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Sustaining Global Growth while Reducing External Imbalances

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With renewed deterioration of the external balance in recent months, it now appears that the US current account deficit will exceed $600 billion in 2004—or over 5½ percent of US GDP. Plausible estimates suggest that, at present exchange rates and with US economic growth continuing to exceed that of most other industrial countries, the US external deficit could reach $1 trillion or more by the end of this decade. The cumulative effect of the persistent external deficits of the past 30 years (which have averaged about 3 percent of US GDP) is already reflected in the transformation of the United States from the world's largest net creditor to the world's largest net debtor. Specifically, the United States has shifted from a position in the mid-1970s when US net external assets exceeded 25 percent of US GDP to a position where US net external liabilities now exceed 25 percent of annual GDP. If current account deficits persist at a level of more than 5 percent of GDP (and rising), the US external liability position is on track to reach 50 percent of GDP within a decade and to exceed 100 percent of GDP within the next 25 years.

It is possible that US current account deficits of 5 percent or somewhat more of US GDP could persist for a while longer. And there is no indication yet that the prospect that US net external liabilities might reach 50 percent of US GDP is a cause for fright and likely instability in global financial markets. However, there is good reason to doubt that US current account deficits of 5 percent or more of GDP can be sustained indefinitely

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or that US external liabilities can expand up to and beyond 100 percent of GDP—a record never achieved by any significant country. Almost surely, adjustments will occur—in the United States and the rest of the world—that will forestall long-run deterioration of the US external position of this extreme magnitude.

Sooner or later, one way or another, a substantial downward correction of these imbalances will come. Whenever and however it comes, the correction will necessarily involve three broad and interrelated macroeconomic developments: (1) The US dollar will need to depreciate substantially in real terms against the currencies of most other countries in order to shift the distribution of total world demand for goods and services toward those of the United States and away from those of the rest of the world. (2) In the United States, domestic demand will need to grow more slowly than domestic output in order to make room for an expansion of US net exports; and as logically necessary counterparts of this downward adjustment of US demand relative to output, there must be a corresponding improvement in the US national savings/investment balance and an equivalent reduction in the net use of foreign savings by the United States. (3) In the rest of the world, domestic demand will need to grow more rapidly than domestic output in order to allow for the reduction of net exports that corresponds to the improvement of US net exports; and as logically necessary counterparts of this upward adjustment of demand relative to output, there must be a corresponding deterioration in the savings/investment balance and an equivalent reduction in the net outflow of capital to the United States from the rest of the world.

The key concern is that these adjustments need not occur in an entirely salutary manner. Economic activity in some countries (particularly in the rest of the world) could be persistently depressed to levels meaningfully below potential, while excessive demand pressures in other countries (notably the United States) could push up inflation and necessitate monetary policy tightening that would depress investment and impair longer-term growth. Indeed, some experienced observers, including Paul Volcker, fear that if the problem of the large US external deficit is not vigorously addressed, there is substantial risk of a major global financial crisis.

Thus, the crucial issue for policymakers—in the United States and the rest of the world—is what responses would be appropriate to facilitate the gradual and orderly reduction of the US external deficit in a manner that is consistent with achieving the most fundamental objectives of economic policy. Specifically, the challenge is to ensure that the timing and method of this inevitable correction in the US external imbalance (and its counterpart for the rest of the world) is such as to support, as best as possible, continued noninflationary growth at the maximum sustainable rate throughout the world economy. Most importantly, the challenge is to avoid an abrupt and disorderly correction of external imbalances, which would disrupt world financial markets and depress global economic activity—

a danger that becomes more acute as external imbalances continue to accumulate at an accelerating rate.

After reviewing the causes behind the deterioration of the US external balance and the reasons why the present (and probably growing) imbalance is not likely to be sustainable in the longer term, this chapter looks specifically at policy adjustments, first in the industrial countries and then in the developing countries, that would facilitate a constructive and orderly reduction of international payments imbalances. To conclude this introduction it is useful to anticipate briefly the content of that discussion.

