

Reducing Risks From Global Imbalances



A Statement by the Research and
Policy Committee of the Committee
for Economic Development



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Research Associate

MATTHEW SCHURIN

Committee for Economic Development



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All CED policy recommendations must have the approval of trustees on the Research and Policy Committee. This committee is directed under the bylaws, which emphasize that "all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group." The committee is aided by a Research Advisory Board of leading social scientists and by a small permanent professional staff.

The Research and Policy Committee does not attempt to pass judgment on any pending specific legislative

proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study.

The full Research and Policy Committee participates in the drafting of recommendations. Likewise, the trustees on the drafting subcommittee vote to approve or disapprove a policy statement, and they share with the Research and Policy Committee the privilege of submitting individual comments for publication.

The recommendations presented herein are those of the trustee members of the Research and Policy Committee and the responsible subcommittee. They are not necessarily endorsed by other trustees or by non-trustee subcommittee members, advisors, contributors, staff members, or others associated with CED.

Purpose of This Statement

For more than a decade, both economists and observers of the financial markets have become increasingly concerned at the growing and persistent trade imbalances in the world economy. In something of a reversal of its prior role, the United States, the world's richest nation, has become an international borrower, running large trade deficits and accumulating a substantial net negative international asset balance. The U.S. trade deficits have reached rates that analysts in the past might have characterized as unsustainable.

Many factors play a role in the growth and continuation of these imbalances, but none of those factors is clearly the sole or even the primary cause, or subject to easy remedy. Furthermore, the potential ill effects of persistent imbalances – protectionism, transfers from future generations of Americans to today's generation, and financial instability – are all troubling.

The concerned members of this CED subcommittee – the business, academic, and policy leaders listed on page viii – began meeting in the fall of 2006 to consider these global financial imbalances. They debated the sustainability of large and continuing U.S. current account deficits, and the root causes and long-term economic consequences of today's global financial imbalances. There was a real concern among the group that the public debate might devolve to counterproductive policies, including protectionist steps, to address this issue. Although many CED Trustees believed that the imbalances could be smoothly resolved through market forces alone, there emerged a consensus that it would be wise to “buy insurance” by adopting policies that would reduce the risks of a disorderly adjustment. In the tradition of CED, the subcommittee recommends a set of practical, actionable policy steps for all major contributors to the imbalances – steps that each nation

should want to take in its own interest and that often serve other important economic objectives. The recommendations also include ideas for an international process to facilitate such cooperative adjustment.

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Reducing Risks from Global Imbalances

Executive Summary

In *Reducing Risks from Global Imbalances*, CED traces the evolution of the current large global trade and financial imbalances, examines their sources, and makes recommendations that, if adopted, will help ensure continued growth in the global economy.

Findings

- ✦ Since 1991 the global economy has become increasingly “imbalanced,” as the trade deficit in the United States and trade surpluses in many foreign countries have grown rapidly. In 2005 and 2006 the U.S. current account deficit (which includes international investment income flows and transfer payments as well as trade in goods and services) reached an unprecedented 6.1 percent of GDP.
- ✦ The counterpart of these U.S. deficits has been large current account surpluses in the oil-exporting countries, Japan, China, and certain other Asian and European economies, which have accumulated extremely large private and public holdings of dollar assets. As a consequence, U.S. net international debt rose to 16 percent of GDP in 2006.
- ✦ These global imbalances have resulted from several factors, including declining saving in the United States and high saving in the surplus countries; an increase in the demand for dollar assets due to globalization; the recent rise in energy prices; relatively rapid economic growth in the United States; and exchange rate intervention by China and other countries pursuing export-led growth.
- ✦ Market-driven changes in exchange rates and the structure of global demand are likely eventually to produce an orderly adjustment of these global imbalances if there are no shocks to the system. Such an adjustment process appears already to have begun. However, the process is likely to be slow, and the continuation of large imbalances poses several risks:
 - Protectionist pressures are mounting in the United States in reaction to the trade deficit and, in particular, the large bilateral deficit with China.
 - The continuing growth of net debt implies additional transfers from younger or future generations of Americans to adults living today, which CED believes to be unwise and inequitable.
 - If investors and governments lose confidence in the ability of the United States to finance continuing deficits at acceptable rates of return, a sharp drop in the dollar resulting in financial and economic disruption is possible.

Recommendations

- ✦ As a general matter, all economies should contribute to global adjustment, which will require both changes in relative prices (exchange rates) and a rebalancing of global demand. A multilateral cooperative approach to adjustment is most likely to be successful in securing these global adjustments in demand and exchange rates and the political “buy-in” needed to implement them.
- ✦ The United States, as the preeminent deficit country, must avoid a protectionist response. Instead, it should increase national saving by eliminating the “on-budget” fiscal deficit within five years. This fiscal consolidation will require comprehensive expenditure reductions as well as increased revenues, which might best be pursued through CED’s recommended tax reforms or energy taxes. Private

saving also should be increased through tax reform and targeted saving initiatives such as the adoption of “automatic” 401(k) plans by employers.

- ✦ Europe should pursue policies that continue to strengthen domestic demand, including structural reforms of product and labor market policies and supportive monetary policy. Authorities should refrain from intervention to prevent further appreciation of the euro against the dollar.
- ✦ Japan also should pursue structural reforms and a careful balancing of fiscal and monetary normalization that will support growth. Japan should continue to refrain from intervention or public statements that impede the yen appreciation that is needed for global adjustment.
- ✦ China should expand public consumption in health care, education, public pensions, and other programs. Financial reforms to improve the intermediation of private saving would raise private consumption and improve the efficiency of private investment. There should be a significant near-term appreciation of the renminbi against the dollar, in the range of perhaps 10 percent, with future appreciation in the range of 5-7 percent annually for several years. In the longer term, China

should continue to gradually liberalize its capital account and eventually move to a largely market-determined exchange rate.

- ✦ The petroleum exporters should continue to increase public and private investment programs to raise domestic demand. Gulf Cooperation Council countries should consider following Kuwait’s example in moving from a rigid dollar peg to a more diversified currency basket.
- ✦ Smaller surplus countries also have a role to play. Some have accumulated very large exchange reserves, and in the aggregate they can make a significant contribution to adjustment. They should resist the temptation to be “free riders” as larger countries adjust. Instead, they should allow exchange rate adjustment and expand domestic demand as their individual circumstances permit.
- ✦ The International Monetary Fund (IMF) can and should be more proactive in catalyzing governments to consult on and implement adjustment policies. The multilateral consultations organized by the IMF in 2006-2007 should be institutionalized in an international consultative group to be organized as circumstances require.



I. Introduction

The U.S. trade and current account deficits, after rising since 1991 to levels previously thought unsustainable, may have stabilized in late 2006 and early 2007. It is too early to say whether they will now fall significantly. Certainly, some important features of international economic adjustment have emerged that might facilitate a drop in the U.S. current account deficit and in its counterparts, the large current account surpluses in other countries: The dollar has fallen against the euro and some other currencies since early 2002; economic growth has slowed in the United States and strengthened in Europe and Japan; China, India and other Asian economies are booming; oil prices have stabilized, and the oil exporters are beginning to work off their large petro-surpluses with major import-increasing investment projects.

Should we therefore conclude that an orderly market-driven unwinding of these imbalances is inevitable, and that “benign neglect” is the appropriate policy? We believe not, after analyzing the sources of the imbalances and the risks they pose for the U.S. and global economies. After examining the process of adjustment, we acknowledge that market forces acting on global demand and exchange rates may well prove sufficient for smooth and orderly adjustment. But we also find substantial risks for both the United States and other countries.

One risk arises because not all the conditions for market adjustment are in place. No significant policy changes have yet been enacted to reduce the U.S. fiscal deficit, which we believe is an important source of the U.S. external imbalance. This poses an inflationary danger, and a problem for monetary policy, if the dollar continues to fall. Similarly, although the euro has appreciated, market exchange rate adjustment has been impeded in China and some other Asian economies, where current account deficits and reserve holdings from currency intervention continue to rise sharply.

The possibly protracted timeline of market adjustment poses another risk. Forces for both trade and financial protectionism are growing, under the political pressures of continuing large bilateral deficits with China; this danger affects other advanced countries as well as the United States. Furthermore, as the U.S. external debt grows, resources continue to be “borrowed” from future generations to benefit today’s consumers – which we believe to be fiscally imprudent. A protracted period of adjustment, with continued large external deficits and rising external debt, also raises the danger that some shock to the system, or myopic investor expectations, will precipitate a break in confidence that could produce disorderly exchange rate changes and possibly economic disruption affecting both the United States and other countries.

For these reasons, even if an orderly market-driven adjustment may be the most likely outcome, we believe the prudent course of action is to hedge against such risks by “buying some insurance” in the form of precautionary policies to prepare for and facilitate adjustment. It is strongly in the self-interest of the United States, as well as other countries, to do so. While policy actions need to be taken by the United States and other countries as well, it is essential that the United States exercise strong leadership in both the domestic and international dimensions of policy. Domestically, the United States must take long overdue action to reduce the federal budget deficit – first, as a matter of simple self-interest; second, as part of a multilateral effort to facilitate international adjustment; and finally, because the credibility of U.S. international leadership requires that it first put its own fiscal house in order. Internationally, the United States must lead simply because no major multilateral efforts can succeed without the United States, and (as we argue in this statement) the chances of success are much higher if governments work together rather than separately.

The policy statement concludes with recommendations for actions – by the United States and other systemically important countries, such as China, Japan, and the Euro Area – that would be most helpful in facilitating adjustment. The proposed actions would help rebalance global demand and make exchange rates more responsive to market forces. These are generally actions that these countries should take in their own self-interest, but that in some cases may be more palatable in a multilateral framework. We also offer suggestions for extending into an ongoing process the multilateral consultations on adjustment that were convened and catalyzed by the International Monetary Fund (IMF) in 2006-2007.

Finally, we emphasize that these recommendations are not offered as rigid, hard-wired actions to be implemented in exquisitely coordinated simultaneity by many countries as a comprehensive program. That would be quite unrealistic – technically, economically,

and politically. Our recommendations should rather be seen as directional objectives, likely to be implemented over a period of several years, with some participants more constrained than others by domestic considerations in their policy contributions. But we nevertheless believe that such an ongoing process would improve on current arrangements by making it clear that adjustment is a collective enterprise, and by effectively rewarding governments that are seen to participate in the program and contribute to international stability. Such a multilateral process will not replace bilateral discussions and negotiations of policy differences, which may be necessary for both substantive and political reasons. But it may reduce some of the political difficulties and tensions characteristic of bilateral negotiations, and the associated accusations, pleas, threats, and denials that often surround disagreements between countries on economic policies.

II. "International Imbalances" and Their Recent Rapid Growth

What Are "International Imbalances?"

The term "international imbalances" most commonly refers to the difference between the historically large U.S. international trade deficit (more precisely, the *current account* deficit, which includes payments for international investment income and transfer payments as well as trade in goods and services), and the correspondingly large trade and current account surpluses of many of this nation's trading partners. (Globally, of course, the sum of all trade (and current account) balances must net to zero, absent measurement errors, which can be substantial.¹) Figure 1 shows the large growth in major current account imbalances since 1990.

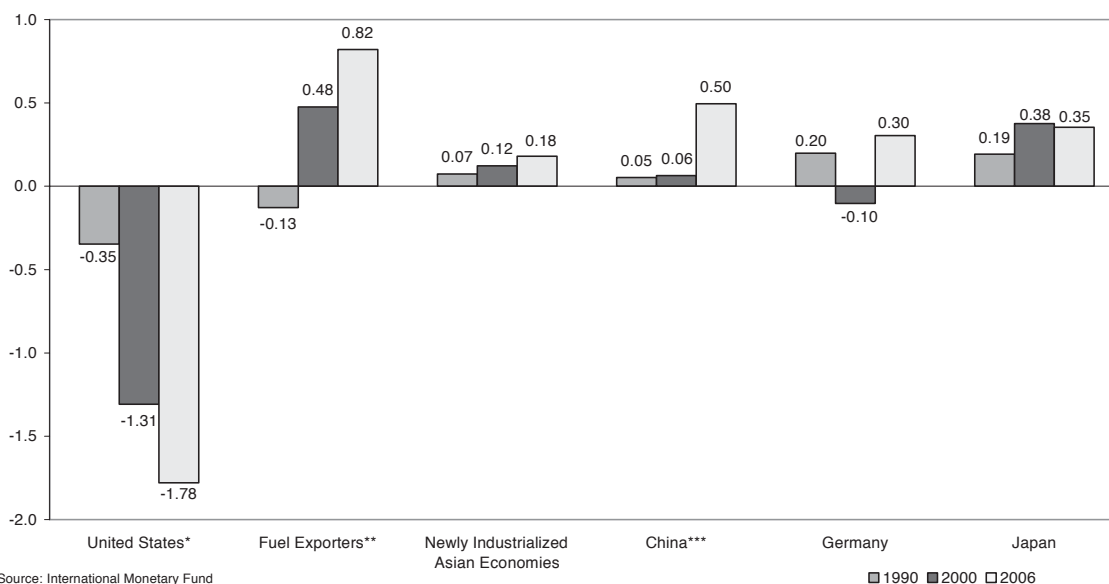
The U.S. trade deficit effectively represents the difference between the total expenditures on and production of goods and services, a difference that (net of

international income and transfer payments) must be financed by selling assets abroad. Such sales and purchases of assets over time change the *net international investment* ("balance sheet") positions of both debtors and creditors. Persistent, large current account deficits and surpluses tend to produce large differences between countries in these net investment positions, and the term "international imbalances" is also sometimes used to refer to these balance sheet differences and the composition of assets and liabilities that underlie them.

Why Should We Care About International Imbalances?

The term "imbalances" may carry a negative connotation, because it seems to imply that "balance" should be restored among national trade and current accounts and creditor/debtor positions. In general,

Figure 1. Current Account Balances of Selected Countries and Regions (Surplus (+) or Deficit (-), Percent of World GDP)



this is not the case, and this policy statement uses the term in a descriptive rather than this normative sense. Historically, trade imbalances have been the mechanism by which creditor countries have lent resources to borrowing countries. This is generally appropriate and desirable, since the returns to capital are presumably higher in the borrowing countries, so that both borrowers and lenders benefit. The United States ran trade and current account deficits for many years when it borrowed the capital from Europe to finance its early development, and many other developing economies have borrowed in similar fashion.² As the global economy grows, such resource transfers, and indeed capital movements in general, increase the efficiency of resource use worldwide and raise global living standards.

In fact, the recent unprecedented growth in international imbalances has proven very attractive for both the major lenders and borrowers involved. The imbalances have allowed traditional export-oriented economies, such as Japan and Germany, joined recently by China and others, to have very large export surpluses to stimulate growth and employment. At the same time, they have permitted capital importers – preeminently the United States – to continually spend more than they produce, borrowing the additional goods and services from abroad. It has been a mutually beneficial, even “co-dependent” arrangement. As former Federal Reserve Chairman Paul Volcker has said with reference to financing the large U.S. borrowing, “There is no sense of strain. It’s all quite comfortable for us.”³ Not surprisingly, there consequently has been little desire by either individuals or governments to take actions to reduce the imbalances, especially since doing so (as we note below) would sometimes entail painful economic adjustments.⁴

We argue in this policy statement that these imbalances have now become so large that they begin to pose risks to the economic stability and growth of the United States and other countries. Therefore, the process of adjustment should be facilitated by changes

in policy that reduce these risks. As discussed in more detail below, the large imbalances create at least three principal risks:

- *Protectionism.* We fear that continuing large trade deficits, and in particular the very large U.S. bilateral deficit with China, may aid the efforts of domestic industries in seeking government protection from import competition. This could halt, or even reverse, the progress towards the more free and open international markets that have benefited United States and the postwar world.
- *Financial or Economic Instability.* The continued rapid accumulation of foreign private and public holdings of dollar assets could lead to a collapse of confidence in the dollar if this accumulation were suddenly perceived to be unsustainable. As noted below, various shocks to the system might produce such a change in expectations about the value of the dollar. A sharp fall in the demand for dollar assets could disrupt financial markets and possibly affect output and employment in the United States or elsewhere.
- *Borrowing From the Future.* The rise in U.S. net international debt has principally financed an increase in consumption, which effectively will be paid for by future generations of Americans who will have to service that debt. We believe this is inequitable and problematic because of the likely costs associated with an older population, including higher health care costs, and the costs of dealing with climate change and other environmental problems.

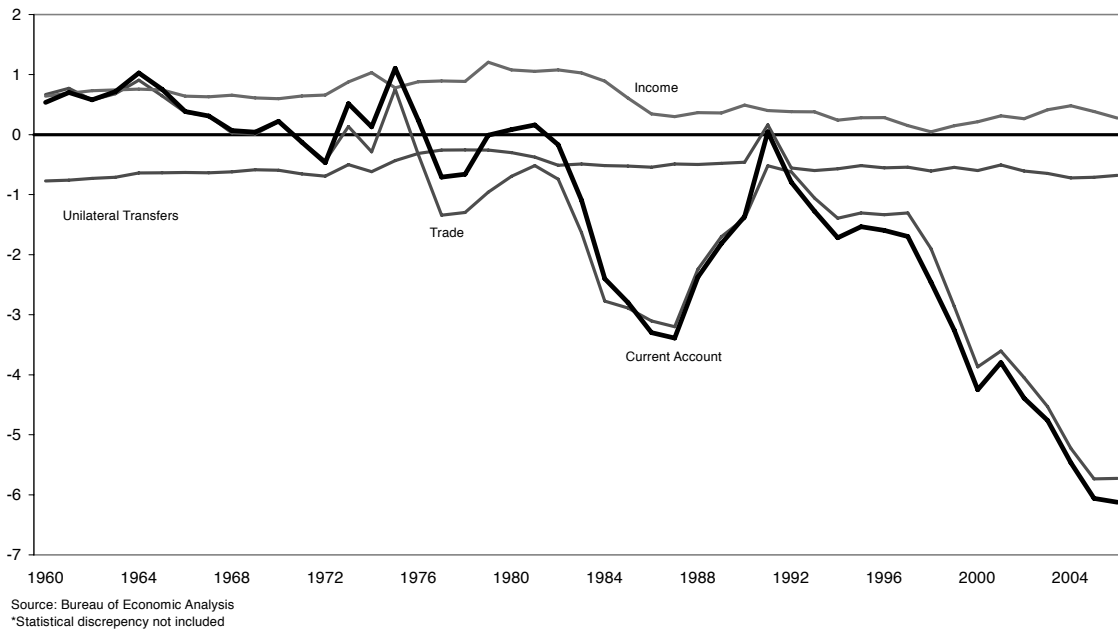
Recent Trends in International Imbalances

The U.S. Current Account

Figure 2 shows the U.S. current account balance from 1960-2006, as well as its components: the trade, income, and current transfer accounts.ⁱ In the 1950s and 1960s, the dollar was fixed to gold, which the United

ⁱ The deficit on unilateral transfers, which has generally run about 0.5-0.8 percent of GDP, consists primarily of private remittances and transfers and government grants. Private remittances have become increasingly important as a result of continued immigration and the rise of the foreign-born proportion of the U.S. population.

Figure 2. U.S. Balances on Current Account, Trade, Income, and Unilateral Current Transfers, 1960-2006*
(Surplus (+) or Deficit (-), Percent of GDP)



States held as reserves; and most currencies were fixed in relation to the dollar, although these rates were occasionally changed if believed to be in “fundamental disequilibrium.” The U.S. trade and current account balances were consistently positive, and a large surplus on income reflected the U.S. position as the world’s major creditor nation. However, in the late 1960s, the U.S. trade surplus fell towards zero as trade competition from Japan and Europe increased. As foreign dollar claims increased, the capacity of the United States to cover those claims with a roughly fixed supply of gold reserves came into question, and in 1971-1973 the fixed rate system broke down. It was replaced with the current system of floating rates among major currencies, with minor currencies sometimes floating but often fixed or closely managed in relation to a major currency, most commonly the dollar.

The trade and current accounts moved briefly into surplus in 1975 with the devaluation of the dollar and a severe recession in 1974-1975. This was followed, however, by a very sharp deterioration of the trade and current accounts in the mid-1980s, as the U.S. macroeconomic policy mix of large fiscal deficits and

severe anti-inflationary monetary restraint produced a large drop in national saving and a sharp appreciation of the dollar. However, a relative stabilization of the fiscal position, the easing of monetary policy, and an internationally coordinated intervention combined to bring the dollar back down in 1985 and swing the trade and current accounts back towards balance. (Indeed, the large transfers to the United States from allies to finance the Gulf War brought the current account into surplus temporarily in 1991.)

