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Policy Brief

Global Imbalances: Time for Action

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Bruegel, the Korea Institute for International Economic Policy, and the Peterson Institute for International Economics held a joint workshop in Washington on February 8 and 9, 2007, on how to achieve an orderly reduction in global imbalances. Thirty of the world's leading experts presented analyses and evaluations of the requirements for such an adjustment. The discussions centered on two sets of contributions: (1) country papers that provided a perspective on the underlying factors behind surpluses and deficits and the scope for adjustment in the current account and (2) multicountry simulation papers that produced estimates of the changes in policy variables and the corresponding exchange rate adjustments that are consistent with scenarios for a reduction in current account imbalances. This policy brief, by six experts from the organizations that hosted this workshop, **reports on the results and the** *workshop discussions and outlines an adjustment package that would address the global imbalances.*

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One of the principal dangers currently facing the world economy arises from the large and unsustainable imbalances in current account positions. Some observers argue that these imbalances will unwind gradually and nondisruptively, while others emphasize the risks of a sudden change of sentiment in financial markets that could result in an abrupt and damaging adjustment. No one knows which scenario will materialize, but a priority

for policymakers should be to reduce the risks of a crisis, which could produce a world recession and disruptions to the global trading system. For that, the global economy requires official sponsorship of a credible, comprehensive adjustment program. This policy brief outlines such a program.

Section 1 presents why the current situation is unsustainable. Adjustment must take place and will require significant movements in exchange rates. Section 2 argues that adjustment induced by policy actions is more likely to be orderly than one initiated by financial markets. We view the current stalemate regarding policy actions as dangerous, as financial-market participants are likely to change their minds at some stage about the sustainability of imbalances unless they see that the main players are able to agree on the direction of desirable policy changes. Section 3 presents estimates of the exchange rate implications of global current account adjustment from a variety of models. Section 4 describes the policy implications the authors of this brief drew from these results and the workshop discussions.

WHY THE CURRENT SITUATION IS UNSUSTAINABLE

There has been a great deal of discussion recently of global current account imbalances. Much of the attention has focused on the historically large US current account deficit, which, according to the US Bureau of Economic Analysis, reached $857 billion (6.5 percent of GDP) in 2006. The counterpart to this deficit can be found mainly in Asia and the oil-exporting countries. According to the International Monetary Fund (IMF), China's surplus swelled to an estimated $184 billion (7.2 percent of GDP) in 2006,[1] while Japan recorded an estimated surplus of $167 billion (3.7 percent of GDP) last year. High oil prices propelled the surplus for countries in the Middle East to $282 billion last year.

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1. This estimate appears conservative. China's trade surplus in goods was $178 billion in 2006, with imports reported on a cost, insurance, freight (c.i.f) basis. When the import data are adjusted to free on board (f.o.b.), the trade in goods surplus will likely come in at about $215 billion. Based on trends in the other items in the first-half balance of payments, Nicholas Lardy estimates that China's surplus last year was $240 billion (see Nicholas Lardy, *Toward a Consumption-Driven Growth Path*, Policy Briefs in International Economics PB06-6, Washington: Peterson Institute for International Economics, October 2006).

Figure 1 Current account balance (percent of world GDP)
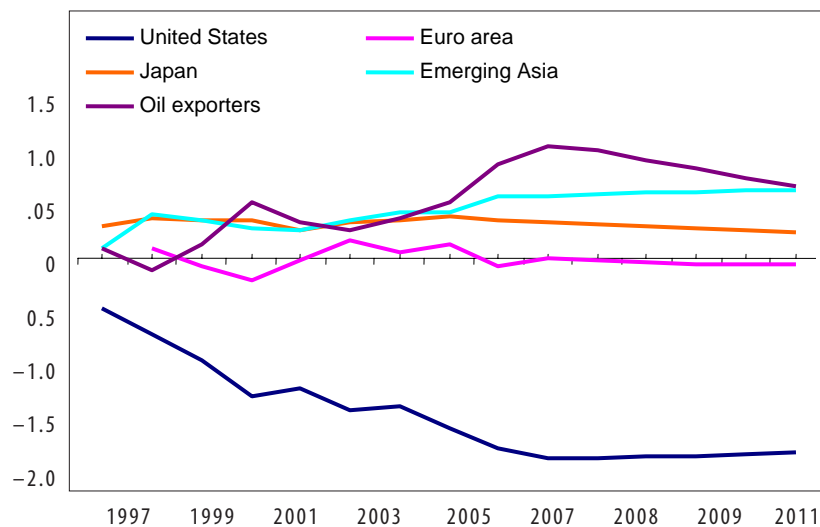
Source: IMF, *World Economic Outlook*, September 2006, 17.