Among the industrial countries, the United States faces the task of slowing the growth rate of domestic demand below the growth rate of output, particularly in circumstances where the dollar has depreciated sufficiently to make net exports a positive contributor to GDP growth. Fiscal consolidation, which is needed for its own sake to restore longer-term fiscal sustainability, can aid in restraining the growth of domestic demand and can reduce the need for restrictive monetary policy to play this role as US output rises to its potential level. An easier monetary policy (than would otherwise prevail) should, in turn, contribute to a necessary downward correction in the foreign exchange value of the dollar, which will assist in improving the US external balance.

For other industrial countries, the principal policy challenge will probably be to achieve and sustain adequate growth of domestic demand. In these countries, domestic demand growth over the past decade has generally needed a boost from improving net exports but will now need to compensate for a deterioration of net exports that is a necessary (partial) counterpart to improvement in the US current account. Moreover, unlike the United States where fiscal consolidation, which is needed for its own sake, can help to curb domestic demand growth and thereby contribute to the reduction of external imbalances, in other industrial countries expansionary fiscal policies are generally not a desirable means of boosting domestic demand growth. More vigorous efforts at structural reform in most of western Europe and Japan are highly desirable because they will aid growth in the longer term, thereby also contributing to somewhat stronger growth of demand for US exports. But in the medium term of the next few years, structural reforms are unlikely to do much to support adequate growth of domestic demand. That policy task will fall largely to the monetary authorities, who will have to pay careful attention to the need for adequate demand growth, as well as to any dangers of a resurgence of inflation.

Aside from Japan, industrial countries generally allow market forces to determine exchange rates. This approach has permitted a significant downward correction of the US dollar since early 2002. Further (hopefully gradual) market-determined adjustments in this direction are likely to be needed in the medium term and should not be resisted. For Japan, the policy of vigorously resisting appreciation of the yen through occasion-

ally massive official intervention was desirable when the Japanese economy was very weak. But as the Japanese economy has gathered strength, this policy is no longer defensible. The Japanese authorities should allow the yen to appreciate—especially in the context of a broader necessary appreciation of the currencies of most Asian developing countries.

For developing countries, the issue of exchange rate adjustments is generally a more pressing policy issue than for industrial countries. This is so both because many developing countries actively manage their exchange rates (in contrast to the laissez-faire policies of most industrial countries) and because the exchange rates of most developing countries (including those with strong balance-of-payments positions) have not adjusted upward against the US dollar—as will clearly be needed as part of the process of reducing the US external deficit. At present, this issue is most pressing for emerging Asia—certainly including, but not limited to, China.

Because the situations of individual developing countries differ considerably, little can be said in general about policies that may be needed to support demand growth in the face of some deterioration of net exports (as a partial counterpart to the necessary improvement in US net exports). Probably this should be less of a problem for most developing countries than for most industrial countries because underlying forces of economic growth are generally stronger in developing countries.

One general concern that bridges the interests of developing and industrial countries is the need for more reliable—less crisis-prone—mechanisms to facilitate international capital flows from industrial to developing countries. Here, the bedrock requirement is for developing countries to pursue economic policies that support sustainable growth and avoid excessive risks from either poorly run domestic financial systems or imprudent foreign borrowing. But, as revealed in the series of disastrous emerging-market financial crises of the past decade, the international mechanisms for helping to avoid or resolve such crises can use some work. With more reliable mechanisms to facilitate capital flows to developing countries, these countries should be able to grow more rapidly and (as a secondary benefit) be able to contribute more constructively to sustainable reduction of global payments imbalances.

Forces Behind the Recent Rise of the US External Deficit

As a prelude to the discussion of policies that might facilitate an orderly reduction of present international imbalances, it is useful to review briefly the causes and consequences of the US external deficit—and the corresponding surplus of the rest of the world—as they have evolved over the past quarter century. These developments involve complex interactions among the broad macroeconomic forces that have shaped the course of the world economy. In light of these developments in the global economy,

it is important to recognize that the generally growing and fluctuating US external imbalance has, in several important respects, been beneficial both to the United States and the rest of the world.