Since 1991, as Figure 2 shows, the U.S. current account and trade balances have been in virtually unremitting decline, the former reaching about 6.1 percent of GDP in 2005 and 2006. Current account deficits of this size are nearly twice the earlier record of 3.4 percent of GDP reached in 1987, and far above the levels once thought to be “sustainable” in the near term in the conventional economic wisdom.⁵ It is striking that the current account deficit has now grown to about half of goods and services exports.

The fall in the trade balance, as Figure 2 shows, has accounted for the entire decline in the current account balance. This decline in the trade balance, apart from

the recent impact of higher oil prices, has been due primarily to a slowdown in export growth, especially after 1994, rather than (as commonly believed) a flood of imports from China or elsewhere. U.S. non-petroleum imports grew at about 8 percent per year both during 1984-1994 and from 1994-2006. Non-petroleum exports, on the other hand, grew at 9.2 percent per year during 1984-1994, but at only 6.1 percent during 1994-2006. This slowdown in export growth was very broadly based and not confined to particular products or importing countries. The reason for the slowdown is something of a puzzle, but it appears to be related to a continuing appreciation of the dollar and perhaps an increased sensitivity of exports to relative prices as the pace of globalization accelerated in the last decade.⁶

The net sales of U.S. assets abroad to finance these trade and current account deficits resulted in a decline in the (negative) U.S. net investment position, which in turn gave rise to a smaller surplus on investment income. The possible explanations of this unprecedented decline and its implications are discussed below, where we also examine the modest improvement in the trade balance in 2006-2007 and the apparent stabilization and possible improvement in the current account balance.

Current Accounts Abroad

The U.S. current account deficit and associated net capital imports have their counterparts, of course, in net current account surpluses and capital exports in the rest of the world. Figures 3 and 4 show the estimated national composition of global current account deficits and surpluses in 2006, and the recent evolution of the current account surpluses of the major surplus countries or groups of countries juxtaposed against the growing U.S. deficit.

As shown in Figure 3, the United States in 2006 accounted for an extraordinary 60.5 percent of the world's net capital imports. Seven relatively advanced economies each accounted for some 2-8 percent (and in the aggregate about one-fourth) of the total, and

all other countries together for less than 15 percent. Capital exports are less concentrated by country, but a small group of surplus countries – China, Japan, Germany, and the oil and gas exporters – nevertheless account for about two-thirds of global capital exports.ⁱⁱ As Figure 4 indicates, Japan has run chronic current account surpluses for many years – the last recorded deficit was in 1980 – and effectively has provided the counterpart to the U.S. deficits. However, as the U.S. deficit has grown in recent years, large surpluses have also emerged in Germany (which also ran surpluses in the late 1980s), China, the newly industrialized Asian economies, and especially, with the recent rise in energy prices, the oil and gas exporters in the Middle East, Russia, and elsewhere. As seen in Figure 1, these recently burgeoning surpluses, along with that of Japan, now total roughly 2.15 percent of world GDP, fully accounting for the equivalent U.S. current account deficit of about 1.8 percent.

While a larger number of developing countries import rather than export capital, a striking recent development in the global pattern of capital flows is the shift of many newly industrialized and emerging market economies from their traditional role as importers of capital to that of capital exporters, usually with large current account surpluses. China, whose current account surplus has grown over the last decade from less than \$10 billion to about \$238.5 billion, or 9 percent of GDP in 2006, is the most striking example; but large current account surpluses have also characterized Hong Kong, Malaysia, Taiwan, and Singapore during recent years, and other countries have seen their current account deficits fall. Conversely, not only the United States, but also the United Kingdom and some major European countries such as France, Italy, and Spain, now import more capital than they export.⁷

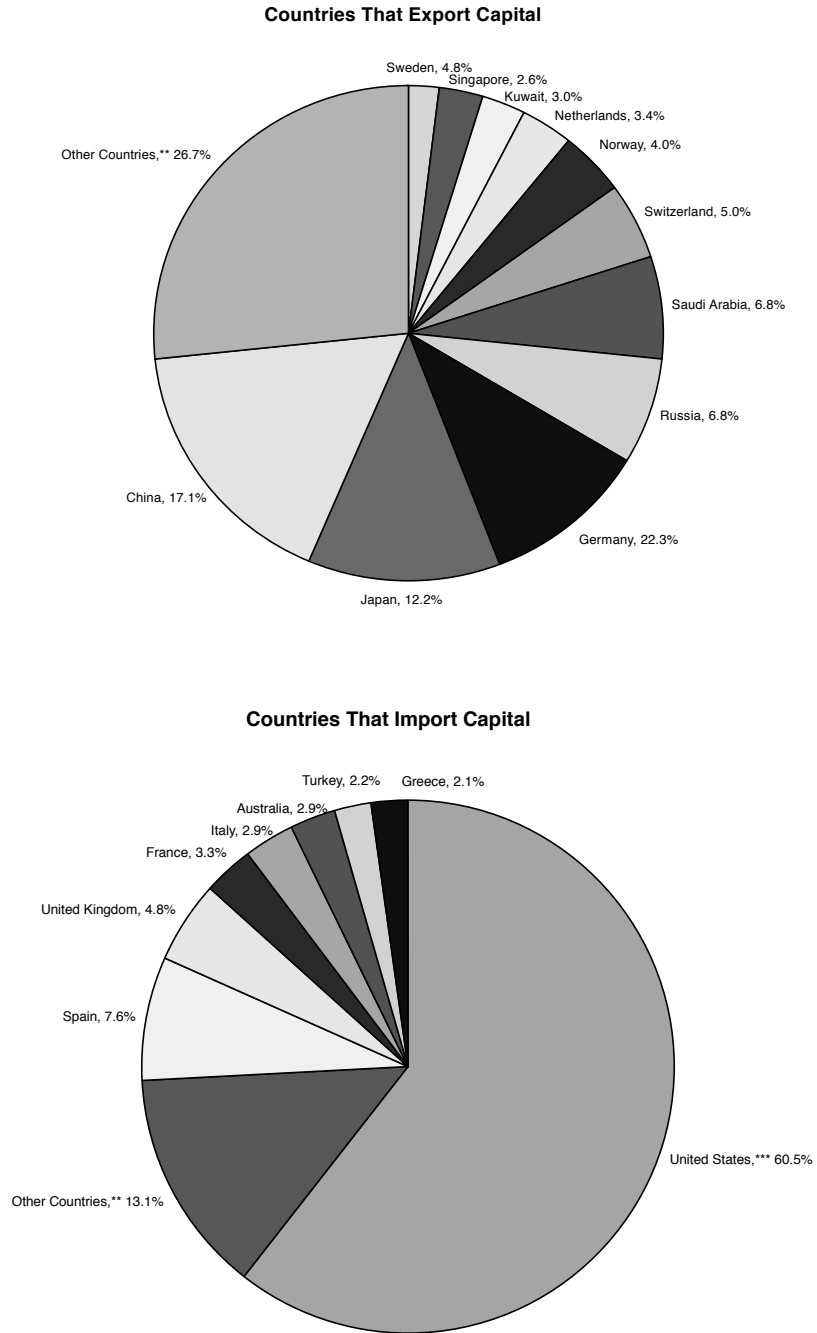
The U.S. Capital Accountⁱⁱⁱ

The large expansion of international trade in goods and services in the last several decades has been accompanied by an even more rapid and dramatic growth of

ⁱⁱ While Germany and the Benelux countries have recently run large surpluses, the euro area as a whole ran a small current account deficit in 2006, with Spain and Portugal having large deficits. Because of the single currency, a common monetary policy, and constraints on national fiscal policies introduced by the Stability and Growth Pact, individual euro-area countries are circumscribed in the policies available to address external imbalances, as we discuss below.

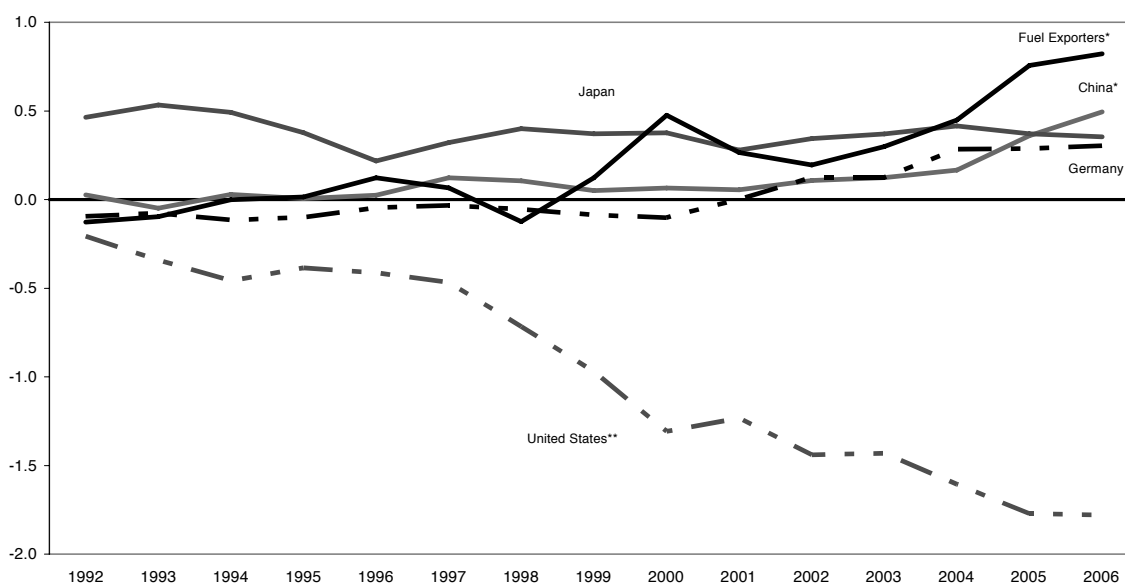
ⁱⁱⁱ In accordance with common usage, we use the traditional "capital account" to refer to what BEA now terms the "financial account." The new "capital account" refers to the accounting of a set of relatively insignificant capital transfer items.

Figure 3. Major Net Exporters and Importers of Capital in 2006*



Source: International Monetary Fund, updated version of figure 1 in the appendix of the April, 2007 IMF Global Financial Stability Report
 *The amount of capital that a country exports (imports) is equal to its current account surplus (deficit) in U.S. dollars
 **Other Countries* are those with a share of the global surplus or deficit of less than 2 percent
 ***Observation does not reflect June 2006 current account revisions

Figure 4. Current Account Balances of Selected Countries and Regions, 1992-2006
(Surplus (+) or Deficit (-), Percent of World GDP)



Source: International Monetary Fund
*2006 is an IMF projection
**Data do not reflect June 2006 current account revisions

cross-border trade in assets.⁸ Global economic growth, the reduction of national barriers, large declines in the costs of transactions and communications, and innovation have facilitated international specialization in the trade of physical and financial assets just as they have in trade of goods and services. This capital mobility appears to have been enhanced by a reduction in the “home bias” which links national investment to saving, prompting the international diversification of investment portfolios.⁹ Increased capital mobility has not come without costs, such as the financial instability and economic hardship experienced in the Asian crisis of the late 1990s. And foreign investments are sometimes undertaken to avoid tariffs, taxes, or regulations, thereby raising private, but not necessarily social, returns. Nevertheless, we believe that cross-border investments have generally benefited society, as capital sought its highest returns, resources were transferred from lenders to borrowers, assisted by financial intermediation, and portfolio diversification spread and reduced risk.

Figure 5 shows the increases (relative to GDP) in U.S. capital outflows (net asset purchases, which are virtually all private) and inflows (net asset sales) since 1982,

with the latter divided between official and private inflows.¹⁰ The increase was especially large after 1991, albeit interrupted by the 1998 Asian crisis, the end of the dot-com bubble, and the subsequent brief recession in 2001. Both inflows and outflows of private capital have been large and rapidly growing, reflecting the globalization of asset trade discussed above. As Figure 5 indicates, net private capital inflows, at least as officially recorded, financed most of the growing current account deficit until about 2002; but since 2003, recorded official purchases of dollar assets have increased substantially. In addition, a proportion of the massive asset accumulations of the monetary authorities and sovereign wealth funds of the oil exporters shows up as private capital inflows into the United States after intermediation directly by private agents or indirectly by the capital markets in third countries.

The U.S. Net International Investment Position (NIIP)

As a result of this rapid growth in capital flows, the stock of both assets and liabilities rose rapidly in relation to GDP, as shown in Figure 6, which reflects both these capital flows and changes in asset valuations. The

Figure 5. U.S. Gross Capital Outflows and Private and Official Inflows, 1982-2006
(Inflows (+) and Outflows (-), Current Account Deficit (+), Percent of GDP)

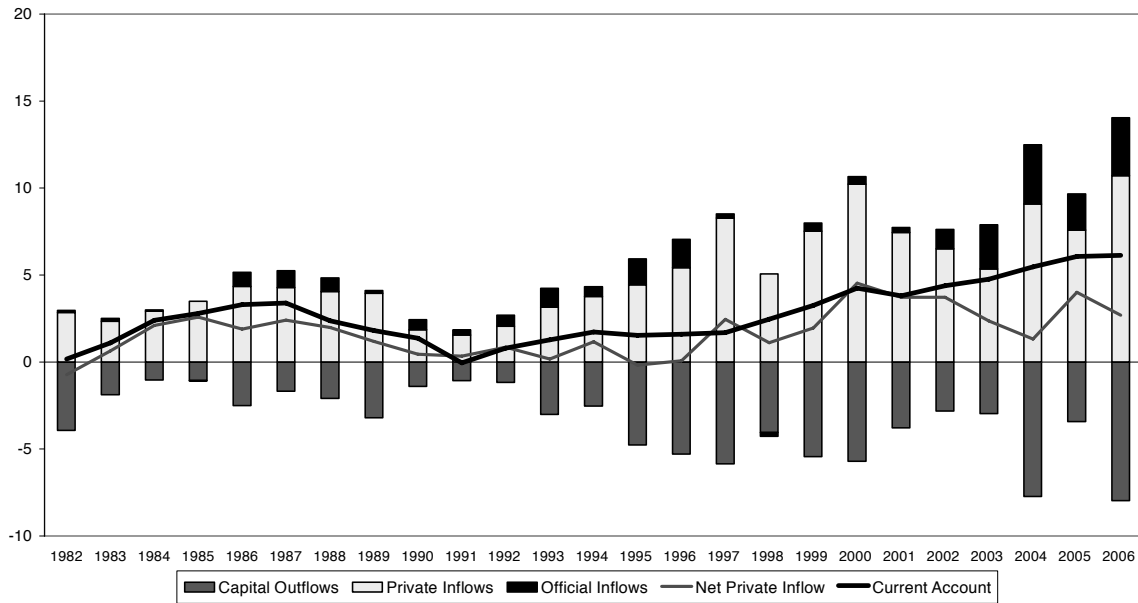
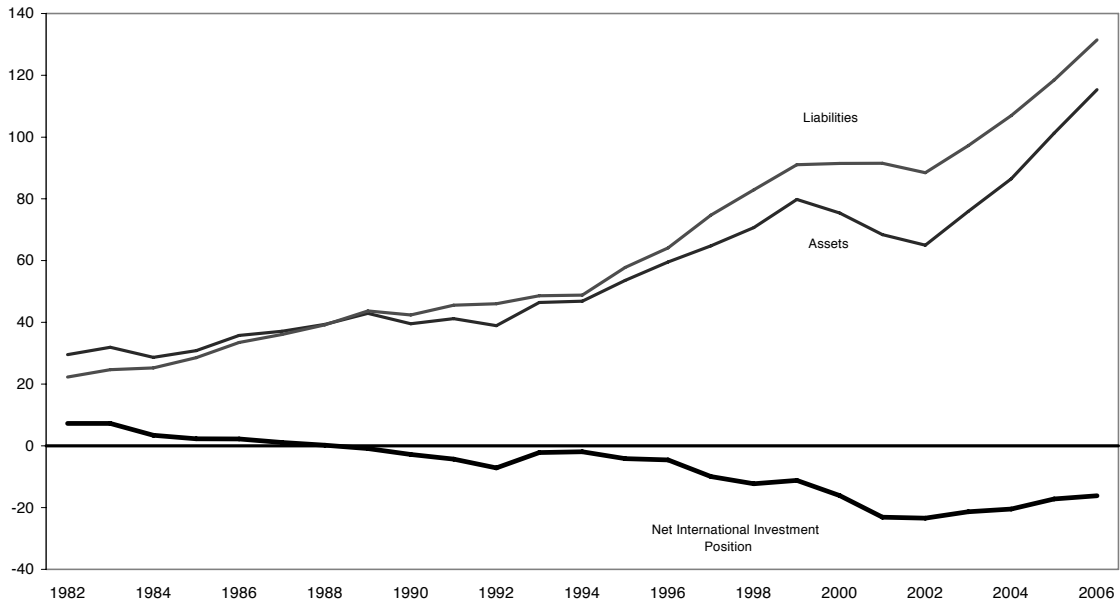


Figure 6. U.S. Assets, Liabilities, and Net International Investment Position, 1982-2006*
(Assets (+) and Liabilities (-), Percent of GDP)



difference between these gross asset and liability positions is the U.S. net international investment position (NIIP). Because the U.S. current account deficit has as a counterpart a corresponding net sale of assets, the NIIP in principle must equal the cumulative total of its current account deficits adjusted for valuation changes. (In practice, the recorded assets and liabilities are subject to significant measurement errors.) As Figure 6 shows, the persistent U.S. current account deficits since the early 1980s have produced a substantial decline in the NIIP, which declined from a creditor position of \$236 billion (+7.2 percent of GDP) in 1982 to a debtor position of \$-2.140 trillion (-16.0 percent of GDP) in 2006.

Although U.S. net external debt has increased greatly since 1980, its rise has been greatly moderated because the total returns to the United States on its assets held abroad have been systematically larger than the total returns paid to foreigners on U.S. liabilities.¹¹ Two factors account for this:

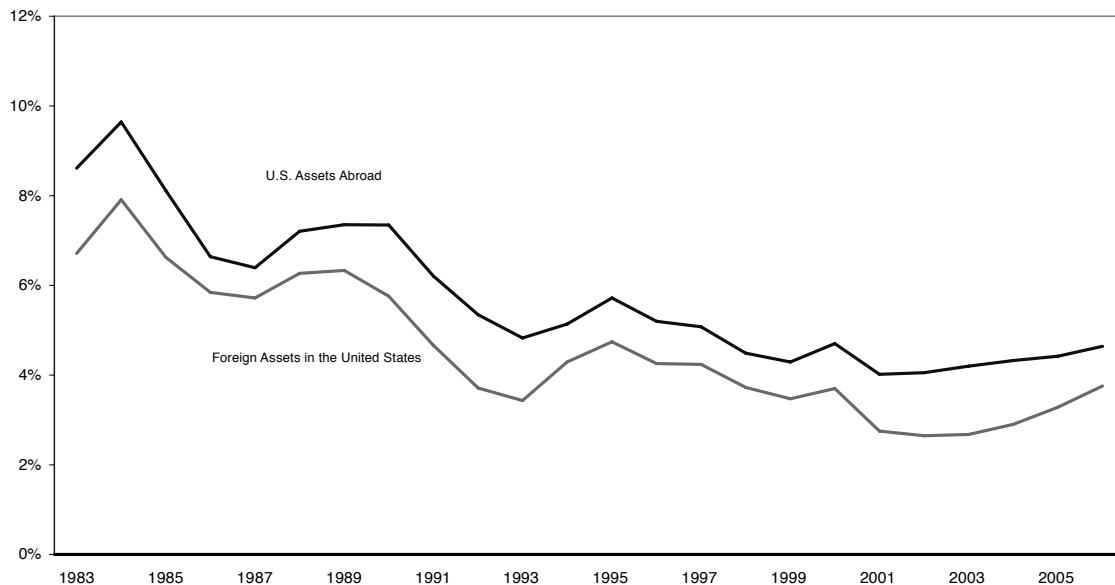
1. The *income* on U.S. assets held abroad consistently has exceeded that on its foreign liabilities. This is partly because a larger proportion of assets than liabilities has been in portfolio and direct

investment equities that produced higher earnings than fixed-income securities. However, the income returns have also tended to be larger on U.S. assets than liabilities within asset classes, and consistently so for foreign direct investment (FDI).¹² Figure 7 shows the persistent differential between income on all U.S. assets and liabilities, which averaged 1.2 percentage points during 1983-2006; Figure 8 shows this differential for FDI only.

