unless something changes, Europeans are fearful that this unequal distribution of adjustment will continue. Taking a longer-term perspective on current account balances in the major regions, the EU has been largely a self-financing region over the past twenty-five years. Current account imbalances have never been very large. For Europe to shoulder a major part of the new adjustment would be an unprecedented experience. To put it differently: Europeans have never accepted large changes in Europe's current account position to allow global adjustment. The only exception is the brief period between 1986 and 1988, when Europe tolerated a moderate shrinking in its current account surplus, coinciding with the period in which international co-ordination was effectively in place (that is, over the period from the Plaza Accord of September 1985 to the Louvre Accord of February 1987). A second, interesting observation is the stark difference between the 1980s imbalances and today's. In the 1980s, Japan contributed most of the adjustment and acquired most of the dollar assets. In recent years, the adjustment has been shared more equally among the Asian economies. In contrast to the 1980s, there is now a co-ordination problem on the Asian side. In other words, in the 1980s, any externality from the adjustment (the fact

Aerial view of Monfort Beef's cattle feedlot near Greeley, Colorado; it is the world's largest cattle feed-lot (120,000 head). Photograph: Glowimages/Gettyimages.



that stopping support for the dollar would have consequences for the home-currency value of the previously accumulated dollar assets) was internalized by Japan. This is no longer the case. This may be one reason why developing Asia and Japan seem to have gone in different directions since 2004, with an increasing share of the action being official interventions: as Japan slows its support for the dollar, developing Asia increases its support, in fear of a falling value of the dollar.

This is significant from a European perspective. In the 1980s, the Europeans were dragged into the Plaza Accord (against opposition, especially from the Bundesbank) because the US and Japan were able to reach an agreement. Now the situation is different. It would take co-ordination between the US and many Asian economies before Europe could be coerced into a similar exercise. The same logic suggests that Europe has little interest in promoting international co-ordination with the Asian economies and the US. Europe would prefer to hide behind

the argument that the ECB is independent and cannot be forced to co-operate. The key point is that there are profound implications for Europe of exchange-rate régime change in Asia. Currency régimes in Asia continue to receive a great deal of attention from policymakers and the press around the world. The US, for example, has been a strong advocate for a more flexible exchange-rate system in China. Obviously, European policymakers, fearful that Europe may have to bear a disproportionately large share of the adjustment of the US external position, have a keen interest in this debate. So far, the response of euro-area policymakers has been to make the sensible suggestion that other countries, whose bilateral dollar and effective exchange rates have not appreciated over the past few years, and in many cases have depreciated in effective terms, should allow their currencies to adjust.

Since adjustment will involve depreciation in the US exchange rate, the question arises: to what extent will governments in

Asia allow their currencies to appreciate? Especially important in this regard is China's exchange-rate régime. As we have seen, China, in particular, has pegged its currency firmly to the US dollar for many years. In July 2005, the renminbi was allowed to appreciate about 2 per cent, and has been stable since. China's government announced that, in the future, it would peg to a basket of currencies, but the exact composition of this basket remains unspecified. Future adjustments in China's exchange-rate policy have two dimensions that are relevant for Europe. One is the level of the exchange rate. The more the renminbi is allowed to appreciate against the dollar, the larger the part of the US current account adjustment that falls on the trade flows between China and the US and the less need there is for adjustment between the US and Europe. The other dimension is the exchange-rate régime. The more the Chinese peg shifts from the dollar to the euro, the more China will become a net buyer of euro assets. This is likely to result in a euro-area current account deficit *vis-à-vis* China, and an appreciation of the euro's real exchange rate, thereby weakening euro-area exports. Europe therefore has a clear interest in a significant appreciation of the renminbi against the dollar, but not in an increase in the euro's share in the currency basket to which the Chinese peg their currency.

From a European perspective, a key consideration revolves around what might happen to the foreign exchange value of the euro *vis-à-vis* the dollar, should China move to a floating exchange-rate régime, as some observers are advocating. On the one hand, if China moves to a floating system, its demand for dollar assets will drop, eliminating a major source of demand for dollars. As a result, the dollar might be expected to drop against the euro. On the other hand, to the extent that the renminbi appreciates against the dollar under a Chinese float (as most observers would expect), then the euro may not have to

play as large a role in bringing about the necessary drop in the real effective dollar to close the US trade deficit.

Can Europe Cope?

Given that the single European currency has been in existence for only a short period of time, there are legitimate questions about the ability of European institutions to cope effectively with an exchange-rate shock. Whether or not these institutions can deliver in the face of a sharp exchange-rate adjustment obviously matters enormously for Europe, but it also has important implications for Asia. If EU institutions do not deliver, Europe's responses could be more erratic, with an increased risk of a more protectionist response. What role will EU institutions play during global current account adjustment and what are the main open questions concerning the likely effectiveness of the current arrangements in Europe? If a sharp adjustment in exchange rates were to occur that threatened to result in deflationary pressures in the euro area, the ECB would be expected to loosen monetary policy promptly and aggressively. One issue is the extent to which a rise in the value of the euro passes through into imported prices. If exporting firms practise a price-to-market policy, then an appreciation of the euro will squeeze the profit margins (after being converted into euros) of European firms exporting to the US, but the (euro) price of imports from the US will not be affected. As a result, the dampening effect on inflation of lower import prices will be absent, possibly ruling out aggressive ECB actions.¹¹