From the end of World War I through the 1960s, the US current account was in persistent surplus. As a consequence, the United States accumulated net financial claims on the rest of the world and ultimately became the world's largest net creditor nation. By the late 1960s, however, the US external payments surplus began to erode, and a substantial depreciation of the US dollar (associated with the collapse of the Bretton Woods system of pegged exchange rates) was needed to restore a US external payments surplus.

Emergence of the "Twin Deficits" During the 1980s

During the 1980s, the US current account fell into substantial and persistent deficit. The relatively strong recovery of the US economy following the worldwide recession of the early 1980s (especially as measured by growth of domestic demand) was one important force behind this deterioration in the US current account. But the most important proximate cause of the current account deterioration was the spectacular appreciation of the US dollar between 1980 and early 1985—the lagged effects of which induced further deterioration in the US current account through 1987.

Several factors lay behind the exceptional strength of the dollar in the early to mid-1980s and may be regarded as underlying causes of the deterioration in the US current account that operated through the mechanism of dollar appreciation. In particular, the strength of the US economic recovery and the restoration of confidence in prospects for the US economy encouraged a sharp rise in investment spending in the United States. When domestic savings proved inadequate to finance this surge of investment, foreign savings was called upon to fill the gap. And foreign investors enthusiastically poured funds into the United States, thereby contributing to upward pressure on the dollar.

In this connection, the US macroeconomic policy mix of the early 1980s—featuring tight monetary and loose fiscal policies—undoubtedly contributed to dollar appreciation and to the deterioration of the US current account. This policy mix raised directly the demand for the use of foreign savings to finance increased government deficits, and it tended to raise US real interest rates, which made it more attractive for foreigners to move funds into the United States. Probably more importantly, the success of the policy mix both in bringing a rapid and sustained victory over inflation and in promoting a vigorous economic recovery helped to stimulate both demand for the use of foreign savings to finance US investment and the appetite of foreign investors to supply the requisite funds.

More simplistically, the apparent coincidence of the rise in the US current account deficit and the rise in the structural (or cyclically adjusted) fiscal deficit in the early 1980s encouraged some analysts to proclaim that these were really "twin deficits." The clear implications of this simplistic view were first that the rise of the structural fiscal deficit was the primary cause of the deterioration in the current account and second that reducing the fiscal deficit was the surefire way to reduce, probably about one-for-one, the current account deficit. Subsequent developments, however, would dispel these simplistic notions.

The depreciation of the US dollar from early 1985 through 1987 effectively reversed the massive appreciation of the early 1980s. With the usual lag of about two years, the US current account deficit peaked and began to turn downward by 1988. The current account deficit generally continued on a downward course over the next three years and briefly shifted into surplus in early 1991 (thanks partly to transfer payments received by the US government in connection with the Gulf War). The continued relatively low value of the US dollar and the relative weakness of demand growth in the US economy after 1988 in comparison with growth in key trading partners clearly contributed to this improvement in the current account. Notably, the actual fiscal deficit worsened considerably between 1987 and 1991, and the structural fiscal deficit showed no meaningful improvement—pointing to the fallacy in the simplistic notion of the "twin deficits."

As the US economy recovered from the recession of 1990–91, the US current account again fell into significant deficit, but this deficit remained below 2 percent of US GDP through 1997—well below the peak of nearly 4 percent of GDP in 1987. Recovery in the growth of US domestic demand after the recession was certainly one factor contributing to the deterioration in the US current account. So too was the weak performance of other industrial countries. In particular, boosted by the bubble economy, Japan continued with over 4 percent real GDP growth through 1991; but growth then fell off sharply and generally remained very sluggish under the impact of the collapse of the bubble. In western Europe, growth received a strong boost in 1990–92 from the effects of German policies pursued in connection with reunification. As a consequence, the recession that hit the United States in 1990–91 did not start until two years later in continental Europe—by which time the tightening of monetary policy by the Bundesbank to combat rising inflation helped to induce a general economic slowdown in Europe.