2. *Valuation changes* have substantially raised the value of U.S. assets relative to liabilities. These “capital gains” (broadly defined) resulted from price changes (which again principally benefited equity investments), exchange rate changes (whereby the depreciation of the dollar increases the dollar value of U.S.-owned assets abroad), and a broad set of “other changes” in valuation.¹³

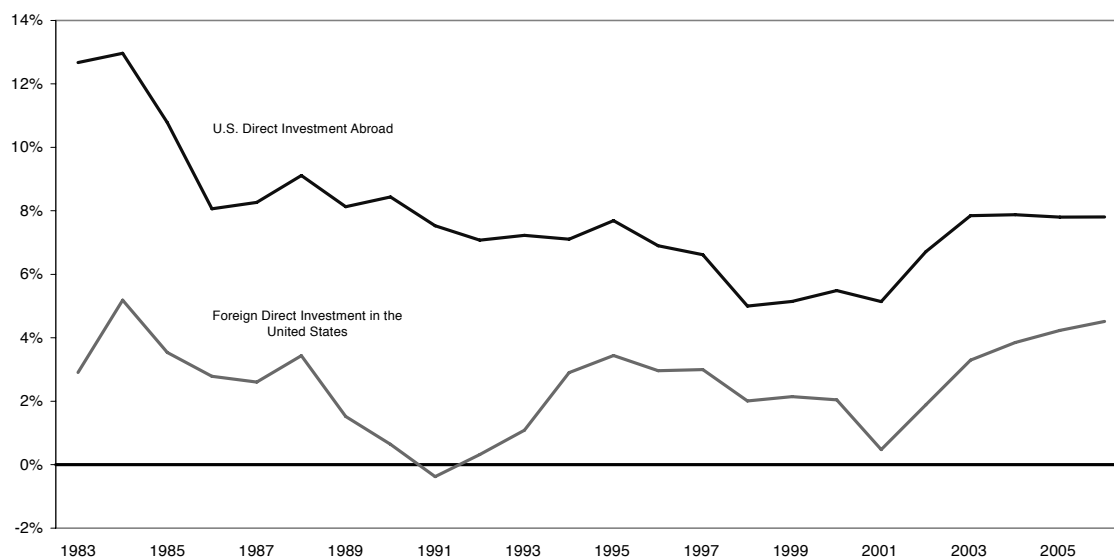
As a result of this difference in total returns, the large shift of the United States from net creditor to net debtor status was much smaller than might have been expected from the cumulative effect of the deficits on trade and transfers. Thus, while the deficit on trade and transfers during 1983-2006 totaled \$6.6 trillion, the decline in the NIIP was only \$2.4 trillion. Of the

Figure 7. Rates of Return on U.S. Assets Abroad and Foreign Assets in the United States, 1983-2006*



Source: Bureau of Economic Analysis
 *Direct investment at market value. Rates of return are equal to the income receipts (payments) on U.S.-owned assets abroad (foreign-owned assets in the United States) divided by the average of beginning-of-year and end-of-year values for total assets

Figure 8. Rates of Return on U.S. Direct Investment Abroad and Foreign Direct Investment in the United States, 1983-2006*



Source: Bureau of Economic Analysis
 *Direct investment at market value. Rates of return are equal to direct investment receipts (payments) divided by the average of beginning-of-year and end-of-year values for direct investment abroad (in the United States)

\$4.2 trillion difference, the favorable income differential accounted for \$0.6 trillion, while valuation changes accounted for a full \$3.6 trillion. These differential returns that attenuate the decline of the U.S. NIIP help to increase the sustainability of large U.S. current account deficits, which we examine below.

U.S. Liabilities, International Portfolios, and International Reserves

As U.S. international indebtedness has increased, of course, the asset holdings and net investment positions of countries with current account surpluses have tended to increase. As we shall see below, two issues that are of considerable importance in examining the sustainability of international imbalances are the role of the dollar in international portfolios and the position of official international dollar reserves in the international liabilities of the United States. The integration of capital markets has led to considerable portfolio diversification internationally. The United States, by virtue of both its size and the relative depth of its capital markets, is by far the largest producer of financial assets. A recent estimate suggests that U.S. liabilities comprise

roughly 40 percent of global gross holdings of foreign assets.¹⁴ As Figure 9 shows, from the perspective of U.S. international liabilities, this is reflected in the large absolute and relative increase in portfolio assets (U.S. Treasury securities and other bonds and corporate stocks), which increased from 16 percent to 36 percent of total liabilities during 1982-2006.

During the last decade, foreign official holdings of dollar reserves have consistently been less than 20 percent of total U.S. international liabilities – a smaller proportion than the 20-30 percent characteristic of the 1980s and early 1990s. However, the proportion has risen since 2000; and just as private dollar asset holdings have exploded in the past decade, U.S. official dollar liabilities have become very large. (See Figure 9.) Foreign exchange reserves are also held in a few other major currencies, and Figure 10 shows the dramatic growth in the recorded foreign exchange reserve holdings of selected large reserve holders over the last decade. Figure 10 also shows year-end 2006 reserves, which are very large by historical standards as percentages of annual imports of goods and services for these countries.

Figure 9. Composition of U.S. Gross Liabilities, 1982-2006
(\$ Trillions)

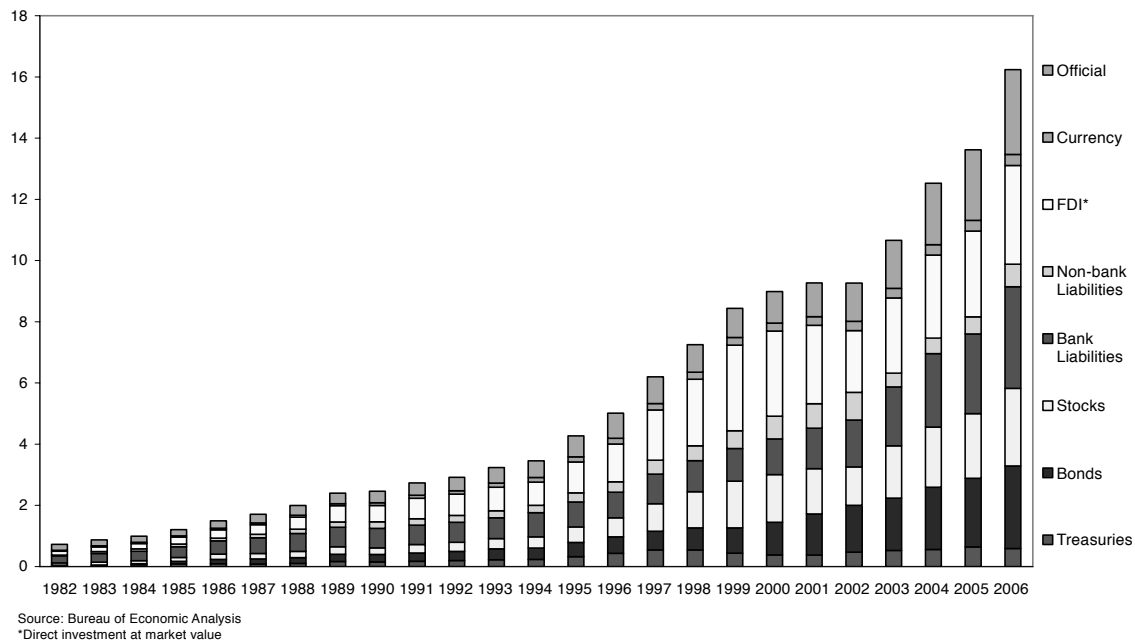
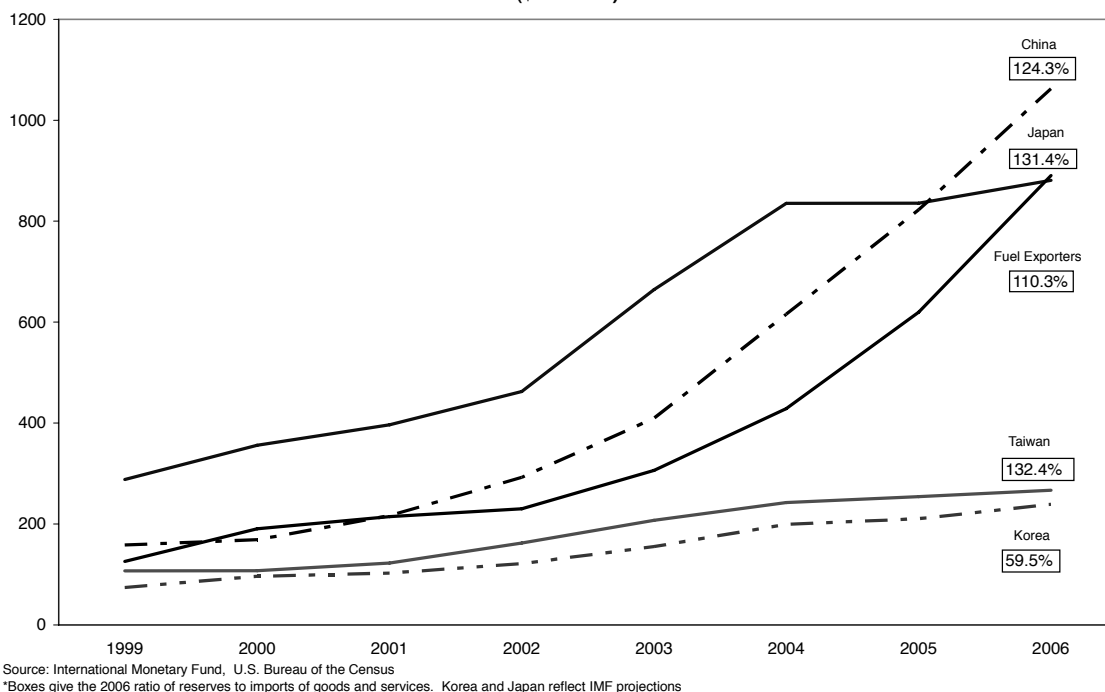


Figure 10. Selected Countries with Large Reserve Holdings, 1999-2006*
(\$ Billions)



III. The Sources of Large International Imbalances

The large international imbalances in trade and current accounts, and the associated capital movements, are the result of the interplay of myriad economic variables – such as incomes, prices, interest rates, and exchange rates – that affect economic behavior in the global economy. These variables are mutually and simultaneously determined, while changing through time. As a result, it is difficult to identify simple causal relationships that definitively locate the “sources” of the imbalances, and a number of different explanations have been offered to account for them. While these explanations are often presented as competitive, in fact they are not mutually exclusive and often complement one another. For instance, other things being equal, both a reduction in U.S. net saving and an increase in the desire of foreigners to hold dollar assets will tend to raise the value of the dollar, although through different mechanisms.

These explanations highlight different changes in the global economy that appear to us as quite plausible causal factors in the growth of the imbalances.¹⁵ Five such factors seem to be particularly important:

1. A global “mismatch” between the United States and certain major surplus countries in their desired saving and investment;
2. A strong demand for dollar assets in foreign private and official portfolios;
3. Until very recently, rapid economic growth (fueled by domestic demand) in the United States relative to growth in other advanced economies;
4. The recent increase in energy prices; and
5. Exchange rate intervention by a number of countries to prevent appreciation against the dollar and promote export growth.

The International “Mismatch” Between Desired Saving and Investment

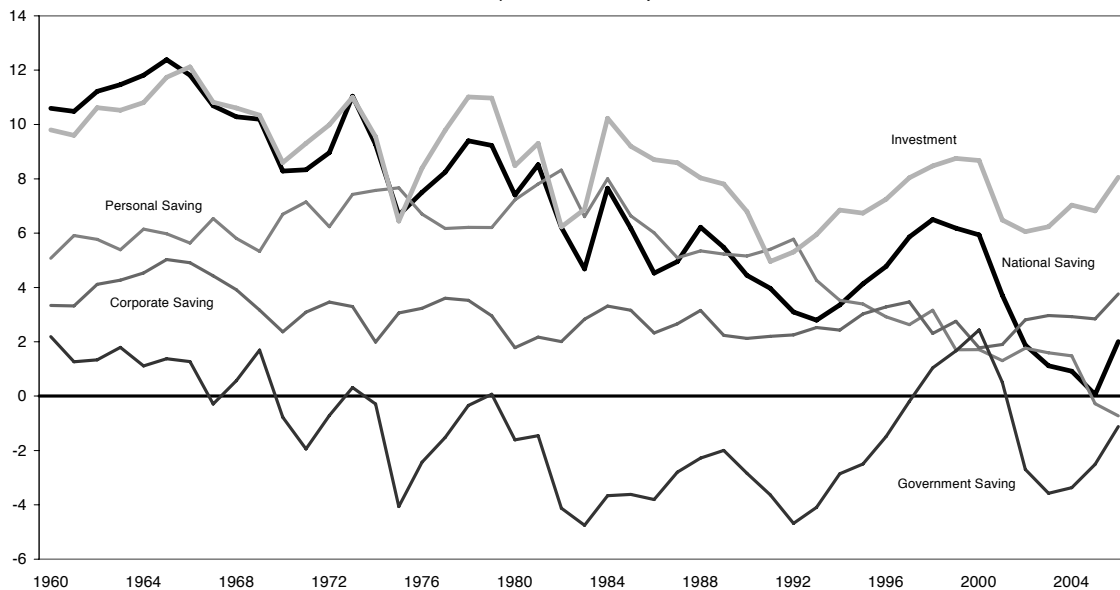
Any country’s current account balance must equal the difference between its national saving and investment, measured after the fact, as an arithmetic matter of national income accounting. In this tautological sense, all current account imbalances can be “accounted for” by corresponding saving-investment imbalances; *any* factor that changes the current account must also induce a corresponding change in saving and/or investment. The international economy is a “general equilibrium” system in which “everything affects everything else.” Nevertheless, there are fundamental factors such as the desire to save by households and national fiscal policies that directly affect trends in national saving and investment and contribute powerfully to these “mismatches.”

The Decline in U.S. Saving

As shown in Figure 11, U.S. net domestic saving has declined from over 10 percent of GDP in the 1960s to 0 to 2 percent in the last several years.^{iv} This drop in domestic saving was driven principally by a steady decline in personal saving (mitigated by strong corporate saving) and a rise in dissaving by the federal government, as the federal budget moved into chronic deficit, apart from a brief period of surpluses in 1998-2001. Personal consumption expenditures (as conventionally defined) have risen steadily from 63 percent of GDP in 1960 to 70 percent in 2006, with a corresponding decline in net personal saving from an average of 6 percent in the 1960s to its current negative value. This long-term downward trend of personal saving was compounded by the rapid increase in personal wealth associated first with the stock market boom of the late 1990s, and subsequently with the run-up in housing values. The recent end of the housing boom presumably will mitigate some of this most recent household saving decline, as households increase savings to offset

^{iv} Net, rather than gross, saving and investment is the appropriate concept in this context, because the foreign saving obtained from abroad supplements net domestic saving in financing net investment. The total domestic saving-investment balance is the same whether gross or net of depreciation.

Figure 11. U.S. Net Domestic Investment, and Net National, Corporate, Personal, and Government Saving, 1960-2006* (Percent of GDP)



Source: Bureau of Economic Analysis
*Statistical discrepancy not included

declining home values – unless a rising stock market offsets the loss of housing wealth.

Because net domestic investment has fluctuated within a range of about 6-12 percent of GDP, with a much milder downward trend, there has emerged a persistent long-term gap between U.S. domestic investment and saving – equivalent to the gap between domestic expenditures and production.^v This gap has been filled by importing resources from abroad, and selling assets to pay for them. To be sure, this evolution of the investment-saving gap has had several stages. Generally during the 1970s and 1980s, and more recently after 2001, the rise in the current account deficit was sometimes simplistically attributed to the large federal budget deficits that depressed national saving (the “twin deficits” view). However, during the 1990s boom, when investment was very strong, the current account deficit continued to grow in spite of federal budget surpluses and higher national saving. The *difference* between total investment and saving is the critical variable, but the longer-term trends in the United States certainly call attention to the importance of the fall in saving.¹⁶ In

some other advanced economies, such as Japan, saving rates have also fallen, but investment rates generally fell as much or more.

This shortfall in U.S. saving is thus an important part of the story of the emergence of large current account imbalances. However, this cannot be the whole story, because a growing gap between U.S. desired investment and saving, other things equal, would raise long-term interest rates. A remarkable feature of the last few years is that long-term interest rates have remained low. This strongly suggests a rising supply of desired saving (relative to investment) abroad.

The Emergence of Saving-Investment Gaps Abroad

A number of factors have contributed to the emergence of a large gap between saving and investment for some of the major exporters of capital. This gap has been famously called a “savings glut,” which perhaps describes China, whose very high gross investment rate of 44 percent is nevertheless overshadowed by an extraordinary 51 percent gross saving rate.¹⁷ However, in a number of advanced and emerging market economies,

^v The current account balance, which reflects this resource gap, also reflects a sometimes sizable and highly variable statistical discrepancy related to the mismeasurement of saving and/or investment.

the gap might better be characterized as a slump in investment. Global investment, especially if the United States is excluded, has shown a downward trend over thirty years.¹⁸ But in any case, as noted above, it is the difference between saving and investment that is relevant for the emergence of large imbalances.

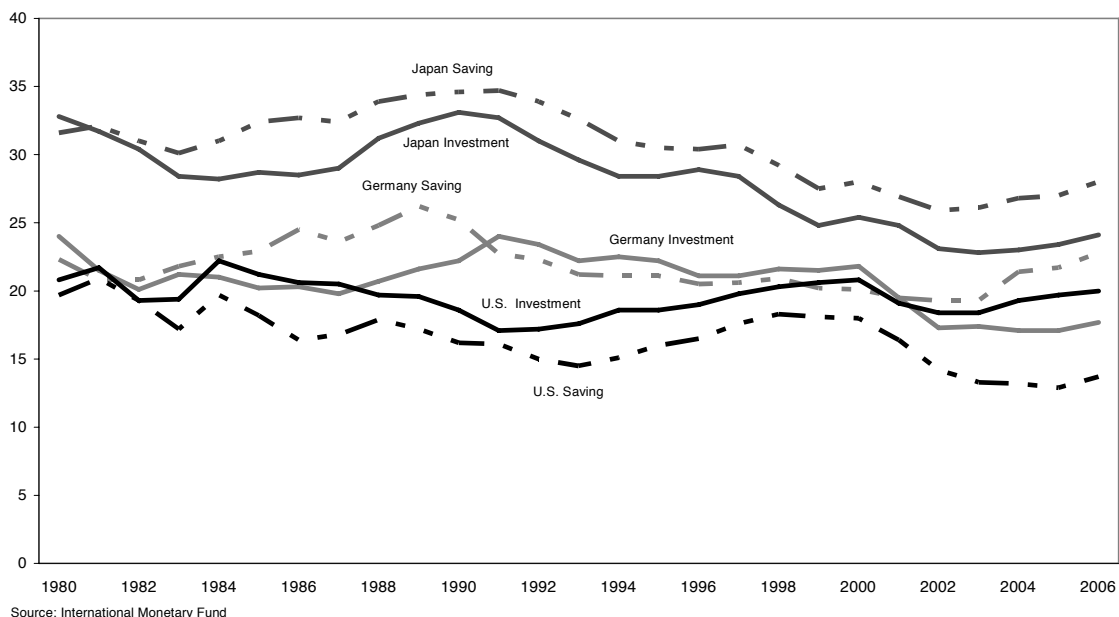
Among the large industrial countries, *Japan and Germany* stand out with respect to a gross saving-investment gap. (See Figure 12.) Both these large economies have experienced weak economic growth in the recent past; the prolonged stagnation of the Japanese economy during the 1990s was especially severe. Notwithstanding recent modest increases in growth, investment rates have declined significantly in both countries in response to both long periods of weak growth and population aging, which has reduced the relative number of younger people and thereby the demand for investment to equip new workers and provide for additional housing and schools. More generally, older, aging societies such as Japan and Germany may find more attractive investment opportunities for their savings abroad than at home, especially if their economies are less flexible and dynamic than the

foreign alternatives.¹⁹ A number of smaller European countries that share some of these same characteristics, such as Switzerland, the Netherlands, Belgium, Finland, and Sweden, are also running very large current account surpluses relative to GDP (while the euro area as a whole is in approximate saving-investment and current account balance).