There was broad agreement among the workshop participants on a number of points. First, as a result of the increase in global financial integration over the last decade or so, larger and more persistent current account imbalances are possible for many countries today than they were in the past. Global capital markets are larger and more liquid, and new financial instruments have developed that make it easier for investors to manage risk. What effect financial globalization and the proliferation of derivative instruments has had on the probability of a smooth unwinding of global imbalances is an open question.

Second, the United States is presently deriving significant benefits from the situation. Financial inflows from abroad have boosted US asset prices and helped to keep US long-term interest rates low, thereby spurring and financing domestic spending in the United States. In addition, it is well known that the return on US gross foreign assets exceeds that on US gross foreign liabilities. The effect is that, although US net foreign liabilities exceed 20 percent of GDP, net income payments on these liabilities are small.[2] Moreover, because foreign claims on the United States are almost entirely priced or denominated in dollars, while US direct and portfolio equity assets abroad as well as a portion of credit claims on foreigners are priced or denominated in foreign currency, the decline in the foreign

exchange value of the dollar over recent years has boosted the dollar equivalent of foreign assets, thereby reducing US net foreign liabilities as measured in dollars. As a result, the increase in US net foreign liabilities over the past few years has been considerably smaller than the cumulative current account deficits.[3]

Nevertheless, the current pattern of global imbalances is not sustainable. Medium-term projections by the IMF indicate that at unchanged real effective exchange rates, large current account imbalances will persist (see figure 1). Persistent external deficits and surpluses of this scale imply an implausible accumulation of foreign liabilities on the US side and an implausible accumulation of assets on the Chinese and Japanese sides. The implied steep increase in US net foreign liabilities (figure 2) from about 8 percent of world GDP (26 percent of US GDP) in 2006 to roughly 15 percent of world GDP (over 51 percent of US GDP) by 2011 raises serious questions about the willingness of foreign investors to continue accumulating net claims on the United States, especially considering that gross foreign holdings of US assets would be far larger. At some stage, foreign investors will begin to demand ever higher returns on the US assets that they buy, though where that limit might be is impossible to tell at this point.

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2. In fact, despite continuously rising net foreign liabilities, income receipts on US-owned assets abroad were greater than income payments on foreign-owned assets in the United States until the fourth quarter of 2005.

3. For comprehensive data on the valuation effects, see Philip Lane and Gian Maria Milesi-Ferretti, *The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970-2004*, IMF Working Papers 06/69 (Washington: International Monetary Fund, 2006).

Figure 2   Net foreign assets (percent of world GDP)
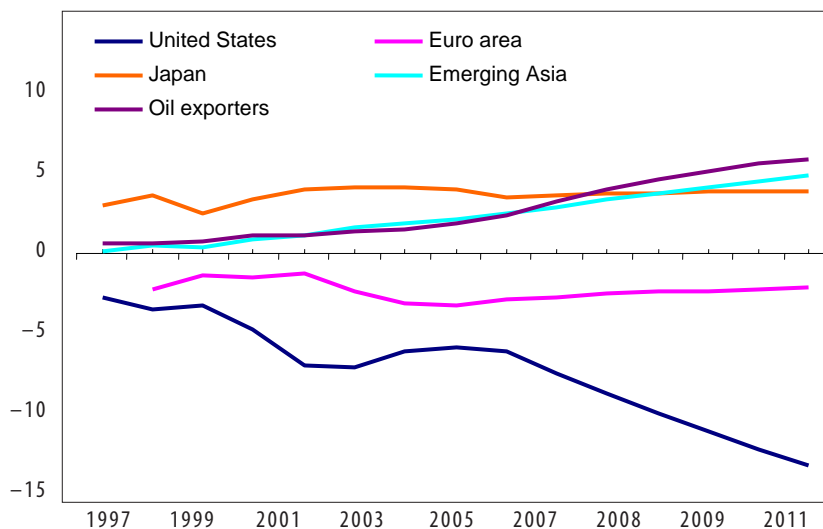
The clear implication is that global current account adjustment must take place. The most elementary theory tells us that this adjustment will require movements in exchange rates, including a significant depreciation in the dollar and corresponding appreciations in the currencies of other countries, as well as a rebalancing of demand and saving across the globe.[4]