Notably, the foreign exchange value of the US dollar remained weak through the first half of the 1990s, reaching all-time lows against the yen and the deutsche mark in early April 1995. This weakness of the dollar (which is partly attributable to the relative ease of US monetary policy in comparison with Bundesbank policy) contrasts dramatically with the spectacular strength of the dollar in the initial period of recovery from the

recession of the early 1980s. And this difference in the behavior of the dollar in the recovery from the 1990–91 recession helps to explain why the deterioration in the US current account was smaller on this occasion.

In this connection, it is also relevant that US fiscal policy was pursuing a course of gradual consolidation during the 1990s, in comparison with the fiscal expansion of the early 1980s. Also, while the Federal Reserve tightened US monetary policy sharply in 1994 as a preemptive move against risks of rising inflation, this monetary tightening was nothing compared with the massive tightening that the Federal Reserve had to pursue to bring down rapid inflation at the start of the 1980s. Thus, the stances of US monetary and fiscal policies in the early 1990s were, for good reasons, very different from the policy mix of a decade earlier. Not surprisingly, this difference in macroeconomic policies was reflected in the more moderate behavior of the dollar and of the US current account in the first half of the 1990s in comparison with what happened a decade earlier.

From its trough in early 1995, the dollar generally appreciated throughout the remainder of the 1990s (for a cumulative rise of about 40 percent), reaching a broad and flat peak (measured in real effective terms) from roughly mid-2000 through early 2002. With the usual two-year lag, the proximate effects of this dollar appreciation are apparent in the substantial and continuing deterioration of the US current account from 1997 onward to 2004.

Factors Behind the Strong Dollar of the Late 1990s

As is always the case, a complex of interacting forces lies behind the strength of the dollar and the deterioration of the US current account since the mid-1990s. The effect of any particular factor on these developments is difficult to measure with precision. But the main forces that have been at work can be identified.

First and foremost, an unexpected but sustained acceleration of productivity growth in the United States boosted both the recorded growth of the US economy and assessments of prospects for its future growth; and these productivity developments were particular to the United States and not widespread across other countries. As usual, stronger output growth supported stronger growth of domestic demand in the United States, and this boosted US imports. The absence of similar developments abroad, however, meant that there was no comparable boost to demand for US exports—with the result that the US trade balance deteriorated.

The strengthening of US productivity growth, along with other developments, also affected the difference between output and demand and, correspondingly, the national savings/investment balance. Absent structural changes in fiscal policy, stronger growth and rising asset values (which tend to be induced by stronger growth prospects) raise govern-

ment revenues and improve the fiscal balance—ultimately with the effect of pushing the US budget into significant surplus in 1999–2000. By itself, such an improvement in the government fiscal balance implies a corresponding improvement in the national savings/investment balance.

But stronger growth and stronger growth prospects also tend to boost investment spending. And rising incomes and rising asset values (associated with stronger growth prospects) tend to boost household consumption and diminish household saving (as measured in the national income accounts). The result is that the private savings/investment balance tends to deteriorate. Indeed, this happened on such a massive scale in the late 1990s that it swamped improvements in the government's fiscal balance and induced a substantial deterioration in the national savings/investment balance. This, in turn, was reflected in US demand to make use of foreign savings and, correspondingly, in a deterioration in the US current account.

Stronger growth prospects and higher expected returns to investment also made the United States more attractive to foreigners as a place to allocate their savings. This meant a stimulus to voluntary net capital flows to the United States that put upward pressure on the foreign exchange value of the dollar. The stronger dollar, in turn, provided a key part of the mechanism for a deterioration in the US trade balance, which was the means through which the US economy made use of increased net inflows of foreign savings.

Another general factor that has contributed to the deterioration of the US current account and the strengthening of the dollar since the mid-1990s was the economic difficulties suffered by other countries (beyond their failure to achieve accelerations in productivity growth similar to that in the United States). Among the industrial countries, Japan's economic performance was particularly weak, with outright declines in real and nominal GDP realized between 1997 and 2002. In the face of this persistent economic weakness, Japanese imports fell, and the Japanese current account thereby tended to improve. The Japanese yen also tended to be weak; and the Japanese authorities actively encouraged this weakness as one of the few available means to help stimulate recovery in the Japanese economy.