Many newly industrialized and emerging market economies, with the notable exception of China (discussed below), have also experienced a decline in national investment rates during the last decade. The investment decline may in part reflect caution and increased risk aversion in reaction to the financial and economic crises of the late 1990s, and a recognition that some investments made during the preceding boom and surge of capital imports were ill conceived. At the same time, rapid output growth and higher public saving have tended to support overall saving rates, which generally fell less than investment, or recovered more.²⁰

Precautionary motives related to public saving and protection against sudden capital outflows such as those of the late 1990s also have contributed to the

Figure 12. Gross Saving and Investment in Japan, Germany, and the United States, 1980-2006
(Percent of Own GDP)



Source: International Monetary Fund

recent exceptionally large accumulation of official foreign exchange reserves. The newly industrialized Asian countries have consistently run high saving rates and current account surpluses associated with export-led growth, often facilitated by managed exchange rates. Taken as a group, the emerging Asian economies other than China and India averaged current account deficits of 11 percent of exports during the 1988-1997 decade, but in the last decade have moved into current account surplus, accompanied by large accumulations of reserves.²¹

The Strong Demand for Dollar Assets

Analysts focusing on differences between savings and investment have tended to emphasize the “resource gap” between total expenditures and output, which shows up as the trade deficit. However, independent trends in capital flows, and in particular a rising net demand for dollar assets, have contributed to the rising imbalances. Here the mechanism is more indirect; capital inflows most immediately raise the value of the dollar and dollar assets, setting in motion changes in wealth, incomes, interest rates, relative prices, and expenditures that increase the U.S. trade and current account deficits. This explanation complements and overlaps the view that focuses on excess savings abroad, since such savings need to be invested somewhere. But why especially or disproportionately in the United States?

There are several apparent sources of the strong demand for dollar assets:

Globalization and Portfolio Diversification

As noted above, as the integration of national capital markets has accelerated over the last several decades, asset trade has grown substantially faster than trade in goods and services, which in turn has outpaced growth in global output.²² An integral part of this growth in asset trade has been a reduction in the “home bias” that has historically channeled a country’s saving into investments in the same country and currency.²³ This reduction in home bias implies that private foreign investors will diversify their portfolios, shifting their demand at the margin from “home assets” to those denominated in dollars and other currencies. Such diversification presumably would reduce a portfolio’s perceived risk by more than the shift from familiar home assets would increase it. Indeed, it may be useful to view some of

this diversification as a process of financial intermediation, whereby foreign investors acquire lower-risk U.S. assets, and U.S. investors make more-risky (and higher-yielding) investments abroad.²⁴

At the same time that foreign investors diversify into dollar assets, of course, U.S. investors diversify out of dollar assets. However, because private saving relative to total income is substantially higher abroad than in the United States, the portfolio allocation of a significant proportion of new global saving in proportion to national economic size increases the net demand for dollar assets. And, because the proportion of new foreign saving so allocated to U.S. assets is larger than the proportion of U.S. saving flowing abroad, net demand is further increased.²⁵ In the future, a reduction in legal, institutional, and “cultural” constraints on capital outflows and diversification may reduce home bias abroad, but the development of foreign capital markets may also reduce home bias in the United States, so the future net impact on dollar asset demand appears uncertain.

The Dollar as International Money and the Principal Reserve Currency

Domestic money serves as a unit of account, a medium of exchange, a source of liquidity, and a (sometimes) safe store of value. The same is true of international money, for which the U.S. dollar is the premier currency serving these functions in both private and official portfolios.

As international transactions in goods, services, and assets have rapidly expanded, the need for private dollar balances to finance those transactions has increased, because a large proportion of international transactions is invoiced in dollars. Because the U.S. economy is so large and institutionally developed, its broad and deep financial markets offer low transaction costs that enhance liquidity. Similarly, as foreign savings have grown, the need for safe assets in which to store their value, away from prospective political or economic turbulence, has grown for both private savers and the central banks and governments that hold official reserves. Low inflation and strong property rights have helped make the dollar a relatively safe store of value, and U.S. Treasury securities are especially important in providing liquidity and safety to private investors as well as to central banks and government entities holding official reserves.

Official dollar reserves also function as a means of temporarily financing adverse shifts in the trade balance or capital outflows and thereby moderating the negative impact of such changes on a domestic economy. As noted above, the official reserves of many developing economies have grown extremely rapidly in the past few years. Their accumulation arguably has been a precautionary measure to reduce the risk of a repetition of the severe economic shocks some developing nations experienced in the late 1990s in response to capital flight and exchange rate volatility.²⁶ Some argue that this reserve accumulation has been larger than precaution and prudence might require, although this claim is controversial.²⁷ In any case, the growth of official dollar reserves and other dollar liabilities has exploded recently also as a result of the increase in energy prices and very active exchange rate intervention by China and other export-driven economies, as discussed below.

The U.S. Economy as a Magnet for Foreign Capital

Quite apart from the roles of the dollar as international money and a vehicle for portfolio diversification, the large and dynamic U.S. economy, and the assets that are claims upon it, undoubtedly offer major attractions to foreign investors.²⁸ The World Economic Forum has consistently given the United States high rankings with regard to its “business climate.”²⁹ As Japanese auto makers discovered many years ago, the openness of the U.S. economy, the large size of its product markets, its innovative culture, the flexibility of its labor markets, and the strength of its legal and financial institutions create a premier location for foreign direct investment (FDI). FDI in the United States has been rising, both absolutely and relative to GDP, for three decades – with an especially large surge during the strong economic growth of the 1990s.

In recent years, U.S. technological innovation and productivity growth generally have been stronger than those in other advanced economies and have attracted foreign capital as well as FDI to U.S. portfolio equities. A dramatic increase in such investment occurred in the late 1990s, with a massive inflow of capital seeking high returns from the technology boom; this contributed to both the stock market boom and a sharp appreciation of the dollar. Although these inflows, of course, fell off sharply in 2001-2003 after the boom collapsed, FDI inflows have partially recovered and inflows of portfolio

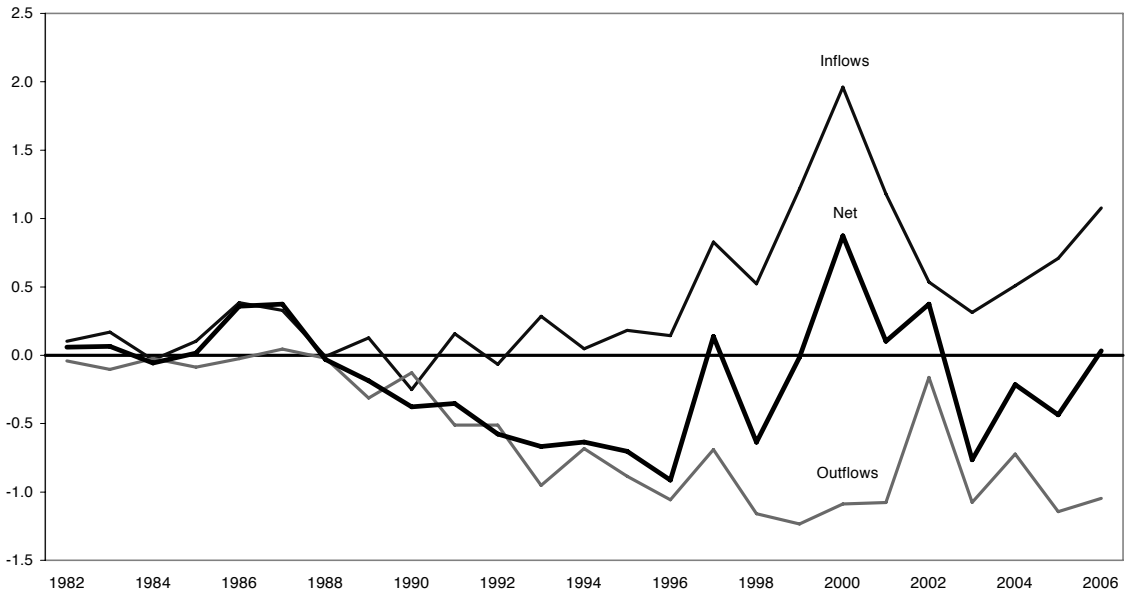
equity remain far above their pre-1997 levels. (See Figures 13 and 14.)

There is therefore little doubt that the attractions of the dollar and the U.S. economy for foreign investors have played an important role in the growth of the U.S. current account deficit. Nevertheless, as with the international mismatches in desired saving and investment, it seems unlikely that this is the whole story.

First, a significant proportion of recorded private capital inflows may reflect to some degree the actions of foreign official institutions rather than purely autonomous private investment decisions. This happens directly when purchases of dollar assets in U.S. custodial accounts are made by foreign banks or other private agents acting under the instruction of central banks or national investment authorities. An indirect, but important, mechanism is the “recycling” of official foreign saving indirectly into dollar assets through the international capital markets. For instance, the acquisition by foreign authorities of bank deposits or other assets (whether in dollars or other currencies) in a third country may give rise to portfolio adjustments that create an outflow of private capital from that country into the United States. A recent study, noting that the increase in net financial inflows into the United States since 2002 has closely mirrored the net outflows from oil exporters, concludes that “most petrodollar investments are finding their way to the United States, indirectly if not directly.”³⁰ This is, to be sure, private foreign capital flowing into the United States, but foreign official asset accumulation is closely related to such capital movements.

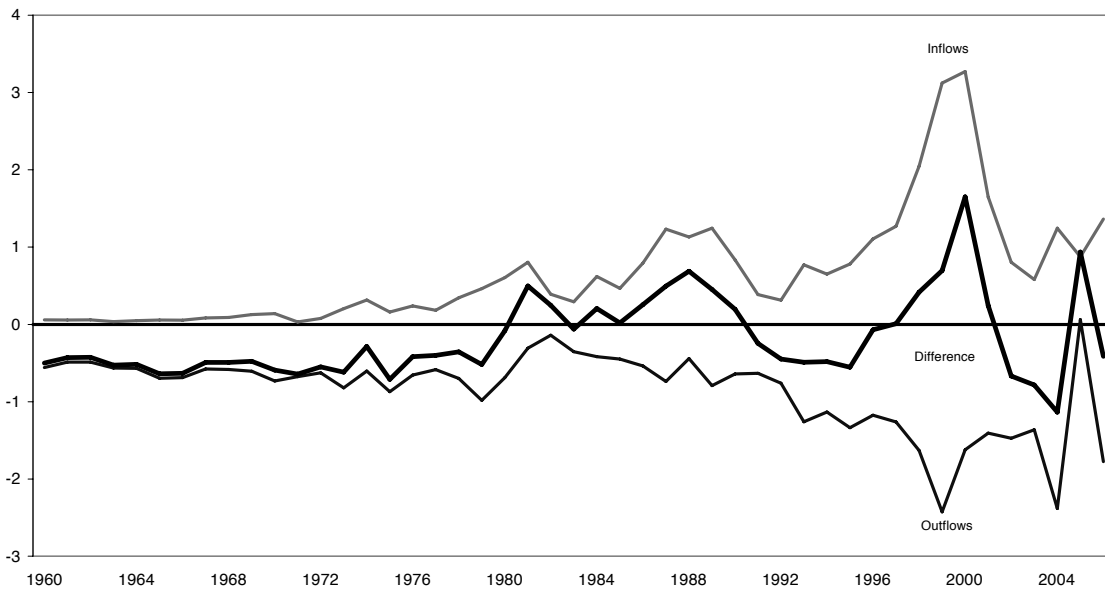
Second, while very large net inflows of portfolio capital into bonds, and especially U.S. Treasury securities, surely reflect the comparative advantage of the United States and the dollar in providing a safe and liquid repository for saving, the case regarding equity capital is less compelling. Flows of private equity capital into the United States have been matched by equity capital exports, sometimes as components of the same transaction, notably in international mergers and acquisitions. Over the last two decades of very rapidly increasing, but volatile, equity investments, U.S. exports of portfolio equity have generally exceeded imports (except during the dot-com boom), while FDI has gone abroad and entered the United States in roughly equal

Figure 13. Corporate Stock Purchases: U.S. Outflows, Inflows, and Difference, 1982-2006 (Percent of GDP)



Source: Bureau of Economic Analysis

Figure 14. Foreign Direct Investment: U.S. Outflows, Inflows, and Difference, 1960-2006* (Percent of GDP)



Source: Bureau of Economic Analysis

*Direct investment at market value

amounts. Whatever magnet draws equity capital across the U.S. border appears to pull strongly in both directions. The reported earnings on this U.S. equity abroad (both portfolio and especially FDI) have consistently exceeded the corresponding earnings on foreign equity in the United States during the last decade of rapidly rising current account deficits, although this earnings differential may to some degree reflect tax considerations and accounting practices that transfer reported profits to foreign subsidiaries abroad.^{vi}

The rise in the U.S. current account deficit might reasonably have been associated with capital imports that financed the rise in the U.S. investment rate during the technology boom of the 1990s, but it has continued in spite of relatively weak investment during the last six years.³¹ While private capital inflows continue, for the last five years the United States has been able to sell these private assets to most of the developed world only at progressively lower prices (exchange rates). And as the IMF has recently noted, the composition of U.S. capital inflows has been shifting from equity to debt, and within debt away from U.S. Treasury securities to riskier forms of debt.³²

All of these considerations are hard to reconcile with the view that an extremely large global advantage to investing in the United States relative to other countries is the predominant factor driving the U.S. current account deficit.

Relatively Rapid U.S. Economic Growth

After 1991, when the sharp decline in the current account began, the United States grew faster than the average of other advanced economies until 2006. Rapid U.S. growth tended to expand the trade deficit directly, by increasing the demand for imports, and probably also contributed to the inflow of capital described above. There is some empirical support for an association between economic growth and trade and current account deficits, and this may be intensified for the United States because U.S. imports appear to respond to domestic growth more strongly than U.S. exports respond to growth abroad.³³ Again, however, this explanation seems more persuasive for the booming 1990s than for the current decade. In any case,

this is certainly not a simple relationship, because economic growth is also associated with – and may in fact be driven by – an expansion of export capacity that improves the trade balance, and is also associated with higher saving.³⁴ Thus, many rapidly growing Asian economies, following export-led policies, have run chronic trade and current account surpluses. Furthermore, recent research suggests that, as a long-term matter over the past 25 years, the U.S. trade deficit's growth can be attributed almost entirely to a continuing appreciation of the dollar, and relative economic growth rates have not played a significant role.³⁵ The conflicting empirical evidence presents a puzzle, although some of the apparent conflict may result from differing short-term and long-term effects. It is probably fair to say that both the exchange rate and (at least in the short to medium term) relative growth rates have played a significant role.

The Recent Rise in Energy Prices

A very large source of the recent sharp rise in international imbalances has been the rise in energy prices and the enormous trade and current account surpluses of major energy exporters, and, of course, the deterioration of the balances of energy importers. (The Chinese 2006 current account surplus of 9 percent of GDP might have been significantly larger without the oil price increase, which was caused in part by surging Chinese energy demand.³⁶) Oil prices more than doubled from 2002-2006, and the oil revenues of fuel exporters more than tripled.³⁷ In response, their imports rose by only about one-third to one-half of the increase in oil exports, so that their current account surpluses rose from \$62 billion in 2002 to \$396 billion, or almost one percent of world GDP, in 2006. These 2006 surpluses were about 1.7 times that of China, and 1.25 times those of Japan and Germany combined.³⁸

Arithmetically, the rise in oil prices accounts directly for roughly 40 percent of the rise in the U.S. current account deficit from 2001 to 2006.³⁹ However, both goods and capital markets have also responded to higher energy prices and increased saving by the oil exporters, with indirect effects on the U.S. current account. On the one hand, the increased saving by the oil exporters depresses global demand and economic

^{vi} Earnings, of course, are not total returns, and attempts to account for capital gains and other "valuation" effects makes the matter more complicated.

activity. This has slowed the U.S. economy, moderating import demand and (oil prices aside) the deterioration of the trade balance. However, the higher saving also has given rise to capital exports by the oil exporters that have increased liquidity and reduced interest rates worldwide. This external financing supported investment and raised asset prices, notably for housing. In the United States, the wealth effect of the housing boom appears to have increased consumption and, presumably, imports and the trade deficit.

In the 1970s, the supply-side oil shocks, combined with a drop in productivity growth in the industrial countries, helped to produce not only large international imbalances, but also stagflation; prices rose sharply, creating a major drop in global demand. The recent oil price increase, however, has been primarily demand-driven, and global demand has continued to grow rapidly. In addition, although the oil exporters have not increased imports more rapidly than in the 1970s, the globalization of capital markets has facilitated an efficient recycling of their saving to the oil importers, where higher asset prices and lower interest rates have supported demand. The global effect has therefore been a large increase in international imbalances, but without the global recession that characterized the 1970s. The prospects are for a continued need for such recycling; oil prices have remained high, and most analysts expect a significant portion of the recent increases to be relatively permanent.⁴⁰ As discussed below, some oil producers are undertaking large investment programs, which should assist a gradual adjustment to higher energy prices that will help reduce the imbalances.

Export-Promotion Policies and Exchange Rate Intervention

During nearly 30 years of economic liberalization and integration into the global economy, China has strongly and consistently promoted exports. The appeal of export-oriented FDI may stem from the transfer of technological and organizational learning (external to the firm). Some argue that, in China's case, export promotion is necessary for the very rapid growth required to absorb more than 200 million additional underemployed rural workers into the non-agricultural labor force, and that the government's unattractive alternative is higher unemployment and a greater risk of social and

political unrest.⁴¹ Whatever the case, China's policies have produced impressive results for many years. China has averaged 9.7 percent annual growth over the last two decades, and raised real per capita income at an astounding 8.6 percent annual rate, according to IMF data.⁴² The domestic investment rate (unlike that in other Asian countries) has risen rapidly, to about 44 percent of GDP in 2006, but the saving rate has risen even faster, to about 51 percent. As a result, the current account surplus increased by 2006 to 9.1 percent of GDP, and reserves to over \$1 trillion, about 40 percent of GDP and 114 percent of exports.⁴³

In the U.S. political arena, the rising U.S. trade and current account deficits have been viewed principally as the result of foreign exchange rate intervention to prevent or limit the appreciation of other currencies (depreciation of the dollar), especially by China, and by smaller Asian economies such as Hong Kong, Taiwan, Malaysia, and Singapore that also link their currencies closely to the dollar. (Japan also actively intervened to depreciate the yen prior to March 2004.) However, a fixed renminbi-dollar rate considerably antedates the dramatic surge in the Chinese trade surplus, which began only in 2004; and China also grew rapidly, with a flourishing export sector, before the surge. The fixed-rate policy may originally have been adopted to anchor and stabilize the renminbi; China's restraint in not devaluing during the 1998 Asian crisis was widely welcomed as a contribution to international stability. However, more recently, with rapid productivity growth and low inflation in China, and the depreciation of the dollar against the euro since 2002, the renminbi has come to be undervalued in effective terms, as evidenced in part by the rapid rise in the trade and current account surpluses and official reserves. The weak renminbi has stimulated exports, suppressed imports, and attracted FDI as part of the export-oriented growth strategy.

Some who focus on exchange rate intervention and export-driven growth, especially in China, as a source of the U.S. current account deficit tend to view the situation as one of "codependency" between China and the United States. In this view, China secures the large consumer market and export-related FDI necessary for growth, while the United States is enabled to spend more than it produces by borrowing the resources to allow spending to exceed output. While

this oversimplified model does not do justice to the complexity of U.S.-Chinese economic relationships and exaggerates the likely stability of the current structure of Chinese trade and investment, it does remind us that producers, consumers, and policymakers all adapt to economic incentives and new structures as they develop, which may then become difficult to change.⁴⁴

However, it is important to remember that the renminbi exchange rate is only one of a number of factors that have contributed to the large Chinese trade surplus and rapid reserve accumulation. China's extraordinarily high saving rate, noted above, is related both to a weak social safety net, which fosters high precautionary saving, and an underdeveloped financial system, which lacks the capacity for intermediation needed to finance higher consumption. Government policies with respect to taxes and subsidies, the allocation of investment, and access to foreign exchange under capital controls all have strongly encouraged exports.

One particularly important element in Chinese export growth has been the interaction between global production networks and FDI-favoring policies that until recently had stringent requirements for export production. A remarkable feature of globalization in recent years has been the increasingly fine division of labor and activities within (and between) multinational firms, and those firms' geographical relocation of activities to achieve production efficiencies, rather than to enhance market entry – resulting in a rapid growth of intra-firm trade.⁴⁵ In many developing economies, this meant undertaking processing and assembly of imported raw materials and components, in China's case extensively for export. Although there have been strong economic forces underlying the growth of these production networks, China's vigorous promotion of FDI through tax, regulatory, and other instruments – in part by competitive and self-interested local governments and state-owned enterprises – has led to an enormous expansion of this processing activity. The processing trade, which now accounts for about 55 percent of China's total exports and about 65 percent of its exports to the United States, is conducted largely by foreign enterprises.⁴⁶

This processing-trade structure has several important implications. One is that the import content of exports is very high, and Chinese value-added low, so that conventional measures overstate the contribution

of China (and other processing-oriented developing economies) to global exports. The outsourcing of certain production activities from some FDI exporters, such as the United States, may have the effect of reducing conventionally measured current account balances in those countries and raising them in FDI importers. One study has estimated that about one-third of the 2002 U.S. trade deficit could be accounted for by the "foreign affiliate trade deficit" – the difference between imports from U.S. affiliates abroad and exports of foreign affiliates in the United States. A conceptually somewhat different "ownership-based" trade deficit for 2005 is about 17½ percent smaller than the conventional measure.⁴⁷ A second important implication of the processing trade is that the large import content of exports makes the Chinese trade surplus less responsive to changes in the exchange rate. This fact, combined with the alternative sources of similar goods in other developing countries and the low price responsiveness of U.S. imports of labor-intensive goods, for which domestic substitutes are limited, suggests that appreciation of the renminbi is far from a panacea for the large U.S. current account deficit.