WHAT ADJUSTMENT?

A key question is whether financial markets or policy actions will initiate the necessary and inevitable adjustment. Market sentiment can change abruptly and the risk of a market-led adjustment is that it might involve global recession, abrupt and excessive changes in key exchange rates and asset prices, and as a consequence aggravated trade frictions. To reduce the risk of such an outcome, policymakers need to initiate a policy-induced adjustment in the near future. The recent volatility in global financial markets is a reminder of the dangers of failing to act promptly.

Agreement on the substance of a policy-induced adjustment is the purpose of the multilateral consultations at the IMF initiated in 2006. However, they have not yet achieved significant results. Meanwhile, the United States is focusing on its bilateral relationship with China, and the Europeans have been getting vocal about the yen. Yet the issue of adjustment has a multilateral character; thus, a multilateral institution or forum, such as the one convened by the IMF or possibly an informal Group of Four (United States, euro area or the European Union, Japan, and China), would seem to be the appropriate venue to deal with it.

There is a large degree of convergence in the economic interest of the key players:

- The United States needs to bring its current account deficit down to an acceptable level, and this will require a significant effective depreciation of the dollar and higher US national saving.
- China needs to curb its accumulation of foreign exchange reserves, rebalance growth toward domestic demand, and continue removing distortions that favor exporting industries.
- Although Japan's weak exchange rate and ultra low interest rates have been instrumental in countering deflation, economic recovery now permits the return of monetary policy and the exchange rate to a more neutral stance.
- Europe's currencies have already appreciated substantially both against the dollar and in effective terms. For Europeans, the priority is to avoid an overshooting of their currencies that might result from a disorderly adjustment. However, it is important to recognize that an effective

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4. See, for example, Maurice Obstfeld and Kenneth Rogoff, Global Current Account Imbalances and Exchange Rate Adjustments, *Brookings Papers on Economic Activity* 1: 67–146 (Washington: Brookings Institution, 2005).

depreciation of the dollar and an effective appreciation of the Asian currencies imply a further bilateral appreciation of the euro and sterling against the dollar. Otherwise, there would be an effective depreciation of the euro and sterling, eroding the extent of potential US external adjustment.

- The Korean won, like the European currencies, has already appreciated sharply both against the dollar and in effective terms. If Korea's current account remains in small surplus as projected by the IMF, then its currency would need to appreciate further against the dollar in the context of global adjustment. If instead its current account swings toward significant deficit in 2007–08, as is being forecast by some Korean institutions, then more limited appreciation against the dollar and corresponding partial reversal of the trade-weighted appreciation experienced to date could be appropriate.[5]

- Several key oil-exporting countries have adopted a more prudent and forward-looking approach than they did in the 1970s and 1980s and are likely to build their stocks of foreign assets further. In other words, these countries' marginal propensity to spend out of oil revenues is less than one. However, their surpluses need to decline as domestic absorption gradually expands.

In spite of this potential convergence of interest, the main participants have not embarked on a set of policies that clearly signal their intention to tackle the global imbalances. This stalemate is dangerous, and it is imprudent to delay a change in stance until financial markets conclude that the present situation is unsustainable.[6] Of particular concern already are

- the trade frictions between China and the United States arising from China's exchange rate policy and
- the weakness of the yen. Although it has strengthened moderately recently, it remains very weak on a historical basis. This weakness not only contributes to the US trade deficit but also hurts other economies in Asia that have suffered a loss of competitiveness against Japan. Yen-funded carry trades may have begun to unwind, but any rebound in the amount of such trades may weaken the yen again. A weaker yen would not be consistent with

the ongoing recovery in Japan's economy and accompanying prospective tightening of Japanese monetary policy.