In the euro area, economic performance since the mid-1990s has been more satisfactory than in Japan. But the recovery from the recession of 1992–93 was not particularly robust, and recovery from the worldwide recession of 2001 has so far been quite disappointing. Moreover, it appears that pessimism about investment returns in Europe (possibly linked to inadequate progress on key structural reforms) may have played some role in the unexpected and substantial weakening of the foreign exchange value of the euro in 1999–2000—a development that has been reversed in the past two years.

For developing countries, a key development that has influenced the evolution of payments imbalances at the global level during the past decade is the series of catastrophic financial crises that afflicted many emerging-market countries. Faced with a sudden loss of external financing, country after country was forced into a large devaluation of its exchange rate, a sudden and massive improvement in its current account, and a sharp reduction in output and even larger reduction in domestic demand. Individually, these developments did not matter much at the global level. But taken together the crisis-induced improvements in the current accounts of emerging-market countries required a similar offsetting deterioration in the current account balance of (mainly) the industrial countries—and this was absorbed primarily by the United States. Similarly, taken together, the crisis-induced real depreciations of the currencies of a number of important emerging-market countries had a meaningful effect on the real effective foreign exchange value of the US dollar.

Recent Developments and Future Prospects

Looking to more recent developments, it is noteworthy that from its high average value between mid-2000 and early 2002, the US dollar has depreciated substantially against the currencies of most other industrial countries since early 2002: by more than 30 percent against the euro (and closely linked currencies) and by roughly 20 percent against the Canadian and Australian dollars and the British pound. Against the Japanese yen, the dollar has depreciated in nominal terms by more than 10 percent, but adjusted for differentials in inflation there has been no real depreciation of the dollar against the yen.

Normally, it should be expected that with about a two-year lag, the recent depreciation of the dollar against other industrial-country currencies would be reflected in at least a leveling off of the US current account deficit—if not a modest improvement. During the second half of 2003 and early 2004, such a leveling off appeared to be in progress. More recently, however, the US current account has deteriorated further and now appears to be headed for a deficit of about $600 billion (or about 5½ percent of GDP) for 2004. This renewed deterioration probably reflects two phenomena: (1) The growth of domestic demand in the United States since mid-2003 has been particularly rapid (exceeding 5 percent), while growth of domestic demand in the major industrial-country markets for US exports has remained tepid; and (2) there has been no downward correction of the dollar against the currencies of countries with rapidly expanding demand—most notably emerging Asia and especially China.

Another key development that has not yet exerted, but may eventually exert, an important influence on the US current account (and possibly on

the dollar) is the massive shift in US fiscal policy since 2000. Measured by the actual fiscal position, the shift from budget surplus to budget deficit between 2000 and 2004 amounts to a massive 6 percent of US GDP. Measured by the structural fiscal position, the shift is somewhat smaller; I would put it at about 4 percent of GDP. Notably, with the US current account deficit up only moderately from the 4¼ percent of GDP registered in 2000, the massive shift in US fiscal policy appears, so far, to have had only a modest effect on the US current account.

This result suggests further caution in proclaiming a tight link between the fiscal and current account deficits—particularly the simplistic notion of the "twin deficits." It is also partly an illusion. As the US economy fell into recession in 2001, with a particularly sharp decline in business investment, the private savings/investment balance improved dramatically. This offset substantial deterioration in the government net savings and left the national savings/investment balance (and hence the current account) little changed. More recently, business investment has begun a vigorous recovery, but increased investment spending has been financed primarily by a spectacular recovery in corporate profits (which is reflected in business savings). Going forward, however, it remains to be seen whether the United States can sustain the combination of continued strong growth of private investment and large structural budget deficits without further deterioration in the current account.