Finally, the rapid increases in the trade surplus and FDI at the same time have led to the extraordinary rise in China's foreign exchange reserves, which reflect not only the large current account surplus, but a consistent capital account surplus over the past two decades.⁴⁸ In effect, the reserve accumulation has provided the intermediation of domestic saving for both domestic investment and future consumption that is otherwise difficult to achieve with a relatively underdeveloped financial system such as China's.

Other Asian economies, often competitors with China in their export markets, have also tended to manage their exchange rates to promote export growth, although (except for Hong Kong) with more flexibility than China. The "newly industrialized economies" (Hong Kong, Korea, Taiwan, and Singapore) ran current account surpluses for many years, but after 1997 these surpluses rose sharply (although Korea's shrank dramatically during 2005-2006 after the won was allowed to appreciate). Since the crises of the late 1990s, which to a greater or lesser degree involved all these countries, their average investment rate has fallen from 30-35 percent of GDP to about 25 percent, whereas their savings rates have fallen much less. Other

emerging Asian economies, such as the “ASEAN-4” (Malaysia, Indonesia, Thailand, and the Philippines), several of which experienced severe balance of payments crises and economic disruption in the late 1990s, have also seen sharply lower investment rates; prior to 1998 they consistently imported capital (in the aggregate), but since then have run significant, albeit declining, current account surpluses.⁴⁹ For the emerging Asian economies apart from China and India, reserves have more than doubled in the post-1997 period.

There are, therefore, a number of factors that have converged to produce the current large international imbalances. But are these imbalances benign or dangerous? It is our view that these imbalances are not sustainable and create significant risks. Because they are not sustainable, adjustments to reduce them are inevitable and, in fact, have already begun. The challenge to governments is to implement policies that will facilitate those adjustments and thereby reduce the risks that would be posed by the continuation and growth of such large imbalances.

IV. Risks Created by Continued Large Imbalances

International imbalances in general, and the large U.S. current account deficit in particular, are often argued to be problematic because, if they prove to be unsustainable, the adjustment process that reduces them may prove disruptive to financial markets and to both the nations involved and the global economy at large.⁵⁰ However, judging when the U.S. current account deficit will become unsustainable has not been a very successful enterprise in recent years, as analyses that suggested immediate dangers from large U.S. current account deficits have proved to be too pessimistic.

The deficit has risen for more than 15 years, since about 1991, although it appears to have stabilized in late 2006 and early 2007, when the trade deficit declined as a result of falling oil prices and an apparent modest improvement in the non-petroleum trade deficit. It is at present uncertain whether this constitutes a turning point for the deficit, or merely a pause in its climb. During the 1990s, the rising deficit produced little concern, because it seemed clearly a response to strong private capital inflows associated with rising business investment, rising public and national saving, and an enhanced capacity to service a larger foreign debt. However, the deficit continued to rise during the period of recession and recovery, with weaker non-residential investment and declining national saving in 2001-2006. This triggered a new set of warnings that the trend is unsustainable, and/or that dangerous thresholds for the size of the deficit or net foreign debt are being passed.⁵¹ Yet the rise of the deficit to 6.1 percent of GDP in 2005 and 2006 had no clear negative effects on the financial markets or the real economy. Indeed, in view of the decline in global investment, large U.S. deficits driven by powerful private consumption growth have been a major force supporting the global economy over the past decade.

Should we therefore conclude that large current account deficits pose no risk and should be treated with “benign neglect” by policymakers? We believe not, for the following reasons:

Even Sustainable Imbalances May Produce Serious Problems

Although we do not believe that imbalances of the current size are sustainable, some of the risks associated with them would exist even if (or, perhaps, especially if) they proved to be sustainable for a long period of time. We discuss two of these risks first, and then turn to the questions of sustainability and adjustment and the risks associated with them.

Protectionism

Economists are fond of pointing out that the principles of international specialization, that make possible the economic benefits of trade in goods, services, and assets, imply that overall balances with the rest of the world, and not bilateral balances with particular countries, should command attention, because large bilateral imbalances are often necessary and appropriate. This, unfortunately, is certainly not the public’s view, nor the picture presented in the headlines or often debated in the Congress. When U.S. imports and trade and current account deficits grow rapidly, especially when associated with job displacement and outsourcing, the cry goes up to find “who’s responsible.”

During the 1980s and 1990s, attention focused on the large U.S.-Japan trade deficit, which peaked at 1.2 percent of U.S. GDP in 1986. This led to domestic pressures and legislation for trade protection and continuing international tension and pressures on the Japanese for exchange rate appreciation and other measures to reduce exports to the United States. Similarly, with the even larger growth in the overall trade deficit and imports in the last decade, the spotlight has turned on the U.S.-China bilateral trade deficit, which has grown extraordinarily rapidly from 0.8 percent of U.S. GDP in 2000 to 1.7 percent in 2006. The result again has been pressure for protectionist legislation and high-level diplomatic efforts by the administration to persuade the Chinese to revalue the renminbi.⁵²

We fear the large bilateral U.S. trade deficits with China are increasing the dangers of protectionist actions by Congress, which may not approve bilateral trade agreements recently negotiated with Korea and several Latin American countries, or renew the President's trade promotion authority, which expired June 30, 2007.⁵³ This authority will be critical for successful completion of the precarious Doha Round multilateral trade negotiations and for maintaining U.S. leadership for any subsequent trade liberalization efforts.⁵⁴ As we enter the Presidential political campaign and approach the 2008 Congressional campaigns, the dangers of commitments to protectionist policies increase, and enormous long-term damage can be done if candidates succumb to the temptation to advance protectionist policies as a response to the U.S. trade deficit.

As foreign direct investment and other cross-border trade in assets have grown rapidly, the dangers of financial protectionism also have grown. Historically, the flow of direct investment, and in large part that of financial capital, have been from advanced to less-developed economies, and the protectionist issues have revolved around the rules governing acquisitions and equity investments in the developing world. However, with the emergence of large current account, and sometimes capital account, surpluses and financial holdings in emerging market economies, and with the rapid development of financial and managerial expertise in those economies, the possibilities and incentives for a reverse flow of equity capital into the "advanced" countries have increased.

There will likely be domestic resistance to this change in economic roles, just as there was resistance several decades ago to Japanese acquisition of U.S. properties, auto plants, and other assets. This resistance has often involved national security concerns, real or imagined. The Committee on Foreign Investment in the United States (CFIUS) is an intra-agency federal panel that reviews foreign acquisition of U.S. assets with regard to national security, and implements the authority of the President to suspend or prohibit transactions that threaten to impair U.S. national security. After September 11, 2001, CFIUS scrutiny and denials unsurprisingly increased. However, after the Dubai Ports World controversy of early 2006, CFIUS, under political pressure, apparently made the approval process more onerous and threatened to impose extremely

large penalties on companies committing minor infractions of investment agreements; twenty bills soon were introduced in Congress restricting foreign investment. This created uncertainty that had the potential to discourage legitimate foreign investment, and cause other countries to restrict U.S. investment abroad.⁵⁵ As a result, Congress and the President have recently enacted the Foreign Investment and National Security Act of 2007, which establishes CFIUS by statute and codifies procedures to safeguard national security while maintaining a relatively open investment climate.⁵⁶ Although the new legislation attempts to balance the competing claims of national security and openness to investment, there nevertheless remains some danger in the current climate that national security may become an excuse for protectionist actions.

This issue may become more problematic, and less clearly a simple matter of protectionism, if U.S. or other private business assets become owned to any significant degree by foreign governments or quasi-official investment authorities. Foreign exchange reserves invested in U.S. Treasury securities or agency assets earn low rates of return. As the growth of foreign official exchange reserves recently has accelerated, more governments have created, or are exploring the creation of, public investment institutions to invest in higher earning securities, including equities, in the United States, Europe, and elsewhere. Singapore and a number of Middle Eastern and other oil exporters have operated such investment authorities for some time, but foreign government holdings of this type may soon become more common and much larger. China is now creating such an authority, to which it may dedicate \$200 billion of its reserves, and Japan is reported to be considering one.⁵⁷ Information on many of these funds is closely guarded, but a recent estimate puts the total at about \$2.5 trillion – almost half as large as the \$5.1 trillion global official reserves at the end of 2006.⁵⁸ Even if such foreign investments involve only relatively small ownership shares of individual companies, and are passive and highly diversified, they may present political, and possibly substantive, difficulties. The U.S. Treasury has begun to suggest that it is concerned about both foreign public ownership of private firms and the possibility that such funds will reduce the incentive for their national owners to change exchange rate policies. Furthermore, the new CFIUS procedures require a full-scale investigation of proposed foreign

government-controlled transactions, although this requirement can be waived by the Secretary of the Treasury if he finds that that national security is not threatened. Resistance in Europe to such acquisitions also appears to be growing.⁵⁹ As one analyst recently has noted, “when governments own companies, that creates the potential for geopolitical mischief.”⁶⁰

Intergenerational Equity: Borrowing from the Future

Current account deficits and international borrowing effectively transfer resources from future generations to those alive today. If those resources are transferred into higher current productive investment – as was arguably the case in the late 1990s – future generations may benefit. However, because consumption has steadily increased as a share of GDP during the period of rising current account deficits, it is difficult to argue that the *principal* effect of increased foreign borrowing over this period has been to increase domestic investment. Instead, the United States in effect has been transferring goods and services from future generations to current consumers.⁶¹

It can be argued, of course, that such an intergenerational transfer is equitable and appropriate, since future generations are likely to be wealthier than the current generation, at least in part as a result of the latter’s actions. Nevertheless, in view of the oncoming rise in the elderly dependency burden, and associated mounting tax burdens to finance sharply rising public health and pension costs, we are not persuaded that “borrowing against the future,” as the United States is now doing, is good public policy. We also believe that the risks of much higher social costs likely to face future generations associated with, for instance, international terrorism, rapidly changing geopolitical conditions, and climate change, make it unwise to shift economic burdens to the future.

Large Imbalances Are Unsustainable in the Long Term

While there are no widely accepted estimates of a political or economic limit to the size of the U.S. current account deficits or net international debt, the sheer arithmetic of debt dynamics when current account deficits are large is troubling. Clearly, current account deficits cannot grow faster than GDP over an extended

period of time. But even large deficits that are stable in relation to GDP have worrisome implications. For instance, were the current account deficit simply to continue at 6 percent of GDP, with 5 percent nominal GDP growth, the negative NIIP might eventually stabilize at 60-120 percent of GDP (depending on the size of valuation changes) and at about half that within a decade.⁶² Although some countries, such as Australia, New Zealand, Spain, Greece, and Portugal have approached such high levels of net international debt to GDP without negative consequences, none are large economies where cross-border asset holdings of this magnitude could have large international effects.

With such an increase in net indebtedness, about 40 to 80 percent of the U.S. capital stock eventually might be foreign owned.⁶³ Notwithstanding the fact that U.S. ownership of foreign capital also would greatly increase, the recent political resistance to foreign ownership of U.S. assets in the Unocal and Dubai Ports World cases, and earlier in large Japanese acquisitions during the 1980s, suggests that such ownership would present political problems. Such problems might be exacerbated if such foreign ownership involved governments, as noted above.

However, even such a large sustained current account deficit would not accommodate a large sustainable trade deficit. Because the increasingly negative net foreign investment position would continually reduce the balance on capital income, the trade deficit would have to fall, and eventually move into surplus to finance an ever-larger income deficit if the current account deficit were not increasing.

Such considerations indicate that the current account deficit eventually must fall substantially. As noted above, the impact of large trade and transfer deficits on the U.S. net foreign debt has been greatly reduced – by a remarkable 64 percent during 1983-2006 – by the higher rates of return (broadly defined to include valuation changes) on U.S. foreign assets compared with its liabilities. An IMF analysis shows that in 2001-2006, this return differential more than offset the enormous increase in net foreign debt of 28.2 percent of GDP that would have resulted from the U.S. trade deficit taken alone. Australia and Spain, which were not blessed with such differential returns, saw their trade deficits fully reflected in sharply rising net external debt. As the IMF points out, it would be unrealistic

to expect the U.S. return differential to remain large enough to obviate the need for reduction in the current account deficit.⁶⁴

How far the current account deficit would have to fall to be sustainable in the medium term is difficult to determine, because this depends on many factors – including the growth rate of the economy, rates of return on cross-border asset holdings, and especially the growth of demand for dollar assets. However, several analysts, including those at the IMF, have estimated that a current account deficit of very roughly 3 percent of GDP would be sustainable, requiring a reduction of about half from its current level of about 6 percent of GDP.⁶⁵ Indeed, given the attractiveness of the United States for both portfolio and direct investment, it could be difficult to reduce the current account deficit much further. It follows from the discussion above, however, that a reduction of the *current account deficit* by 3 percent of GDP would require a substantially larger reduction in the *trade deficit*, because the growth of U.S. external debt will cause the deficit on capital income to grow.

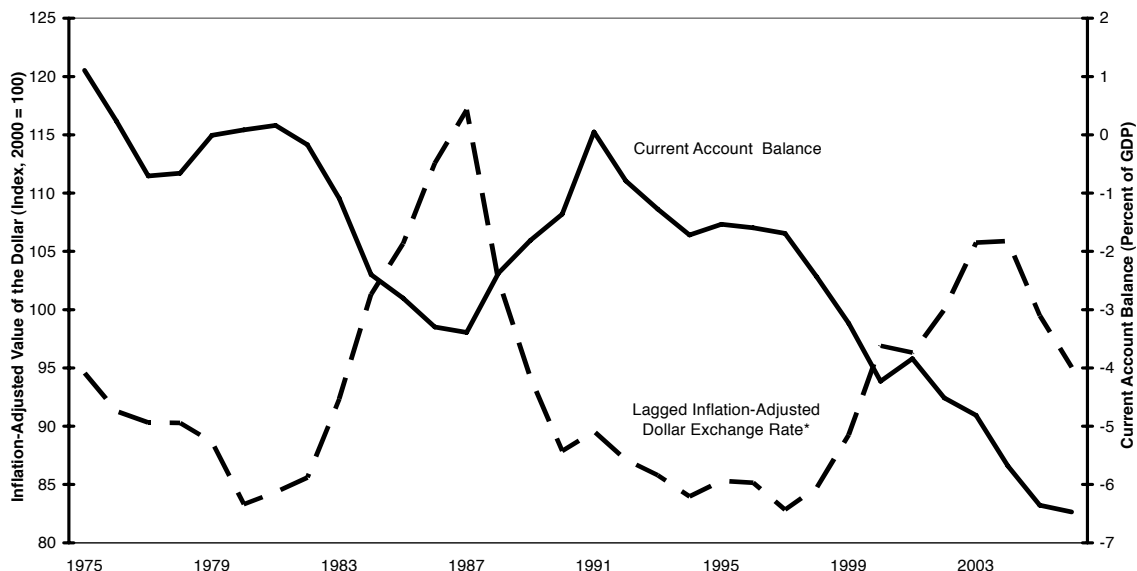
Adjustment and the Reduction of Imbalances

The Idealized Adjustment Mechanism

If large imbalances must eventually fall, through what process of economic adjustment will this happen? Ideally, adjustment would take place in a smooth and gradual manner in which the large saving-investment “mismatches” described above were reduced by an incremental shift of global demand from deficit countries to surplus countries. This demand shift would be facilitated by changes in relative prices, largely through real exchange rate adjustments. (Figure 15 shows how the U.S. trade deficit has responded to changes in the real exchange rate during the last several decades.)

In the United States, as the growth of domestic demand slowed, national saving would rise, bringing overall spending growth more in line with that of output. In the ideal case, actual output and employment would not be significantly reduced; the demand for and production of exports and import substitutes would rise, in response to exchange rate and price adjustments, as those for non-tradable goods fell. In

Figure 15. U.S. Current Account Balance and Inflation-Adjusted Value of the Dollar, 1975-2006
(Trade-Weighted Basis)



Sources: Bureau of Economic Analysis and the Federal Reserve Board
*Price-adjusted broad dollar index. Averages of monthly data. Exchange rate is lagged two years

general, in economies with current account surpluses, the reverse adjustments would take place. National saving would fall as domestic demand grew faster than output; in response to relative price changes, demand would shift away from exports and import-substitutes towards imports and non-tradable goods and services. The overall effect would be to increase net exports and the current account balance in the United States, and to reduce net exports and the current account balances in surplus countries.

For this smooth adjustment to take place, *both* the changes in domestic demand *and* the relative price adjustments are necessary – a point often missing in popular discussion.⁶⁶ A reduction in U.S. total spending large enough to reduce substantially the current account deficit without the price adjustments needed to shift demand to exports and import-substitutes would involve a severe recession. (For instance, without price adjustments, a fall in GDP of roughly 11 percent and rise in unemployment of about 4.5 percentage points would be required to reduce imports and the trade deficit by 3 percent of GDP.)⁶⁷ Similarly, in the surplus countries, higher total expenditures alone, without the price adjustments needed to shift demand to imports, would produce inflationary pressures, unless the economy were already operating below capacity. In a similar manner, exchange rate and relative price adjustments alone, without the shifts in demand, also would be problematic. The depreciation of the dollar in itself would be inflationary in the United States, shifting demand from imports to domestic sectors; a reduction in spending would thus be needed to “make room” for this shift in demand and prevent inflation. Similarly, in the surplus countries, an appreciation of the currency in itself would be deflationary, shifting demand from domestic sectors to imports; an increase in spending would then be required to sustain output.

Is smooth market-driven adjustment that roughly follows this ideal model likely? Market participants presumably do not expect large imbalances and the rapid accumulation of dollar liabilities to be sustained indefinitely, and will come to expect adjustment, including further depreciation of the dollar, higher saving in the United States, and strengthening demand abroad. If those expectations are realized, and the dollar falls as anticipated, with no major unfavorable economic or policy shocks, asset prices and interest rates will incorporate and validate those expectations,

and the imbalances will fall. This may be the most likely path for adjustment, and former Federal Reserve Chairman Alan Greenspan and others have projected such a benign outcome.⁶⁸

Indeed, some important components of this market-driven adjustment process are underway. By July 2007 the dollar had fallen by about 18 percent from its peak of early 2002; and by late 2006 and early 2007 the trade balance in non-petroleum goods was falling, after an expected lag. By May 2007 the monthly trade deficit had fallen by \$7.6 billion from its August 2006 peak of \$67.6 billion, although about 40 percent of the improvement in the goods balance was in the petroleum category. Total spending growth in the United States has slowed with the end of the housing boom. Private saving should begin to rise with the flattening of housing values; and the public saving outlook has improved with stronger state and local economies and unexpectedly strong federal revenues. In the meantime, growth in Europe and Japan has been strengthening and that in China remains very strong, albeit driven by surging exports. Large investment projects are moving forward in the oil exporting countries, as they adjust to the recent surge in export earnings and reserves.

Looking further ahead, we might expect to see some diminution of private saving in Europe, Japan, and China as those societies age, and a reduction in saving and restoration of stronger investment in other developing Asian economies as precautionary saving and reserve accumulation moderate, and memories of the 1998 crisis recede. As the accumulation of large dollar reserves increases inflationary pressures and problems of monetary management in China, further gradual appreciation of the renminbi and liberalization of the capital account are likely, and the development of financial markets and institutions will also boost consumption.⁶⁹

Impediments to Smooth Adjustment

Unfortunately, in spite of these encouraging signs, the further progress and successful completion of this market-driven adjustment process faces some major obstacles.