ADJUSTMENT SCENARIOS

To examine what a return to sustainability might mean for exchange rates, participants in the workshop were asked to present estimates of the exchange rate implications of current account adjustment scenarios in which the US current account deficit narrowed to 3 percent of GDP in the medium term. The scenarios differ in how the burden of adjustment is shared among individual countries in the rest of the world, but all scenarios assume that most of the adjustment would be borne by China, Japan, other Asian economies, a few high-surplus European economies not in the euro area, and the oil-exporting countries. The external balance of the euro area, which is projected to be in slight deficit in 2007, is assumed unchanged. An important goal behind all scenarios is that the adjustment should take place without depressing the rate of growth of world GDP.

Three approaches were used to assess those implications:

- **Partial equilibrium "trade elasticities" models**: The Baily model of US trade performance, the Cline model of optimal exchange rate realignment, and the Stolper and Fuentes elasticity model are in this tradition.[7] So are the macroeconomic balance and external sustainability approaches outlined in the IMF (2006) review of methodologies for equilibrium exchange rate assessment.[8]
- **Macroeconomic models**: The NiGEM model estimates prepared by Barrell, Holland, and Hurst are in this tradition, as are the Federal Reserve estimates with a dynamic general equilibrium model referred to by Christopher Erceg.[9]
- **Reduced-form estimates of equilibrium exchange rates**: The Bénassy-Quéré, Lahrèche-Révil, and Mignon estimates, and those by Stolper and Fuentes using the Goldman Sachs dynamic equilibrium exchange rate (GSDEER) model and by MacDonald and Dias using the

5. See *Economic Forecasting for 2007* (Korea Development Institute, December 2006) and *2007 Economic Forecasting* (Samsung Economic Research Institute, November 2006).

6. Paul Krugman, "Will There Be a Dollar Crisis?" Paper presented at the Economic Policy Panel at the Federal Reserve Bank of New York, February 12, 2007, available at www.cepr.org.

7. See papers presented at the workshop by Martin Baily, "Dollar Adjustment to Reduce the US Imbalance"; William R. Cline, "Estimating Reference Exchange Rates"; and Thomas Stolper and Monica Fuentes, "GSDEER and Trade Elasticities."

8. See paper presented at the workshop by Gian Maria Milesi-Ferretti, "Methodologies for CGER Exchange Rate Assessments" (International Monetary Fund, November 8, 2006).

9. See paper presented at the workshop by Ray Barrell, Dawn Holland, and Ian Hurst, "Correcting US Imbalances." The results presented by Christopher Erceg are based on the Federal Reserve Board's SIGMA model. For more details on SIGMA, see www.ijcb.org.

Box 1 Models and approaches

Workshop paper authors applied three broad modeling approaches to investigate equilibrium exchange rates. The most traditional approach was the partial equilibrium "trade elasticities" method in conjunction with judgmental current account targets. In this approach, exports and imports depend on the price incentive provided by the real effective exchange rate and on the impact of foreign income on demand for exports and of domestic income on demand for imports. The more complete models in this genre include detailed treatment of foreign asset and liability changes and rates of return. These models examine the magnitude of the exchange rate change needed to shift the current account from baseline to target levels. A strength of this approach is its transparency. It does, of course, require a judgment about the size of the current account deficit that is sustainable. There is no explicit modeling of how an exchange rate change is to be achieved (under floating rates). A limitation is that it does not attempt specific modeling of how the corresponding change in absorption is composed (higher private saving, lower public dissaving, and/or less investment).