Sustainable Scale of External Imbalances

For nearly a quarter of a century, the United States has persistently run significant current account deficits. The cumulative consequence of these deficits is that the United States has been transformed from the world's largest net creditor to the world's largest net debtor—with a total shift in the US net asset position relative to GDP of nearly 50 percentage points since 1980. So far, the United States does not appear to have suffered significant ill effects from these developments, despite widely expressed fears of a "hard landing" in the 1980s and other dire warnings of imminent catastrophe. Nevertheless, this massive shift in the US net asset position and the persistent deficits that underlie it naturally give rise to the question: Is there any limit?

Plausible Limits to US Net External Liabilities

In an analysis prepared for the Institute for International Economics five years ago, Catherine Mann (1999) answers this question—firmly and in the affirmative. Like many others, I share her basic conclusion and agree with much of the analysis on which it is based. There must be some upper

limit on the amount of net claims that foreigners will wish to hold against the United States (and its resident businesses and households) on terms that will be attractive both to the foreigners who hold these assets and to the US residents who have the obligations to service them. There is, however, little indication yet that we may be approaching that upper limit, nor is there any way to estimate with precision and confidence where that limit might be.

To gain some perspective on this issue, we can easily calculate what would happen in the long run to the ratio of US net foreign liabilities to GDP under various assumptions about the persistent level of the current account deficit. Let N denote the nominal value of US net foreign liabilities, let C denote the nominal US current account deficit, let Y denote nominal GNP, and let g denote the percentage growth rate of nominal GNP. The relevant mathematical formula states that $n = N/Y$ stabilizes when n times g is equal to C/Y. When n times g is less than C/Y, n is rising; and when n times g is greater than C/Y, n is falling.[1]

For example, suppose that nominal GNP continues on its recent trend and registers a long-term growth rate of 5 percent per year (comprising about 3 percent real growth and about 2 percent annual rise in the GNP deflator). If the US current account deficit continued to run, on average, at 5 percent of GNP, then the mathematics say that the US net foreign liability ratio, $n = N/Y$, would continue to rise from its present level of about 25 percent of GNP reaching 50 percent of GNP within about eight years and would ultimately level out at 100 percent of GNP. If the current account deficit ran, on average, at 6 percent of GNP, then the net foreign liability ratio would rise faster, reaching 50 percent within about five years, and would ultimately rise to 120 percent of GNP.

To put these figures in context, it is noteworthy that only a few present-day industrial countries have ever recorded net foreign liability ratios above 50 percent of GNP, and no significant-sized country has ever reached a net foreign liability ratio of 100 percent of GNP. Moreover, there is reason to fear that if the United States proceeds on its present course in terms of its current account deficit, it would be headed for a net foreign liability ratio well in excess of 100 percent of GNP.

In particular, recent estimates by Mann suggest that, at present exchange rates, three important factors are likely to dictate continued significant expansion of the US current account deficit—expansion of about 1 percent of GNP each year for the foreseeable future: higher growth of the US economy than other industrial countries, a higher income elastic-

1. This formula assumes that the US net foreign liability position changes only as a consequence of net purchases and sales of assets and liabilities by US and foreign residents and not as a consequence of capital gains and losses on already existing asset and liability positions. Allowing for capital gains and losses makes the analysis more complex but does not fundamentally alter the basic conclusions.

ity of demand for imports in the United States than the foreign income elasticity of demand for US exports, and the effect on net factor payments to the rest of the world of rising US net foreign liabilities. These estimates for the current account deficit imply a very steeply rising path of US net foreign liabilities toward ratios well in excess of 100 percent of GDP within the next two decades.[2] This prospect—which is clearly plausible even if not the most likely—serves to heighten concerns that the cumulative consequences of a large and persistent US current account deficit will, within a few years, reach the point where such deficits are no longer consistent with the willingness of foreigners to continue to accumulate net claims against the United States or with the willingness of US residents to accumulate ever-increasing net liabilities to the rest of the world.