Moreover, the experience of 2001 when the ECB showed a pretty subdued reaction to the risk of deflation — at least compared with the Federal Reserve — raises questions about how quickly and forcefully the ECB would respond to a large exchange-rate shock. For example, by the time of the first ECB interest rate cut in mid-2001, when the policy rate

- 11 Thomas Warmedinger, 'Import Prices and Pricing-to-Market Effects in the Euro Area', ECB Working Paper 299 (January 2004)
- 12 ECB President Jean-Claude Trichet recently offered a different point of view, arguing that central bank 'activism' cannot be quantified by simple statistics such as the frequency and size of policy moves, and that the 'ECB's strategy is as active as it needs to be to fulfil our mandate'. See his 'Activism and Alertness in Monetary Policy', a lecture at the Conference of Central Banks, Madrid, 8 June 2006.
- 13 C. Randall Henning, 'The External Policy of the Euro Area: Organizing for Foreign Exchange Intervention,' Institute for International Economics Working Paper 4, June 2006
- 14 Article 111, paragraph 1 of the Treaty of Amsterdam states that 'By way of derogation from Article 300, the Council may, acting unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, after consulting the European Parliament, in accordance with the procedure in paragraph 3 for determining the arrangements, conclude formal agreements on an exchange rate system for the ECU in relation to non-Community currencies'.

15 Article 111, paragraph 2, states that ‘In the absence of an exchange rate system in relation to one or more non-Community currencies as referred to in paragraph 1, the Council, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, may formulate general orientations for exchange rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB [European System of Central Banks] to maintain price stability’.

16 See, for example, ECB President Willem F. Duisenberg’s comments reported in ‘Careful Planning behind Banks’ Euro Surprise’, *Financial Times*, 24 September 2000.

17 Wolfgang Munchau, ‘Eurozone Pettiness is Preventing Policymaking’, *Financial Times*, 26 June 2006

was trimmed 25 basis points to 4.5 percent, the Federal Reserve had already carried out 250 basis points of easing. As a result, real interest rates in the euro area at that time, at about 2 per cent, were almost double the level in the US.¹² National governments would also play a part in responding to adjustment. A fiscal expansion in Europe can mitigate the effects of the decline in aggregate demand that would follow upon the US current account adjustment. To facilitate this response without endangering the sustainability of public finances in the EU countries, governments should move their budgets to balance or to small surpluses now. An additional benefit of these sound policies would be to make European assets more attractive to Asian investors. But the story here is more complicated. The Stability and Growth Pact (SGP) might hinder a sufficiently strong fiscal reaction, especially one that would be forward-looking in the sense that it could act quickly when the dollar declines fast. Furthermore, if the ensuing recession is asymmetric across countries within the euro area, there may be more tension in the European Council between the strongly affected countries, which desire a large fiscal response, and those less affected, which will insist on staying within the SGP limits. Some commentators have argued that the European Commission might be slow to provide the leadership necessary in such situations. Again, this may result in delayed responses.

Another possible policy response in Europe to a perceived excessive appreciation in the euro would be intervention in the foreign exchange market.¹³ According to the Treaty of Amsterdam which revised the Maastricht Treaty, responsibility for exchange-rate policy is divided between the Council of Ministers and the ECB.¹⁴ The council chooses the exchange-rate régime under certain provisions and subsequently the national central banks in the euro area carry out the interventions. Since a formal agreement to peg the euro to the dollar is unlikely, this division of responsibilities is

not of major relevance. That said, the treaty does give the council power to ‘formulate general orientations for exchange rate policy’.¹⁵ It is unclear at this stage how the council might use this power in the event of an excessive exchange-rate shock. Although the ECB decides on all details of intervention, in the only episode of ECB intervention to date — the intervention in 2000 to support the euro — the ECB chose to consult with the Eurogroup of euro-area Finance ministers. ECB officials stressed at the time, however, that the ECB does not need Finance ministers’ permission to intervene in foreign exchange markets.¹⁶ Nevertheless, intervention is unlikely to be successful if Finance ministers were publicly to oppose it. However, in the case of global adjustment, the situation is likely to be the reverse of that in 2000: the Finance ministers may want intervention (to stem the appreciation of the euro), but the central bankers may be opposed to such a move.

The relationship between European institutions and the effectiveness of arrangements in the euro area also comes into focus in the context of the new IMF multilateral consultations on global imbalances. The consultations began in summer 2006 (initially on a bilateral basis with IMF staff) and involve China, the euro area, Japan, Saudi Arabia, and the US. Reportedly, the euro area’s representation consists of the Eurogroup, the ECB, and the European Commission. However, recent squabbling between the ECB president, Jean-Claude Trichet, and the Eurogroup president, Jean-Claude Juncker, augurs badly for effective co-ordination between European policymakers.¹⁷ In sum, an orderly unwinding of global imbalances is by no means guaranteed. Appropriate policy actions in all of the major economies will be needed to reduce the risks of a disorderly and painful adjustment. And given the magnitude of the imbalances, these actions need to be taken immediately. ■