The second approach is to shock a macroeconometric model in such a way that it generates a targeted change in the current account over a certain horizon. In principle, a strength of this approach is that it takes into account feedback effects and explicitly incorporates the monetary and fiscal policies needed to generate a desired shock. An important limitation is the underlying return-to-equilibrium structure of the model, which typically assumes the economy begins in equilibrium and therefore after a shock returns to the same starting point over time from feedback effects. However, the normal policy-feedback rules (such as a "Taylor rule" for monetary policy) that characterize such models are inappropriate when the economy starts in a disequilibrium requiring a policy change. This class of models also provides considerably less transparency than the partial equilibrium models in attributing the calculated changes in outcomes to specific changes in the model inputs.

The third approach is econometric modeling of the influences that are found internationally to be associated with strong or weak real exchange rates, including such variables as net foreign assets and productivity growth. In this approach, the coefficients estimated from international experience are applied to the country in question to determine whether its exchange rate is overvalued or undervalued and by how much. A major limitation of this approach is that it must assume not only that the period observed is one in which on average the countries in the sample are at equilibrium exchange rates but also that the overall coefficients estimated for the panel of countries apply to the country of direct interest (e.g., the United States). A related limitation is that there is no explicit attention to erosion or improvement of a country's relative position over time from factors not directly in the model, such as the secular adverse shift for the United States implied by Martin Baily's findings. There are difficulties in measurement, such as the use of consumer to producer price ratios to proxy productivity, thereby potentially placing what amounts to the real exchange rate on both sides of the equation. There are also difficulties of policy interpretation, such as the result in the IMF model indicating that a larger fiscal deficit is associated with a stronger real exchange rate, even though running a larger fiscal deficit is not a sustainable means of achieving equilibrium.

behavioural equilibrium exchange rate (BEER) model, are in this family.[10] So is the equilibrium real exchange rate approach described in the IMF (2006) paper.

Box 1 describes in more detail the models and approaches used in the workshop papers. Table 1 contains estimates presented at the workshop of the changes in the real effective exchange rates of the main currencies required to meet the objectives for a reduced US current account deficit.[11] Table 2

presents the equivalent changes in bilateral real exchange rates against the US dollar. Markets tend to focus on this figure, but it is the wrong figure in determining the extent of the economic effects of exchange rate changes. The average (i.e., effective) exchange rate movements shown in table 1 are of far greater importance, because they are what determine the change in trade outcomes for each country. They also tend to be much smaller, for the fundamental economic reason that many countries are postulated to be appreciating their exchange rates against the dollar simultaneously.

10. See papers presented by Agnès Bénassy-Quéré, Amina Lahrèche-Révil, and Valérie Mignon, "World Consistent Equilibrium Exchange Rates"; and by Ronald MacDonald and Preèthike Dias, "BEER Estimates and Target Current Account Imbalances."

11. We exclude from the comparisons estimates that do not meet the specifications of the scenario. Estimates from Bénassy-Quéré, Lahrèche-Révil, and Mignon, as well as those of the GSDEER approach of Stolper and Fuentes, did not examine what exchange rate changes would be required to meet the 3 percent of GDP target for the US current account deficit specified in the

workshop terms of reference. Both found surprisingly that the dollar was undervalued, implying that those models find financial markets to be comfortable with a persistent US current account deficit much higher than this target, at least for an extremely long period. Both models are subject to the possible problems noted in box 1 (third approach). Moreover, the alternative elasticities model estimated by Stolper and Fuentes produced results more in line with those of the other papers.

Table 1   Real effective exchange rate change required to reduce US current account deficit to 3 percent of GDP in the medium term (percent change)

Author	US dollar	Japanese yen	Chinese renminbi	Euro
Martin Baily	−15 to −20	n.e.	n.e	n.e.
Ray Barrell, Dawn Holland, and Ian Hurst	−11 to −19	+10 to +14	+3 to +7	−3 to +6
William R. Cline[a]	−18	+8 to +18	+9 to +24	0
Thomas Stolper and Monica Fuentes[b]	−16	+18	+5	+2
Ronald MacDonald and Preèthike Dias	−11[d]	+6	+27	0
Christopher Erceg[c]	−8 to −25	n.e.	n.e.	n.e.

n.e. = not estimated

a. January–August 2006 average. Range refers to two model variants applied to the three scenarios considered by the workshop.
b. Only results from the elasticity model reported.
c. Range refers to the different shocks that are being unwound.
d. Using preferred coefficient estimate.