As noted above, adjustment is likely to be smooth – i.e. dollar depreciation will proceed in a gradual and orderly process – if investors’ expectations are aligned with the changes that will in fact be required to reduce

the imbalances. Although this is quite likely if policies are well managed and there are no shocks to the system, it is by no means foreordained. In particular, if large current account deficits continue over an extended period of time, investors may become myopic, heavily discounting the need for a future large depreciation that may become even larger as the imbalances continue. In these circumstances, when a large fall in the dollar begins, it may turn into a “dollar plunge” as investors are “surprised” by the market.⁷⁰

It appears unlikely that market forces will rebalance global demand and the saving-investment mismatches anytime soon. The April 2007 IMF baseline projection for 2007-2012 (assuming no additional effective exchange rate adjustment) shows the U.S. current account deficit continuing for five years at more than 1.5 percent of world GDP, with correspondingly large surpluses continuing in Japan, China, and elsewhere in Asia; the oil exporters’ surpluses adjust downward slightly but remain very large.⁷¹ Even when assuming substantial effective exchange rate adjustment (including that for China, where it is produced by inflation), a 2006 IMF “no policy change” projection shows the U.S. current account deficit falling only very slowly to about 4 percent of U.S. GDP in 2015. In this scenario, U.S. net foreign liabilities rise to 55 percent of GDP, trending toward 85 percent in the long run, while the dollar share of foreign portfolios increases. The IMF warns that this approximate tripling of U.S. net foreign liabilities relative to GDP without foreign investors demanding a large risk premium in higher interest rates may be unrealistic. The analysis of incongruent expectations noted above also suggests that the low real rates of return that foreigners receive on dollar assets imply a potential for disorderly adjustment.⁷²

It is unclear what role official dollar holdings might play under these circumstances. There generally has been large inertia in official reserve holdings, and the dollar’s position as a reserve currency has remained relatively stable, in spite of the gradual emergence of the euro as a credible alternative.⁷³ It is probably unlikely that foreign monetary authorities would initiate large and abrupt dollar sales, and in response to a flight from the dollar by private investors, they might in fact increase their reserve holdings to stabilize the dollar. However, official holders of dollars, although certainly having different objectives than private investors, may be politically sensitive to the drop in the value of their

reserves, measured in local or non-dollar currencies, that they would incur through a large dollar depreciation. If they see an eventual large depreciation of the dollar as inevitable, the possibility that some would follow private investors in reducing dollar holdings in their portfolios, if only by slowing the rate of accumulation, cannot be dismissed.⁷⁴ Even if official reserve holders do not attempt to diversify out of dollars, the fear among private investors that they may do so can add to uncertainty and increase volatility in the exchange markets.⁷⁵

A second critical impediment to adjustment may be the unwillingness, or incapacity, of policymakers to implement policies to facilitate it, such as public expenditure reductions or tax increases in the United States or exchange rate appreciation to increase imports and consumption in China. Such policy paralysis not only allows the problem to grow as net debtor and creditor positions increase, but may also erode confidence among private investors that policy changes and correction will be forthcoming. It is not surprising that policymakers are less than eager to undertake such changes, because adjustment is likely to impose some painful costs, at least in the short run.⁷⁶ Americans, long accustomed to spending more than they produce collectively, would increase their spending less (privately and publicly), and on average experience a lower growth in living standards, even if their incomes did not fall. Reducing the trade and current account deficits by 3 percent of GDP, or about \$420 billion, would involve a reduction in domestic purchases of roughly \$1,400 per capita (at any given exchange rate) – and a further loss of purchasing power of perhaps \$700 to \$1,100 per capita as a result of the higher import prices from a 20-30 percent nominal effective dollar depreciation.⁷⁷ In the surplus countries, although expenditures and consumption per capita would increase, other aspects of the adjustment could be difficult. The reduction in saving in high-saving societies such as China would go against long-ingrained patterns of behavior, and reallocating demand and output from the export to domestic sectors in export-oriented economies like China, Japan, and Germany might prove unwelcome and difficult.⁷⁸

Policymakers may also be reluctant to act because of the real-world difficulties of reallocating resources and demand internally. China, as a premier example, has developed an export-oriented economic growth strategy that has created unprecedented increases in

output and living standards. Nevertheless, excessive and inefficient investment, rising income disparities, and other problems led the Chinese leadership in 2004 to announce a new policy direction that would shift from investment and exports towards consumption-led growth. However, few of the policy changes required for this change appear to have been implemented. Modifying the existing structure, even if necessary and in China's interest in the longer term, is apparently proving very difficult for risk-averse policymakers concerned with the dangers of social unrest – particularly as the growth in industrial employment has recently slowed.⁷⁹ Similar considerations, in less dramatic form, apply to other Asian developing economies and some advanced countries such as Japan and Germany. Even in a highly flexible economy such as the United States, large and potentially disruptive changes in the exchange rate and relative prices may be required for internal adjustment.⁸⁰

Finally, even if policymakers are prepared to act, an adjustment without significant economic dislocations requires roughly compensating changes in saving and investment patterns between deficit and surplus economies that produce a *shift*, but not an overall reduction, in global demand. For example, an increase in public saving in the United States would likely reduce output and employment (both in the United States and abroad) if not accompanied by a reduction in saving and increase in domestic demand abroad. In practice, policy coordination of this kind faces formidable obstacles. It implies a measure of agreement on policy actions that may not exist, as well as a facility for fine-tuning and timely actions that governments may not possess. In addition, the appropriate policies for reducing external imbalances may conflict with the pursuit of other goals. For example, fiscal expansion in Japan and Germany confronts the realities of large fiscal deficits and the need for fiscal consolidation, and euro area fiscal policies generally are constrained by the Stability and Growth Pact. We examine the implications of these problems of policy coordination in our discussion of policy recommendations in Part V, below.

The Costs of Disorderly Adjustment

What would be the impact on the U.S. economy of an abrupt decline in the demand for dollars, and a sharp drop in the exchange rate? The effects are extremely uncertain. Depreciation in itself would increase total

demand, but this effect is likely to occur only after a lag of more than a year. The danger is that the sharp reduction of capital inflows, and possibly action by the Federal Reserve to forestall inflation originating in higher import prices, would raise interest rates and more immediately reduce demand in housing, consumer durables, and other sensitive sectors. In spite of the flexibility and resilience of the U.S. economy, this could produce a recession, especially if overlaid on existing weakness in the housing sector.

History does not provide reliable guidance on this question. The experiences of other economies (and especially developing countries) may not provide strong evidence because (unlike the United States) they often have had to borrow in foreign currency, so that the domestic currency value of liabilities has been increased by depreciation.⁸¹ Nevertheless, a recent study of the experience with current account reversals in relatively large countries found large impacts on real output, with per capita growth declining by about 2-4 percent in the first year and remaining under trend even three years later.⁸² It also appears that the reversals of larger deficits, and deficits financing consumption – both characteristics of the current United States situation – are associated with larger depreciations, longer adjustment periods, and slower growth.⁸³

The history of adjustments by the United States is limited and mixed. The large dollar overvaluation of the mid-1980s, and the current account deficits that reached 3.4 percent of GDP in 1987, gave rise to ominous warnings of their economic dangers.⁸⁴ Yet those imbalances were reversed by policy adjustments in the G-7 countries, and a sharp drop in the dollar facilitated by coordinated currency intervention, without a U.S. recession.⁸⁵ On the other hand, the United States experience with sharp dollar depreciation after the collapse of the Bretton Woods system in 1971-1973 was much more painful, although it is difficult to disentangle the effects of that adjustment from those of the "oil shock" and the policies responding to it. In any event, the accompanying flight from the dollar probably contributed significantly to the sharp rise in nominal interest rates and inflation, and the deep 1974-1975 recession that followed.⁸⁶

Economic model simulations suggest that adjustment triggered by a reduction in the desire to hold dollar assets could have large repercussions on the U.S. and

global economies. In an IMF “disruptive adjustment scenario,” such a decline in the appetite for dollars produces abrupt exchange rate changes, higher inflation and interest rates worldwide, and sharp reductions (roughly 3 percentage points) in economic growth in the United States and emerging Asia, including China. The IMF notes that these outcomes could be much worse if the abrupt exchange rate adjustments disrupted financial markets.⁸⁷ In the event of such disruption, the now very large international markets for derivatives, and other instruments of intermediation, could be stabilizing or destabilizing, but add another element of uncertainty and risk.⁸⁸

The IMF recently conducted a systematic study of 42 reversals of large and sustained current account deficits in advanced countries during 1960-2006. The costs of adjustment, in terms of the impact on economic growth, unemployed capacity, and investment varied widely. At one end of the spectrum, a quarter of the episodes involved substantial growth slowdowns, which averaged 3.5 percent per year, and a strong decline in investment rates. On the other end, a quarter of the reversals were expansionary, with increases in annual output growth averaging about 0.75 percent and with sustained investment rates. Importantly, these more successful expansionary reversals tended to occur when relatively large real exchange rate depreciation was combined with substantial fiscal consolidation that raised saving and thereby allowed investment to be sustained.⁸⁹

We believe this evidence suggests that disorderly adjustment, while at present unlikely, presents risks that are too large to ignore. It also indicates that measures to facilitate orderly adjustment, by rebalancing global demand and encouraging exchange rate flexibility, can be useful and should be pursued. Furthermore, we note that the magnitude of potential exchange rate changes and of unfavorable impacts on output, employment, inflation, and financial markets is likely to be greater as the size of the imbalance grows. In this context, the ease with which the U.S. current account deficit has been financed poses a dilemma. As two astute observers have graphically put it, the “adjustment will be sharper the longer is the initial rope that global capital markets offer the United States.”⁹⁰ We confront a difficult trade-off: It is desirable that adjustment be gradual to diminish the costs it imposes, but the longer adjustment is postponed, the greater these costs are likely to be. *This implies that delay in adjustment is undesirable, and therefore that policies to facilitate adjustment should be undertaken promptly – the subject to which we now turn.*

V. Facilitating Adjustment: CED's Policy Recommendations

In Part IV we outlined the dangers of protectionism and financial and economic instability associated with large and growing international imbalances. We acknowledged that markets eventually respond and adjust to such imbalances and, indeed, that some positive movement in the adjustment process has already taken place. We noted, however, that many of the major structural sources of the imbalances, and the associated risks, persist; and while the system may adjust under “benign neglect” without significant policy interventions, the prudent course is to “buy some insurance” by implementing policies that will reduce those risks.

We also found that there is great uncertainty both about the level of imbalances (and the U.S. current account deficit) that is sustainable, and about the size of the macroeconomic policy and exchange rate changes, and the time frame, needed to reach such a level. We believe that it will be useful to aim for the “soft target” of a U.S. current account deficit of about 3 percent of GDP within a few years, which is a level at which U.S. external debt might stabilize as a percentage of GDP in the medium term.^{vii} However, our most important objective should not be eventually to reach a “magic number,” but to implement soon policy changes that will reduce imbalances and create confidence that orderly adjustment is proceeding. In this section we outline in general terms the policy changes that we believe will facilitate such an adjustment to a world of smaller and less rapidly growing imbalances.

The General Policy Framework: Three Principles

CED believes that three basic principles are essential to an effective policy framework:

- All economies should contribute to adjustment;
- Changes in both total spending and relative prices are required; and

- A multilateral cooperative approach is more likely to be successful.

All Economies Should Contribute to Adjustment

International economic and financial stability is a public good, benefiting all countries that participate in the international system. It is therefore reasonable to expect that all countries pay some regard to the effects of their policies on other countries and on the system as a whole. (This principle, of course, is codified in, for instance, the rules of the World Trade Organization and the Articles of Agreement of the International Monetary Fund.) Such responsibilities are especially important for large economies such as the United States, Japan, the European Union, and China, whose actions have major systemic implications. However, as we note below, the actions of many smaller economies, taken in the aggregate, can have an important impact, so their policies also should contribute to adjustment.

Policy adjustments also should be broadly shared because the international economy is a closed system. A reduction in the U.S. current account deficit, or a reduction in the Chinese current account surplus, implies an equivalent change in current account balances in other countries. It is incorrect to point (as some do) to a single country's large surplus or deficit as being “the” source of the problem, or of the solution.

Finally, although policy measures to reduce imbalances, by reducing the risk of disorderly adjustment that could affect many countries, are likely to benefit most or all countries, they also entail costs, as noted in Part IV. They are therefore more likely to be acceptable, and implemented, if adjustment is broadly shared. We recognize, however, that compelling domestic problems, or other constraints on policy, may limit the contributions to adjustment that some countries can make.

^{vii} The level at which the current account deficit stabilizes depends critically upon the rate of increase in the deficit on income payments and the reduction in the trade deficit, which would have to decline enough to allow the former to be financed.

Changes in Both Total Spending And Relative Prices Are Required

“Finger-pointing” at a particular country as the source of the imbalances often is associated with a view that only inappropriate macroeconomic policies, or, alternatively, only inappropriate exchange rates, are responsible. Some Europeans would blame the problem simply on U.S. fiscal deficits or (alternatively) an undervalued yen; some U.S. policy makers claim that Chinese exchange rate policy is the sole culprit; while the Chinese authorities have sometimes pointed to U.S. spending, arguing that exchange rates do not matter.

We believe that, in practice as in theory, changes in both domestic demand, which directly affect the saving-investment balance, and in relative prices, principally through real exchange rate changes, will be required for orderly adjustment. As noted in Part IV, in the absence of a rebalancing of domestic demand, often assisted by macroeconomic policies, exchange rate adjustments will have to be larger, and are more likely to “overshoot,” raising the risk of financial and economic disruption. Similarly, shifts in domestic demand without changes in exchange rates and relative prices are likely to reduce output and employment or, conversely, create inflationary pressures.

An effective program for international adjustment will therefore involve many countries in both policy changes that affect domestic demand and policy- or market-driven exchange rate adjustments. In very broad, general terms, countries with persistent, structural (i.e. non-cyclical) deficits – preeminently the United States – should reduce the growth of overall spending relative to output, while allowing effective exchange rate depreciation. By the same token, those with structural surpluses should attempt to increase the growth of demand relative to that of output, while allowing exchange rates to appreciate. As noted, the circumstances of individual countries may constrain the extent and timing of these policy adjustments, but we urge that policymakers not allow such circumstances to become rationalizations for inaction on adjustment.

A Multilateral Cooperative Approach Is More Likely to Be Successful

International adjustment presents a collective action problem. A single country, taking adjustment actions alone, may produce economic results significantly

inferior to those that would result from actions taken collectively by several countries. Fiscal tightening in the United States may reduce output and employment both domestically and globally unless accompanied by an expansion of demand abroad with complementary exchange rate adjustments. The Japanese, Chinese, and many Europeans worry that currency appreciation and U.S. fiscal tightening will weaken export demand, with unfavorable domestic repercussions. Some of these problems, of course, will require compensatory domestic policy actions, but some can be ameliorated by actions taken abroad. In the absence of actions by others, there may be less incentive for countries to act themselves.

In most instances, the policy changes needed for adjustment are those that countries should undertake in their own self-interest, at least in the longer term. However, these policies may also be politically difficult, as witnessed by the difficulty in reducing the U.S. fiscal deficit or modestly appreciating the renminbi. Just as WTO rules protect to a degree liberal trade arrangements from protectionist pressures, a multilateral framework may facilitate adjustment policies, both by creating a sense of shared burden and by offering a protective rationale to political leaders.

We consider below the most suitable approach to multilateral coordination. As a foundation, we first present our recommendations on the actions by the United States and other countries that would be most helpful in facilitating adjustment. However, it is important to note here that we do not regard these recommendations as a rigid, hard-wired, comprehensive program to be implemented with exquisitely coordinated simultaneity by many countries. That would be quite unrealistic – technically, economically, and politically. Our recommendations should rather be seen as directional objectives, likely to be implemented over a period of several years, with some participants more constrained in their contributions than others.

Policies in the United States

With its extremely large current account deficit, the United States is central to international adjustment. The United States should lead by example with its own policies to facilitate adjustment while actively encouraging and supporting adjustment policies by others. It is very important that this leadership be

exercised in multilateral coordination efforts as well as in domestic policies. We believe the U.S. adjustment policies outlined below, as part of a larger global adjustment over several years, could reduce the U.S. current account deficit to the approximately 3 percent of GDP that could be sustained in the medium term without significant risks.

First, What Not to Do: Protectionism

Often when the United States has experienced large trade deficits, and especially large bilateral deficits, some elements of the public and Congress have called for tariffs or other barriers to reduce imports, especially when domestic employment has seemed adversely affected or threatened. In this trade cycle, the administration has recently imposed new restrictions by changing the rules governing countervailing duties on imports from “non-market” economies (preeminently China). Such protectionist barriers are unlikely to be effective in reducing the trade deficit, especially when levied against a single country that has third-country competitors. More importantly, such measures would reduce the large benefits that Americans have gained from liberal trade and investment policies and risk provoking retaliatory measures that could halt progress towards further liberalization or even escalate into a spiral of no-win trade conflict.

As noted in Part III, as foreign direct investment and other cross-border trade in assets have grown, the dangers of financial protectionism have increased. There are three strong reasons for the United States to resist financial protectionism. First, like trade protection, it harms efficient international resource allocation and, in general, reduces welfare in both the United States and the capital exporter. Second, the United States will depend upon imports of capital to assist a smooth adjustment process as the current account deficit falls; impediments to capital inflows could impair that process and, in any case, would raise the cost of borrowing abroad. Finally, over the longer term, the consumption needs of older populations in the United States and other advanced countries may require very large resource transfers (capital imports) from younger, more rapidly growing, higher-saving countries. This presumably will involve the large-scale foreign acquisition of many kinds of U.S. assets; the United States will need to adjust to these economic and demographic facts of life.

CED therefore strongly urges the Congress, the administration, and all political candidates to resist pressures to embrace policies of trade and financial protectionism. In particular:

- Congress should restore the President’s expired Trade Promotion Authority, which is essential for completion of the much-endangered Doha Round of multilateral negotiations, and for any future progress in trade liberalization;
- The administration should work vigorously to complete the Doha Round, and Congress should approve the bilateral trade agreements with Korea and various Latin American countries that are now pending;
- The administration and Congress should employ the new CFIUS procedures carefully and use them to prohibit or reduce foreign investment in the United States only when such use is clearly warranted by national security requirements.⁹¹

Increase National Saving*

A reduction of the U.S. current account deficit to roughly 3 percent of GDP must involve an ex post reduction of total spending relative to output (increase in national saving) of this amount. The current slowdown in the economy following the collapse of the housing boom is producing slower growth in both spending and output, and this slowdown should lead to a reduction in imports. However, reduction of the trade deficit through recession, which would be both costly and temporary, is obviously not the answer. The United States needs domestic policies to raise national saving – the indispensable U.S. obligation in multilateral adjustment – *combined with* the further depreciation of the dollar and strong demand growth abroad that will support U.S. output and employment.

If the United States does not take measures to increase national saving, adjustment may take place through dollar depreciation alone, which would create inflationary pressures. This would probably force the Federal Reserve to raise interest rates, which would “crowd out” productive investment. This is not an attractive solution and would likely be unsustainable, requiring eventual policy adjustments to raise national saving – that should have been made earlier with deliberation.

* See Memorandum, page 46.

CED believes, as we have argued previously, that the most reliable policy for increasing national saving is a reduction in the federal budget deficit.⁹² Although the near-term U.S. fiscal outlook has improved recently due to unexpectedly rapid revenue growth, budget projections based on a continuation of current policies, plus an extension of tax cuts scheduled to expire and indexation of the alternative minimum tax, show unified budget deficits of about 1.5-2 percent of GDP in 2012 rising to about 2.5 percent of GDP in 2017, followed by a far more rapid rise in the subsequent decade.

These unified deficits, however, include the social security “surplus,” which peaks in about 2017 and declines sharply thereafter, thereby masking the true long-term fiscal outlook. Excluding social security, projected “on-budget” deficits rise to about 3-3.5 percent of GDP in 2012 and about 3.5-4 percent of GDP in 2017.⁹³ We recommend that these on-budget deficits be eliminated within five years. International imbalances aside, this is necessary on domestic grounds to prepare fiscally for the impending extreme pressures that will arise from increases in health-care costs and population aging, which are projected to raise Social Security, Medicare, and Medicaid expenditures from 7.8 percent of GDP currently to about 10-12 percent in 2017 and 15-20 percent in 2030, under current policies.⁹⁴

Elimination of these deficits will require a comprehensive program of fiscal restraint, undertaken without delay. This is not the place for a detailed budget proposal, but we believe such a program must include reductions in the growth of *all* categories of spending – including defense, homeland security, and domestic spending. A more rigorous prioritization of defense programs will be necessary, and homeland security expenditures must be allocated more efficiently, with less influence from political considerations.⁹⁵ On the domestic side, large reductions will require reforms in the major entitlement programs of Medicare, Medicaid, and Social Security, although other programs, such as agricultural subsidies, certainly can and should be reduced. CED has previously made proposals for entitlement reforms, which we believe should be included in such a fiscal program.⁹⁶

There are strong arguments in principle for preferring spending reductions to tax increases in reducing the fiscal deficit. However, in practice, given the very large increases in spending projected under current policies, it is most unlikely that spending reductions alone can reach these fiscal objectives. A significant increase in revenues is thus likely to be necessary, although the United States must not allow tax increases to become its “first resort.”

On tax policy, the United States should first do no harm and not enact legislation that actually reduces net revenues. CED reaffirms its view that any reduction in revenues below those provided in current law, such as reform of the Alternative Minimum Tax or extension of the 2001-2004 tax cuts, should be “paid for” with other revenue increases. In this context, we welcome Congress’s reinstatement of the so-called “PAYGO” provisions in its budget procedures.^{viii} With respect to additional revenue sources, there are several options that merit attention:

- The current income tax system is complex, inefficient, and inequitable. CED has proposed a tax reform agenda that would improve the income tax system and supplement its revenues with a value added-tax (VAT). (Such a VAT, which would be rebated on exports under WTO rules, might also raise exports directly.)⁹⁷ The administration and others also have made tax reform proposals, which could be modified to provide additional revenues.⁹⁸
- Large petroleum net imports now account for roughly one-third of the U.S. trade deficit. Increased energy taxation, especially on carbon fuels, would directly strengthen the trade balance, indirectly improve the U.S. energy security position, and begin to address the problem of climate change.

CED has not in general been enthusiastic about tax incentives to increase private saving, which we believe are unlikely to raise national saving significantly after accounting for asset substitution and their revenue effects. However, there are now several innovative mechanisms targeted on low- and middle-income

^{viii} These “Pay-As-You-Go” (PAYGO) provisions require that legislation that reduces revenues or increases entitlement spending also include provisions to offset these deficit-increasing changes with additional revenues or reductions in entitlement spending.

workers that hold more promise for raising private saving, and CED recommends their consideration:

- Adopt “automatic” 401(k)s. Legislation enacted in 2006 allows employers to change the default options for 401(k) plans from “opt-in” to “opt-out,” providing automatic enrollment and automatic escalation of contributions when earnings increase. Automatic payroll enrollment in IRAs should also be made available for workers without access to 401(k)s.
- Modify the Savers Credit. The credit is currently non-refundable (thereby excluding about 50 million low-income households with no income tax liability) and has a complex three-tier rate structure covering annual incomes up to \$50,000. A refundable credit at a uniform 50 percent rate, with perhaps a slightly higher eligibility ceiling, would be more effective.

Such changes are estimated to have powerful effects on saving behavior. Taken together, they could increase national saving by about 0.6 percent of GDP.⁹⁹ The combination of these measures and the fiscal policy changes recommended above could increase national saving (allowing for offsets in private saving) by roughly 3 percent of GDP by 2012.

Depreciation of the Dollar

Between February 2002 (when the dollar adjustment began) and July 2007, the real effective exchange rate of the dollar has fallen by about 18 percent.¹⁰⁰ However, this depreciation has taken place predominately against the euro, sterling, and the Canadian dollar. In real terms, the yen has actually fallen against the dollar during this period, while the renminbi is approximately unchanged, as are a number of other Asian currencies linked in differing degrees to the dollar. In addition, most of the dollar depreciation occurred during 2002-2004; the dollar then rose in 2005 before resuming its decline in 2006-2007.

It is quite uncertain how much further the dollar will need to fall as the trade balance adjusts. The IMF report on the 2006 Article IV consultations put the range of likely adjustment at 15-35 percent, while some recent studies show somewhat lower depreciations of roughly 10-20 percent in the context of global adjustments that would reduce the U.S. current account

deficit to 3 percent of GDP.¹⁰¹ Recent IMF research suggests that the required U.S. depreciation may be smaller than previously believed, because of methodological problems with earlier studies.¹⁰² As noted in Part IV above, the required depreciation will be smaller to the degree that supportive policies are adopted and the period of adjustment is longer, to permit changes in the structure of production.

The United States, as the key currency country, should not actively intervene in the exchange markets under normal circumstances. Further, the United States should urge other countries to refrain from intervening to prevent market-driven exchange rate adjustment and, if both parties recognize the need for sizable adjustment, might note the need for such adjustment in its public statements. (See below in relation to Japan.)

Finally, if fiscal policy is tightened to support the adjustment process, as we recommend, monetary policy can be somewhat easier in seeking non-inflationary growth than it otherwise would be, which will tend to assist depreciation and relative price adjustment and to sustain investment.

Our recommended reduction of the U.S. current account deficit by about 3 percent of GDP would be somewhat smaller than the 3.4 percent experienced during the 1987-1991 adjustment episode, and might take place over a slightly longer period of time. Such a reduction corresponds to approximately a one percent reduction in demand for the rest of the world, which would be spread over several years. We believe that this reduction of U.S. demand in the global economy, taken off a rising trend, could be absorbed by the rest of the world, especially if (as we recommend) further measures were taken to increase demand abroad. In any case, reductions in the U.S. budget deficit to prepare for the future are imperative as a matter of domestic policy.

Policies in Other Countries

Detailed recommendations for the adjustment policies of other countries can be best developed by those countries, most usefully as they participate in the multilateral consultations recommended at the end of this section. However, we do indicate below the direction and broad parameters of policy changes that would be helpful to adjustment.

Europe

As a general matter, Europe should recognize that it needs to participate in the adjustment process, and that responsibility does not rest only with the United States, as the largest deficit country, or the Japanese and Chinese, with substantially undervalued currencies.

It will be helpful if European countries pursue policies to strengthen domestic demand while the U.S. tightening of fiscal policy reduces our economy's contribution to global demand. In this context, it is encouraging to see the apparent improvement in growth in Germany and some other European countries, although much of this recent growth is related to higher exports. We recognize that expansionary fiscal policy in Germany and some other (but not all) euro area economies is constrained by their fiscal positions and/or the Stability and Growth Pact, although their budgets would be aided somewhat if growth were to strengthen in several countries together. Fiscal expansion should be possible in some non-euro countries with large surpluses, such as Sweden, Switzerland, and oil producers Norway and Russia.

Because of the constraints on fiscal expansion, it is important that European countries actively encourage stronger growth through structural reforms, as has long been urged by the IMF and OECD.¹⁰³ Reforms to increase competition in product and services markets can promote higher levels of consumer spending, and reforms that raise labor-force participation can also contribute to growth in incomes, consumption and investment. These reforms are clearly desirable for their own sake, even though their impact on demand may be offset to some degree by increases in potential output that diminish any reduction in current account surpluses.

Finally, especially in light of the limitations on fiscal policy and the time required for structural reforms and their effects, it is very important that the European Central Bank pursue a monetary policy that supports growth. We recognize that this may place downward pressure on the euro that would raise current account surpluses, other things being equal. This may be a necessary price to pay for growth; it is in no one's interest to return to widespread economic weakness in Europe.

Since the dollar began to fall in February 2002 the euro has appreciated (as of July 2007) by about 22 percent in real effective terms, and by about 58 percent against the dollar. However, this appreciation was effectively a recovery from the sharp depreciation that occurred from 1999 to 2001. Given this recent appreciation, and the fact that the euro area as a whole is essentially in current account balance, little further effective (trade-weighted) appreciation of the euro may be required for dollar adjustment, assuming that Asian currencies appreciate.¹⁰⁴

However, we believe that effective *depreciation* of the euro is undesirable, and therefore that additional appreciation of the euro against the dollar will be necessary as other countries adjust. This will be especially true if petro-surpluses remain very large and require more extensive global adjustment. There is room for the euro to appreciate further, because in real effective terms the euro is now at the levels of the mid-1990s. We urge the European authorities to refrain from intervention to inhibit such appreciation against the dollar.

Japan

In struggling to end deflation and emerge from its long economic slump, Japan drove interest rates extremely low and intervened actively to hold down the value of the yen to stimulate exports. In the last several years, the Japanese economy has substantially recovered. Although there has not been active exchange rate intervention since March 2004, the yen (which at that time had already depreciated 15 percent in real effective terms from its average in 2000) had by July 2007 depreciated by an *additional* 26 percent, notwithstanding the continuation of very large current account surpluses. The yen even fell by about 11 percent against the declining dollar during this latter period. Its pervasive weakness, in the absence of intervention, is presumably a response to expectations of continuing low interest rates (in spite of a gradual normalization of monetary policy), to the "carry trade" associated with these low rates, and to expectations of future intervention if the yen were to rise significantly.^{ix}

The role of Japan in the adjustment process presents something of a dilemma. It is above all essential that Japan be a source of growth in the Asian and global

^{ix} Investors in the "carry trade" borrow yen (or other currencies) at low interest rates and use the funds to invest in assets in other currencies at higher rates of return. This involves net sales of the borrowed currency.

economies, and employ its economic policies to that end. However, a huge accumulation of government debt resulting from fiscal expansion during the slump, continuing large (albeit declining) structural budget deficits, and an old and aging population indicate the need for continuing fiscal consolidation. (Indeed, the IMF staff has recommended an acceleration of this consolidation beyond that planned by the Japanese government.)¹⁰⁵ This means that monetary policy must continue to support growth, even though the resulting low interest rates tend to hold down the value of the yen. From an international perspective, rather than to accelerate fiscal consolidation, it might be desirable to adjust the policy mix slightly by taking somewhat more gradual steps toward fiscal consolidation and pursuing monetary normalization somewhat more aggressively. As in Europe, it would also be desirable to encourage more domestic demand, including higher consumer spending, by accelerating the pace of structural market reforms. IMF staff work indicates that this could mitigate the impact of fiscal consolidation in raising the current account surplus.¹⁰⁶

In any case, the limitations of using macroeconomic policies alone for adjustment make it essential that the yen appreciate as part of a global adjustment process. The euro has taken a disproportionate share of adjustment against the dollar since 2002. We believe that, with the recent strengthening of the Japanese economy, a reversal of a significant proportion of the yen's 2000-to-mid-2007 37 percent real effective depreciation – a real effective appreciation of perhaps 10-20 percent – is appropriate. (The implied appreciation against the dollar would be substantially larger.) To accomplish this, the Japanese authorities should not intervene to impede appreciation or signal an intention to intervene in the future when the yen begins to rise. This process should be assisted by a public recognition by the Japanese and other authorities that such an appreciation is a welcome and necessary component of global adjustment. Should the yen depreciate very greatly, and such “jawbone” intervention not suffice, Japan and the United States should consider joint direct exchange rate intervention, following the course they pursued in 1998.

China

The Chinese economy has experienced extraordinary progress in the past quarter-century, producing very

rapid aggregate and per capita growth and an enormous reduction in poverty. Although China's growth strategy has been strongly trade-oriented for many years, as Chinese saving has soared and the renminbi has depreciated with the dollar since 2002, export growth has substantially exceeded that of imports, generating large trade and current account surpluses. In 2006 the latter was an extremely large 9.1 percent of GDP, and the trade surplus increased year-to-year by an enormous 84 percent in the first five months of 2007.¹⁰⁷ As discussed in Part III, the surpluses are related to a very high saving rate, which has long been a feature of the Chinese economy. Also contributing more recently have been the rapid incorporation of China into international production networks, with large inflows of FDI, and an undervaluation of the renminbi associated with rapid productivity growth, low inflation, and a peg to the dollar that has been relaxed only slightly since July 2005. China's structural characteristics have thus combined with its policies to produce an extremely export-oriented pattern of growth, characterized by large current and capital account surpluses and very rapid accumulation of reserves, which totaled some \$1.2 trillion in early 2007.

In spite of its economic benefits, this export-oriented growth has created serious problems both internationally and domestically. Internationally, it has contributed to the global imbalances and increasing trade tensions with both advanced and competing lower-wage countries. Domestically, it has suppressed consumption relative to investment and exports, increased income disparities, reduced monetary policy control over an overheated economy, and distorted the composition of investment.¹⁰⁸ Finally, the accumulation of massive reserves that earn only a fraction of the domestic return to capital reflects an enormous misallocation of resources and economic loss to the Chinese people.

The Chinese authorities clearly recognize these problems, and have announced their intention to place more emphasis on domestic demand and consumption, address social and geographic income disparities, and allow more exchange rate “flexibility.”¹⁰⁹ (A further small widening of the trading band for the renminbi was announced in May 2007.) Nevertheless, while recognizing the difficulties in shifting economic direction in such a large, only partly market-driven economy, progress towards the new growth strategy has been very slow.¹¹⁰

We fear that protectionist sentiments in the United States and other higher-wage countries are rising dangerously, and that the risk of instability posed by the international imbalances is also increasing, as China's trade surplus continues to grow. We therefore urge the Chinese authorities to proceed with greater urgency to shift policies in the directions they have indicated. We recognize that such changes must be made carefully, given weaknesses in the financial system and the social and political requirements for continued rapid growth. But we believe that significant and visible efforts by China are needed to head off the dangers we have described. In particular:

- ✦ Public consumption expenditures should be expanded in education, health care, public pensions, and other programs to improve welfare broadly across the population and reduce the need for precautionary saving.
- ✦ Higher private consumption and efficient private investment should also be encouraged through financial reforms that improve the intermediation of private saving. In this regard, the development of efficient private domestic banks, in competition with foreign-owned banks, is critical, as is a modern system of supervision and prudential regulation.¹¹¹
- ✦ There should be significant near-term appreciation of the renminbi, in the range of perhaps 10 percent (against the dollar) over a one-year period, accompanied by a wider permitted trading band to increase flexibility. After an initial adjustment of this magnitude, we would expect to see renminbi appreciation in the range of 5-7 percent per year for several more years. The real, effective renminbi appreciation would be significantly smaller than that against the dollar, especially if (as we strongly recommend) other highly managed Asian currencies are also allowed to appreciate.
- ✦ In the longer term, over a period of some five to ten years, as China vigorously pursues reforms to improve its financial system, it should continue gradually to liberalize its capital account; eventually it should move to a largely market-determined exchange rate that would prevent a reemergence of large external imbalances as its rapid productivity growth continues.

We recognize that the implementation of these policies, and in particular currency appreciation, would probably have a smaller impact on the U.S. current account deficit, and perhaps even on the Chinese surplus, than anticipated in public discussions in the United States (for the reasons noted in Section III). However, the combination of policies would constitute important progress towards reduction of international imbalances and would be strongly in China's own self-interest.

This acceleration of Chinese policy changes conforms in general to previous public recommendations by the IMF.¹¹² However, we believe their timely implementation is more likely in a framework of multilateral discussions organized by the IMF than as a result of bilateral discussions with only the United States. In such a multilateral context, China can provide a powerful confidence-building signal that it recognizes the need for global adjustment and its international responsibilities as a major economic power.

Petroleum Exporters

The extremely large and rapid increase in the trade and current account surpluses of the oil exporters during 2002-2006 ended when oil prices stopped rising in mid-2006, but the surpluses have remained large. After oil price spikes in the past, large current account surpluses fell or even gave way to large deficits in some cases as oil prices came down and spending on imports increased. Although this may happen again, the surpluses are now much larger in real terms than in previous episodes; most analysts expect relatively high oil prices to continue; and the imports of the Gulf Cooperation Council (GCC) countries appear to be growing more slowly, as noted in Part III. These current account surpluses may therefore remain unusually large, and the risk of even higher oil prices and larger surpluses continues because of the political instability in the Middle East.

Middle East oil exporters in general have been increasing public expenditures very rapidly in the last several years. Saudi Arabia and the United Arab Emirates have undertaken large public-private investment programs in both the energy and non-energy sectors to increase oil production and diversify their economies.¹¹³ The rate of increase in their spending is limited by the absorptive capacities of their economies and a prudent regard for the fiscal uncertainties related to the future

of oil prices. Their current expenditure policies may therefore be making as much of a contribution to global adjustment as is feasible; Saudi Arabian imports increased by about 40 percent in 2006, after increasing by 23 percent annually on average in the preceding three years.¹¹⁴

Prior to Kuwait's switch to a peg based on a basket of currencies in May 2006, the currencies of the GCC countries were all pegged rigidly to the dollar, both because of the need for some exchange rate anchor and in contemplation of a planned GCC movement to a single currency in 2010. As the dollar has fallen, the peg has produced an anomalous effective depreciation of these currencies in spite of soaring terms of trade, current account surpluses, and foreign asset accumulation. This has somewhat inhibited adjustment by slowing the growth of imports, especially because GCC imports have a much larger European than U.S. component, although the small amount of domestic production in these economies limits the scope for expenditure-switching to imports. More important, as in the case of China, the dollar peg has reduced the effectiveness of monetary policy and made it harder to control inflation in these booming economies. This was the reason given for Kuwait's recent policy change.¹¹⁵

Presumably, floating exchange rates would prove too volatile for these countries, but we believe some appreciation would be appropriate for both domestic and international reasons. While we understand the reluctance to expose these economies to the "Dutch disease" of uncompetitive overvalued exchange rates, this is not a strong argument for exchange rate depreciation. In fact, domestic inflation may produce effective appreciation that is much harder to control. Because these countries are reconsidering their currency arrangements in any case, those other than Kuwait might consider, as their individual circumstances dictate, either a discrete appreciation of the dollar peg or (as Kuwait has done) a link to a more diversified currency basket weighted towards the euro and Asian currencies that reflect the composition of GCC imports.

There are, of course, a number of non-Middle East oil exporters with large current account surpluses, such as Norway, Russia, Algeria, Nigeria, and Venezuela. These countries should also allow their currencies to appreciate as part of the global adjustment process.

Other Surplus Countries

As noted in Part III, although the United States accounts for nearly two-thirds of global current account deficits, a large number of countries run current account surpluses, even after accounting for the large surpluses of the petroleum exporters, Japan, China, and Germany and the Netherlands within the Euro Area. Taken in the aggregate, these smaller surplus countries constitute a significant proportion of U.S. trade. (For example, Malaysia, Taiwan, Hong Kong, Singapore, Norway, Sweden, Switzerland, and Russia together have a larger weight in the Federal Reserve's broad real dollar index than either China or Japan.)¹¹⁶

It is difficult to generalize about a large group of countries, where circumstances and competing objectives differ widely. However, where circumstances permit, these smaller countries, some of which are running extremely large surpluses relative to their economic size, also should allow their currencies to appreciate and attempt to raise domestic demand. Many smaller surplus economies have become more dependent on external demand, with lower growth of investment and consumption, than prior to the currency crises of the late 1990s. Economic, financial, and governance reforms can help raise investment rates in some of these countries. Without adjustment in the smaller countries, exchange rate adjustments of the major currencies may be larger, and possible disruptions to output and employment more costly for all nations.

In East Asia, Hong Kong, Malaysia, Taiwan, and Singapore, like China, have maintained fixed or tightly managed links to the dollar, and developed large current account surpluses (especially relative to their GDPs), and extraordinarily large reserve accumulations for relatively small countries. It would be helpful for those countries that have tightly managed floating exchange rates to allow their currencies to appreciate, but this is unlikely unless China does so. There is, therefore, a regional problem of East Asian adjustment, centered on China, which provides a very strong rationale for multilateral consultations and cooperation. Hong Kong, which has long operated a fixed rate through a currency board, may, of course, wish to maintain that arrangement, in which case a real appreciation of the currency is likely to take place ultimately through domestic inflation.

Other Measures to Reduce Risk

As noted in Part IV, large and growing current account surpluses in recent years have given rise to an enormous increase in official foreign exchange holdings. At the same time, other currencies, and in particular the euro, have emerged as alternatives to the dollar in these official portfolios. Assets denominated in currencies other than the dollar are also likely to find a place in the portfolios of the national investment authorities that more countries with very large reserves are now using as a means of diversifying, and seeking higher returns on, their foreign asset holding.

While the currency composition of official foreign exchange portfolios has been quite stable, and diversification has been limited, the potential for larger exchange market volatility or sudden exchange rate movements as a result of portfolio changes, or the rumor of such changes, has clearly increased. We recommend that major holders of foreign exchange act to minimize such risks by voluntarily adhering to an international reserve diversification standard. In accepting such a standard, countries would agree to (a) routinely disclose the currency composition of their foreign exchange portfolios, and (b) make any adjustments of the currency composition of their portfolios gradually. We believe the additional transparency and assurance of gradual adjustment provided by such a standard would inspire confidence and reduce the risk of disruption in the foreign exchange markets.¹¹⁷

Multilateral Consultations and a More Proactive IMF

The IMF convened multilateral consultations in 2006 among the United States, Europe, Japan, China, and Saudi Arabia (with IMF staff) to address the issue of large international imbalances. This group reported to the IMF's International Monetary and Financial Committee (IMFC) on the outcome of its discussions on April 14, 2007, and each of the participants listed a number of policies it was pursuing, or contemplated pursuing, that are consistent with the overall adjustment strategy that had been endorsed by the IMFC in September 2006.¹¹⁸

This has been an important first step in developing a framework for multilateral consultations. Importantly, the consultations were convened by the IMF, and

the participants agreed upon a joint report. In these respects the process broke new ground.¹¹⁹ The policies enumerated in the report, however, appear to be principally those that these governments had adopted, or set as general goals, prior to the consultations process. Thus, the United States says it will eliminate the budget deficit by 2012; China suggests that exchange rate flexibility will gradually increase; and the Euro Area indicates again its support for the Lisbon Strategy of market reforms. Notably absent is any discussion of the more extensive exchange rate changes that we believe are necessary for adjustment. While the development of these multilateral consultations has been constructive, it is not clear that they are likely to affect the policies of the participants significantly; in fact, the U.S. Treasury Secretary denied that their purpose was "to produce joint policy commitments."¹²⁰ The participants indicated no firm intention of meeting again, but agreed to do so "when developments warrant."