Note: + implies appreciation; − implies depreciation

- In principle, the extent of exchange rate adjustment depends on the underlying factors behind surpluses or deficits and on what policy actions are taken. Also, as the US deficit shrinks, the assumed distribution of the adjustment across the rest of the world matters. Specifically, the greater the share of the adjustment that a country undertakes through a decline in its current account balance, the larger the required appreciation of that country's real effective exchange rate.

- The models generally find that a real effective depreciation of the dollar of between 10 and 20 percent from the current level is needed to shrink the US current account deficit to 3 percent of GDP over the next few years.

- To reduce the Japanese current account surplus to levels specified in the scenarios (that is, to between $36 billion and $54 billion, depending on the scenario, from $167 billion in 2006), the models typically find that a real effective appreciation in the yen of between 10 and 15 percent is needed. This movement requires a 25 to 30 percent real appreciation of the yen vis-à-vis the dollar, moving the exchange rate to around 90 yen/dollar compared with roughly 118 yen/dollar today.[12]

- The workshop produced a fairly wide range of estimates for the required movement in the Chinese renminbi. This uncertainty in part reflects the difficulty of estimating precisely the sensitivity of Chinese exports and imports to exchange rate movements.[13] **Effective appreciation of** between 5 and 25 percent was calculated to be required to reduce China's surplus by between roughly 3.5 and 6.5 percentage points of GDP (with the low end of the range being accompanied by an expansion of domestic demand in China that more than compensated for the loss of foreign demand). **As in the case of the Japanese** currency, this strengthening of the renminbi in effective terms implies a substantially larger bilateral appreciation against the dollar.

- Since the scenarios assume a roughly unchanged current account deficit in the euro area, little or no change in the effective value of the euro is needed. As the models find that the euro depreciates against the Asian currencies, a stable effective euro implies a marked bilateral apprecia-

12. The implied yen/dollar figure assumes that most of the required movement in the real bilateral exchange rate comes about through a change in the nominal exchange rate.

13. The time series of data on Chinese exports and imports is relatively short. In addition, the enormous structural changes that the Chinese economy has undergone over the past decade complicate econometric estimates of China's trade elasticities. Generally, the more sensitive to exchange rate movements that China's trade is estimated to be, the less appreciation of the renminbi is needed.

Table 2 Bilateral real exchange rate change against the US dollar consistent with REER movements in table 1 (percent change)

Author	Japanese yen	Chinese renminbi	Euro
Martin Baily	n.e.	n.e.	n.e.
Ray Barrell, Dawn Holland, and Ian Hurst	+24	+18	+16
William R. Cline[a]	+28 to +39	+31 to +44	+20
Thomas Stolper and Monica Fuentes[b]	+25	+10	+15
Ronald MacDonald and Preèthike Dias	n.e.	n.e.	n.e.
Christopher Erceg	n.e.	n.e.	n.e.

n.e. = not estimated
REER = real effective exchange rate

a. See table 1, footnote a.
b. Nominal exchange rates. Only results from the elasticity model reported.

Note: + implies appreciation

tion of the euro vis-à-vis the dollar to between $1.45 and $1.50 per euro compared with about $1.33 today.

To summarize, the model estimates presented at the workshop placed the order of magnitude of effective depreciation of the dollar needed to bring about the targeted adjustment at around 15 percent. Effective appreciations of around 10 percent for the yen and 15 percent for the renminbi would provide part of the counterpart. To bring about these effective exchange rate movements, much larger bilateral appreciations against the dollar would be required, of maybe 25 to 30 percent for the yen and 30 percent for the renminbi. But there will also be a need for substantial bilateral appreciations against the dollar by currencies whose effective exchange rates do not need to change. In particular, the euro would need to strengthen to at least $1.45 per euro, while sterling would rise to well over $2 per pound.