In spite of these consultations, the international economy does not currently have established, well-functioning arrangements for multilateral cooperation on adjustment policies. Under its *Articles of Agreement*, the IMF has a mandate to oversee the effective operation of the international monetary system and the compliance of members with their obligations to pursue policies that promote international stability. The IMF exercised this mandate quite actively under the Bretton Woods gold-exchange standard, when the discipline imposed by fixed exchange rates provided it with considerable leverage over national policies. However, during the past three decades, the exchange rates of major currencies largely have been floating, and the IMF has little power beyond that of "moral suasion" to affect the policies of countries that do not need to borrow, in particular the large, systemically important economies such as the United States, Japan, China, and the larger European countries.

The IMF has long conducted "surveillance" and annual bilateral consultations with member countries individually, and in the process has provided policy advice, including advice on systemic adjustment and stability. However, policy implementation depends entirely upon a country's political "buy-in," and this inevitably has required direct discussions and negotiations among the major economic powers. Not surprisingly, therefore, policy coordination has emerged principally at times

of crisis under large-power agreements by, for instance, the G-10 (Smithsonian Agreement, 1971), G-5 (Plaza Accord, 1985), or G-7 (Louvre Agreement, 1986). While these political groups have acted effectively, they have operated largely outside the IMF. The IMF has not played (or been allowed to play) a major role in organizing international cooperation at such times of crisis.¹²¹

The IMF, through its charter, membership, and expertise, is uniquely equipped to conduct surveillance, organize multilateral consultations, and provide advice on global imbalances and similar international economic and financial issues. Obviously, only governments can perform the task of initiating and implementing policies to facilitate adjustment. But we believe the IMF can and should be more proactive as a *catalyst* for consultations on, and implementation of, adjustment policies. Indeed, the IMF's own Office of Independent Evaluation recently issued an evaluation of the IMF's exchange rate policy advice during 1999-2005 that found the "IMF's global responsibilities were often perceived to be underplayed, particularly in being a ruthless truth-teller to the international community and a broker for international policy coordination."¹²² The evaluation found that insufficient attention was given to "policy spillovers" and multilateral and regional perspectives in its bilateral surveillance activities.¹²³ Since the release of that report, the IMF's Executive Board has issued a new *Decision on Bilateral Surveillance* that replaces its 1977 policy statement on exchange rate surveillance with a broader set of rules that explicitly take into account the effect of a country's economic and financial policies (including exchange rate policy) on external stability, and provides guidance on the type of actions that would constitute "currency manipulation."¹²⁴

We commend this new action by the IMF. The *Decision on Bilateral Surveillance* complements the recent multilateral consultations in taking initial steps towards a more pro-active multilateral role. However, for the IMF to play this role in a continuing and systematic way, it will require both leadership and vision on the part of the major governments systemically involved with the imbalances. If a multilateral process is to succeed, representatives from some key countries must step forward as "champions," and be willing to commit their governments to the consultation process and to

implementation of the necessary adjustment policies. Needless to say, U.S. leadership in urging multilateral adjustment policies will be credible and effective only if the United States implements reductions in its own fiscal deficit.

As we have noted, the process of adjustment of the current large imbalances may take a long time. In addition, as discussed in Part III, the ongoing and long-term process of globalization can be expected to increase the size of imbalances in both current and private capital accounts. This is the likely result of the increased specialization in the trade of both goods and services and assets, involving both the reorganization of international production and portfolio diversification. These larger imbalances may or may not turn out to be benign and reflect new international equilibria in a more interdependent world. But, in any case, they will hold the *potential* for greater instability. We therefore believe that a regular and ongoing process of multilateral surveillance and consultations, convened by the IMF, should be organized by the IMF and its shareholders.

The composition of such an ongoing "international consultative group," and its relationship to the broader IMF membership, will have to be worked out. The composition might change to reflect new problems and circumstances. A small working group of roughly the size recently convened may be necessary for the core consultations to be effective. However, in order to produce the necessary political support, a mechanism that also involves the broader IMF membership and especially other very large emerging economies – not only China, but also India, Brazil, and Russia – will be needed. Furthermore, although the recent consultations involved a single seat for the Euro Area, European governments make fiscal policy decisions, so that major European governments will have to be involved. It will not be an easy task to devise an appropriate and effective mechanism. However, we hope that by keeping the arrangements relatively fluid, the composition of a consultation group or groups can be separated from the ongoing debate about a more fundamental reform of IMF governance, which may require considerable time.¹²⁵

We believe that such an ongoing multilateral consultation process would improve on current arrangements by making it clear that adjustment is a collective

enterprise, and by effectively “rewarding” governments that are seen to participate in the program and contribute to international stability. Our recommendations should be seen as directional objectives, likely to be implemented over a period of several years, with some participants necessarily more constrained in their policy contributions than others. Such a multilateral process will not replace bilateral discussions

and negotiations of policy differences, which may be necessary for both substantive and political reasons. But it may reduce some of the political difficulties and tensions characteristic of bilateral negotiations and the associated accusations, pleas, threats, and denials that often surround disagreement on national economic policies.

VI. Conclusion

This policy statement has examined a new phenomenon in the international economy, the unprecedented size and duration of very large imbalances between the current account deficits of capital importing countries – preeminently the United States – and the counterpart surpluses of large capital exporters, among them China, Japan, Germany and the Netherlands, a number of other smaller Asian economies, and the fuel exporters. We believe these imbalances reflect a number of factors. Of primary importance are the explosion of financial globalization, with its cross-border asset trade and portfolio diversification; the structural differences between low saving in the United States and high saving abroad; and policies that interfere with the market adjustment of these imbalances, including massive exchange rate intervention in China and some other Asian economies.

While large imbalances to some degree reflect increased globalization, they also create risks for the United States and other countries – especially when their size is enlarged by inappropriate policies that impede international adjustment. One major risk is the growth of protectionism in the United States and other advanced countries, where wages are under pressure from foreign competition. Another important risk is the possibility of “disorderly adjustment” – sharp changes in exchange rates, prices and interest rates, and possibly economic growth – that might ensue if investors failed to finance ever-larger U.S. current account deficits. Although we believe that an orderly market-led adjustment of the imbalances is the most likely outcome, we also believe it would be imprudent to ignore these risks.

We have therefore made recommendations for directional adjustments in policy by the United States

and other countries, over the next several years, which would reduce these risks. In general, this would involve an incremental rebalancing of global demand from the United States towards the rest of the world (and especially Asia), and measures to increase the response of exchange rates to market forces. We have also proposed that an ongoing international consultative process, convened by a more pro-active IMF, would improve the likelihood that governments would implement such adjustments in policy.

The process of globalization has resulted in unparalleled economic growth and improved standards of living for people in many parts of the world. But with ever-increasing divisions of labor, capital and specialization across countries, globalization is likely to continue to create imbalances from time to time because trade and capital flows are not symmetrical among the world’s trading partners. It is important not to allow these imbalances to precipitate crises through disorderly adjustment or to become an impediment to extending the benefits of globalization as widely as possible.

The CED calls upon the leadership of the key countries and of multinational institutions, especially the IMF, to give greater attention to international imbalances and the risks that accompany them. World leaders need to take both global and national considerations into account as they develop and implement policies that will adequately address imbalances, so that adjustments will be facilitated with minimum risks. The CED believes that the adoption of these recommendations would improve the prospects for a well-functioning and prosperous global economy.

Memoranda of Comment, Reservation or Dissent

Page 35, James Q. Riordan, with which John White has asked to be associated.

The report addresses critical issues and offers many sound proposals. Unfortunately it does not adequately deal with the need to increase U.S. savings – especially private savings. Our tax system contributes to the problem because it favors consumption over savings. CED’s paper, “New Tax Framework,” (restated on pages 35-37) does little to correct this unfortunate bias against savings. Fundamental changes are needed. The premature and double taxation of saving need to be ended. Tinkering with subsidies for low income non-taxpayers will not do the job. It is a minor rearrangement of the deck chairs on our savings Titanic.

Endnotes

- 1 The total of recorded current account deficits systematically exceeds total surpluses by about .3 percent of world GDP indicating that the measured imbalances are somewhat overstated. IMF World Economic Outlook Database, April 2007 Edition, <http://www.imf.org/external/pubs/ft/weo/2007/01/data/index.aspx> (average of the world current account balance over world GDP from 2000-2005). In 2005 the world had a recorded current account deficit equal to \$45.4 billion.
- 2 For the absence of regular debtor to creditor progression, see William R. Cline, "The International Debt Cycle and the United States as an External Debtor," chap. 1 in *The United States as a Debtor Nation* (Washington, DC: Peter G. Peterson Institute for International Economics, Center for Global Development, 2005).
- 3 Edwin M. Truman, "Postponing Global Adjustment: An Analysis of the Pending Adjustment of Global Imbalances," *Working Paper Series* (Peter G. Peterson Institute for International Economics), 2005, no. 6: p. 12.
- 4 *Ibid.*, pp. 2-3.
- 5 Catherine Mann, *Is the U.S. Trade Deficit Sustainable?* (Washington, DC: Peter G. Peterson Institute for International Economics, 1999).
- 6 On the export slowdown, see Martin Neil Baily and Robert Z. Lawrence, "Competitiveness and the Assessment of Trade Performance," chap. 10 in *C. Fred Bergsten and the World Economy*, ed. Michael Mussa (Washington, DC: Peter G. Peterson Institute for International Economics, 2006), pp. 235-236; Goldman Sachs, U.S. Economic Research Group, "The Case of the Missing Exports," *US Economics Analyst*, 2006, no. 06/08: pp. 4-6.
- 7 IMF, *World Economic Outlook, Spillovers and Cycles in the Global Economy, April 2007* (Washington, DC: IMF, 2007), pp. 248-252, tables 26-28.
- 8 Philip R. Lane and Gian Maria Milesi-Ferretti, "International Financial Integration," *IMF Staff Papers* 50, Special Issue (2003); Philip R. Lane and Gian Maria Milesi-Ferretti, "A Global Perspective on External Positions," chap. 2 in *G7 Current Account Imbalances: Sustainability and Adjustment*, ed. Richard H. Clarida (Chicago: University of Chicago Press, 2007), pp. 67-98.
- 9 The classic paper demonstrating this home bias was Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *The Economic Journal* 90, no. 358 (1980): pp. 314-329. There is recent evidence that this home bias has declined, see endnote 23.
- 10 The "official" inflows are understated because significant dollar assets of the governments of oil exporting countries are held indirectly through European or other non-official intermediaries. In some countries, such as Singapore, Saudi Arabia, and other oil exporting countries, substantial dollar claims are also held by quasi-official investment entities and do not appear as official reserve holdings. Matthew Higgins, Thomas Klitgaard, and Robert Lerman, "Recycling Petrodollars," *Current Issues in Economics and Finance* (Federal Reserve Bank of New York) 12, no. 9 (2006).
- 11 Measurements of the NIIP with direct investment at market value, which are used throughout this report, are available only from 1982. However, the NIIP with direct investment measured at current cost, peaked in 1980 and then began its decline. U.S. Bureau of Economic Analysis, "International Investment Position of the United States at Yearend, 1976-2006," International Investment Position Table 2, 2007, <http://www.bea.gov/international/index.htm>.
- 12 Cline argues that higher returns for U.S. held assets occur only in FDI; see Cline, *Debtor Nation*, p. 67, table 2A.1. However, Lane and Milesi-Ferretti indicate that the U.S. has sometimes enjoyed higher differential returns in other asset categories. Lane and Milesi-Ferretti, "Global Perspective on External Positions," tables 3-5.
- 13 U.S. Bureau of Economic Analysis, "Changes in Selected Major Components of the International Investment Position, 1989-2006," International Investment Position Table 3, 2007, <http://www.bea.gov/international/index.htm>; Cline, "Valuation Effects, Asymmetric Returns, and Economic Net Foreign Assets," chap. 2 in *Debtor Nation*; Lane and Milesi-Ferretti, "Global Perspective on External Positions." The "other" valuation adjustments in the data, which have consistently raised the NIIP position, have averaged nearly \$70 billion annually since 1988. They reflect differences between market and book values on the purchase, sale, liquidation, and capital gains and losses of foreign affiliates and other

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- revaluations and changes in classification and coverage. See Jeffrey H. Lowe, "Foreign Direct Investment in the United States: Detail for Historical-Cost Position and Related Capital and Income Flows for 2002-2005," *Survey of Current Business* 86, no. 9 (2006): p. 37.
- 14 Cline, *Debtor Nation*, p. 157.
- 15 Barry Eichengreen, "The Blind Men and the Elephant," *Issues in Economic Policy* (Brookings Institution), no. 1 (2006).
- 16 Richard Cooper argues that U.S. saving is substantially understated in our current national accounting framework, which does not recognize, for instance, that expenditures on consumer durables and, especially, education and the creation of knowledge constitute investment and saving. This is important in considering the adequacy of saving and capital formation with regard to future living standards. However, even if this mismeasurement has become increasingly important (as seems likely), the reclassification of consumption expenditures would increase both domestic investment and saving, and would not affect the gap between the two that contributes to the current account deficit. It would, however, suggest a different characterization of the trends underlying the gap. Richard N. Cooper, "Understanding Global Imbalances" (speech, Conference Series 51: Global Imbalances - As Giants Evolve, Federal Reserve Bank of Boston, Chatham, MA, June 14-16, 2006).
- 17 IMF, *People's Republic of China: 2006 Article IV Consultation – Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion* (Washington, DC: IMF, October, 2006), p. 38, table 8; Ben S. Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit" (speech, Homer Jones Memorial Lecture, Federal Reserve Bank of St. Louis, St. Louis, MO, April 14, 2005); IMF, "Global Imbalances: A Saving and Investment Perspective," chap. 2 in *World Economic Outlook, Building Institutions, September 2005* (Washington DC: IMF, 2005); Raghuram Rajan, "Perspectives on Global Imbalances" (speech, Global Financial Imbalances Conference, Chatham House, London, January 23, 2006).
- 18 Rajan, "Perspectives on Global Imbalances," chart 2.
- 19 Cooper, "Understanding Global Imbalances."
- 20 IMF, "Global Imbalances: A Saving and Investment Perspective;" IMF, *World Economic Outlook, Financial Systems and Economic Cycles, September 2006* (Washington, DC: IMF, 2006), table 43.
- 21 IMF, *World Economic Outlook, September 2006*, p. 230, table 28.
- 22 Lane and Milesi-Ferretti document the increasing dispersion of international net asset positions and the even faster growth of gross positions (asset trade). Lane and Milesi-Ferritti, "Global Perspective on External Positions."
- 23 See endnote 9 for a description of the "home bias." The correlation between saving and investment rates within each region has fallen from 0.6 in 1970-96 to 0.4 in 1997-2004. IMF, *World Economic Outlook, September 2005*, p. 95; Alan Greenspan, "Global Finance: Is it Slowing?" (speech, International Symposium on Monetary Policy, Economic Cycle, and Financial Dynamics, Banque de France, Paris, France, March 7, 2003).
- 24 Pierre-Olivier Gourinchas and H el ene Rey, "From World Banker to World Venture Capitalist: U.S. External Adjustment and the Exorbitant Privilege," chap. 1 in Clarida, *G7 Current Account Imbalances*, pp. 11-55; Ricardo J. Caballero, Emmanuel Farhi, and Pierre-Olivier Gourinchas, "An Equilibrium Model of 'Global Imbalances' and Low Interest Rates," *NBER Working Paper Series*, no. 11996 (February 2006).
- 25 Following Richard Cooper's rough calculation, the "fully globalized" allocation of new saving would produce a net capital inflow into the U.S. of about 0.9-1.0 trillion, more than enough to finance the \$0.8 trillion current account deficit. Actual private capital flows ran about one-third (outflows) to one-half (inflows) of these idealized amounts. Cooper, "Understanding Global Imbalances," p. 12.
- 26 Larry H. Summers, "Reflections on Global Account Imbalances and Emerging Markets Reserve Accumulation" (speech, L. K. Jha Memorial Lecture, Reserve Bank of India, Mumbai, India, March 24, 2006; Dani Rodrik, "The Social Cost of Foreign Exchange Reserves," *NBER Working Paper Series*, no. 11952 (January 2006).
- 27 Olivier Jeanne and Romain Ranciere, "The Optimal Level of International Reserves for Emerging Market Countries: Formulas and Applications," *IMF Working Paper*, 2006, no. 229.

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- 28 Cooper, "Understanding Global Imbalances."
- 29 World Economic Forum, "Global Competitiveness Index 2006-2007: Top 50," Country Rankings, 2006-2007, <http://www.weforum.org/en/initiatives/gcp/Global%20Competitiveness%20Report/index.htm>.
- 30 Higgins, Klitgaard, and Lerman, "Recycling Petrodollars," p. 6; Martin Feldstein, "Why Uncle Sam's Bonanza Might Not Be All That It Seems," *Financial Times*, January 10, 2006, p. 19.
- 31 In 2001-2006 fixed non-residential investment averaged 10.4 percent of GDP; the decade averages for the 1970s, 1980s, and 1990s were all in the 11-12 percent range. U.S. Bureau of Economic Analysis, "National Income and Product Accounts Tables," tables 1.1.5 and 5.2.5, 2007, <http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N>.
- 32 IMF, *World Economic Outlook, April 2007*, p. 14; IMF, *Global Financial Stability Report, Market Developments and Issues, April 2007*, pp. 15-16.
- 33 Goldman Sachs, US Economic Research Group, "Turns of Trade," *US Economic Analyst*, 2007, no. 07/22; Cline, *Debtor Nation*, p. 29, fig. 1.11. The seminal study of the asymmetry between import and export responsiveness to growth at home and abroad is Hendrick S. Houthakker and Stephen P. Magee, "Income and Price Elasticities in World Trade," *Review of Economics and Statistics* 51, no. 2 (1969): pp. 111-125.
- 34 IMF, *World Economic Outlook, September 2005*, p. 99, table 2.2.
- 35 Baily and Lawrence, "Competitiveness and the Assessment of Trade Performance," pp. 232-234.
- 36 IMF, *World Economic Outlook, Globalization and Inflation, April 2006* (Washington, DC: IMF, 2006), p. 78, fig. 2.5.
- 37 Higgins, Klitgaard, and Lerman, "Recycling Petrodollars," pp. 1-2.
- 38 IMF, statistical appendix to *World Economic Outlook, April 2007*, pp. 250-257, tables 27, 28, and 30.
- 39 The calculation applies 2001 unit values to 2006 volumes of imports and exports of petroleum products. U.S. Census Bureau, "FT900: U.S. International Trade in Goods and Services," exhibits 9 and 17, March 2002 and March 2007, <http://www.census.gov/foreign-trade/www/press.html>.
- 40 Energy Information Administration, "U.S. Data Projections," Oil (Petroleum), Prices, yearly forecasts to 2030, <http://www.eia.doe.gov/oiaf/forecasting.html>.
- 41 Michael P. Dooley, David Folkerts-Landau, and Peter Garber, "The Revived Bretton Woods System," *International Journal of Finance and Economics* 9, no. 4 (2004): pp. 307-313; Eichengreen, "Blind Men and the Elephant."
- 42 IMF World Economic Outlook Database, April 2007.
- 43 GDP at exchange rate conversion. IMF estimates; for investment rates, saving rates, and exports see: IMF, *People's Republic of China: 2006 Article IV Consultation*, p. 38, table 8; for reserves see IMF, statistical appendix to *World Economic Outlook, April 2007*, p. 269, table 35; for GDP and current account data see IMF World Economic Outlook Database, April 2007.
- 44 Dooley, Folkerts-Landau, and Garber, "The Revived Bretton Woods System."
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2000 L Street N.W., Suite 700
Washington, D.C. 20036
202-296-5860 Main Number
202-223-0776 Fax
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