Finally, although the primary focus of the workshop was on the currencies of countries taking part in the IMF multilateral talks, currencies of other economies running large external surpluses would also need to appreciate on an effective basis in order to meet the targets for correcting global imbalances specified in the workshop scenarios. Otherwise US external adjustment would fall below target. The combined role of the smaller surplus economies in Asia and Europe (outside of the euro area) in the adjustment process will be more important

than either China or Japan.[14] This consideration illustrates once again the multilateral nature of the adjustment problem, which to date has arguably been addressed with an excessive emphasis on just one facet: the US-China relationship.

POLICY CHOICES

The authors of this brief draw the following policy implications:

- With the US economy currently operating close to full employment, adjustment requires a rate of growth in US domestic demand below that of output over coming years to prevent inflationary excess demand. A prime candidate to facilitate this adjustment is fiscal contraction to offset the increasing contribution to growth from rising US net exports. A rebalancing of world demand between the United States and East Asia is indispensable.
- Japan and China hold the key to the adjustment in Asia. Unless both Japanese and Chinese policymakers accept

14. For four East Asian economies (Hong Kong, Malaysia, Singapore, and Taiwan) and four European economies (Norway, Sweden, Switzerland, and Russia) with large current account surpluses, the combined weight in the Federal Reserve's broad real exchange rate index for the dollar amounts to 13.2 percent, higher than that of either China (11.3 percent) or Japan (10.5 percent).

the appreciation of their currencies, it is difficult to see how the adjustment process can start in Asia as other Asian economies would in turn resist the appreciation of their currencies. Moreover, Japan has been at the forefront of promoting monetary integration in Asia. A Japan that is committed to cooperation on exchange rate policy in Asia should take the lead in the region on exchange rate adjustment against the dollar.

- Now that the yen has begun to strengthen, it is important that Japan not intervene to bail out speculators that engaged in the yen carry trade when the yen was very weak. Moreover, it is reasonable to expect that the yen will appreciate further in the near term as the Bank of Japan continues its moves toward normalizing monetary policy. If not, there would be a case for intervention in foreign exchange markets to push the yen higher. In this regard, we note that on a real effective basis the yen is currently at its lowest level since 1986 and that it stands about 20 percent below its average over the 20-year period since then. By comparison, when there was coordinated intervention to boost the euro in late 2000, the real effective euro was 19 percent below its 20-year average.[15]

- In China, priority should be given to further eliminating distortions favoring exporting sectors and gearing macroeconomic policy toward promoting domestic demand. Given the substantial real appreciation of the renminbi that is required, a step revaluation of the renminbi of, say, 10 percent in the near term would seem appropriate. This move should be followed by further appreciation, with the aim, over a horizon of perhaps three to four years, of

fully eliminating intervention designed to prevent appreciation of the renminbi.

- In Europe, policymakers should not resist appreciation of the euro vis-à-vis the dollar so long as it happens in the context of global adjustment and does not imply effective euro appreciation. Otherwise if the Asian currencies were to appreciate against the dollar, then the real effective exchange rate of the euro would depreciate. If Europe is not to run a current account surplus, then the euro will have to strengthen vis-à-vis the dollar.

- For the oil-exporting countries, evidence presented at the workshop by Brad Setser suggested that significant adjustment is in the pipeline, with domestic absorption rising at a gradual pace. Therefore, it is not clear that further actions on their part are called for (assuming that the oil price does not increase again), other than to maintain the expansion of domestic spending.

In conclusion, policymakers should not wait until financial markets force global adjustment. The heightened volatility in international financial markets recently underscores the risks of an abrupt market-led adjustment if they fail to act. It is unlikely that the policymakers of each country will resolve independently to take actions that add up to a coherent package. There needs to be an international effort to persuade each country to contribute its fair share to a whole capable of bringing about adjustment without interrupting world growth. In principle, the IMF's multilateral surveillance exercise provides an ideal context for organizing such an international effort. The forthcoming spring meetings of the IMF will provide a crucial opportunity to assess progress made so far and move in earnest toward reaching agreement on an adjustment package along the lines sketched in this brief.

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15. Pre-1999 calculation uses the value of a synthetic euro based on the value of its legacy currencies.