On the other hand, there are good reasons to believe that the United States is a particularly attractive place for foreigners to invest substantial fractions of their wealth, and there is little indication yet that foreigners are becoming concerned about the growing volume of these investments. Along with the downward correction of equity prices since early 2000, private flows of foreign capital to the United States have diminished from the torrid pace of the late 1990s. But the diminished pace of private capital inflows does not suggest serious worries about the longer-term security of massive (and still growing) foreign private investments in US-based assets. Increases in foreign official purchases of US assets, especially by Asian governments and central banks, have recently more than made up for the slowdown in private capital inflows. Hopefully, the pace of these foreign official acquisitions of US assets will abate somewhat, along with policy changes to allow significant appreciation of (especially Asian) currencies against the dollar. As discussed below, this needs to be a key element of the strategy to achieve a gradual and nondisruptive reduction of the US external deficit. However, foreign official entities will almost surely have a strong interest in avoiding sudden large changes in their acquisitions of foreign assets (or in their existing portfolios of such assets) that might have costly and disruptive effects on their own exchange rates, financial systems, and economies.

Moreover, the United States has an exceptional record of economic and political stability—unrivaled by any other large country over the past century. Property rights are respected and protected. There is a wide diversity of assets available to foreign investors, including vast quantities of equities, real estate, and other real assets, and privately issued bonds and mortgages, as well as highly secure government debt. Investors are generally well treated, and there is no record of any significant discrimination

2. Another senior fellow at the Institute, William R. Cline, has alternative projections for the US current account that rise less rapidly than indicated by Catherine Mann's estimates. According to Cline's projections, the US current account deficit will rise to just over 6 percent of GDP by 2010. Even with this projection, however, US net foreign liabilities would appear to be headed above 100 percent of GNP.

against foreign as compared with domestic investors. These attractions to foreigners of investment in the United States are probably an important part of the explanation of why, with a net debtor position of already about 25 percent of GDP, the United States stills seems able to secure inward foreign investment on terms (e.g., interest rates on bonds) that are below the returns that US residents earn on their investments abroad.

Nevertheless, as the US net debtor position rises higher, the United States will need to offer more attractive terms in order to continue to attract large additional inflows of foreign investment. This, in turn, should make US residents less enthusiastic about increasing their net foreign liabilities. When we reach the point where US residents are unwilling to offer the improved returns necessary to attract further increases in net foreign investment, the game will end. No one knows where this point is, although it appears to be well beyond the present ratio of US net foreign liabilities to GDP. My guess is that for the United States, a net liability ratio of 50 percent of GDP is still not a critical problem; but I would worry a great deal about ratios rising toward 100 percent of GDP.

This guess suggests that the United States could continue to run current account deficits in the range of 5 to 6 percent of GNP for another few years without serious risk of reaching the effective limit for US net external liabilities. However, going on at this rate for another decade, or for a shorter time if current account deficits expand as suggested by some forecasts, should raise serious concerns about the potential for a crisis that would bring an abrupt end to the continued rapid rise of US net external liabilities. How serious is the risk that such a crisis might do important damage to the United States and to the world economy?

In assessing this risk, it is prudent to be cautious—in both directions. The large US current account deficits that accumulated in the 1980s were brought down to manageable proportions with the aid of the massive depreciation of the dollar (from extraordinarily high levels) that occurred between early 1985 and late 1987. The US economy felt no immediate ill effects from this dollar correction, and the short-term negative impact on growth in the rest of the world was relatively mild. Thus, in contradiction of widely expressed fears of a "hard landing," the large and rapid correction of the US external imbalance in the late 1980s cannot reasonably be characterized as a damaging crisis. Moreover, it should be emphasized that the United States is not similar to a number of emerging-market countries that experienced very damaging foreign financing crises during the past decade. In particular, the United States is not a net debtor to the rest of the world in foreign currency, and it does not have a fragile financial system that would be devastated by sudden depreciation of the dollar.

In the direction of greater concern, it should be noted that (leaving aside the threat to economic growth from the recent escalation in world oil prices), the US economy could be approaching its potential level of output in the next year or two. At that point, a sharp depreciation of the dol-

lar (brought on by unwillingness of foreigners to continue to accumulate US assets on such a massive scale) could add to inflationary pressures in the United States. This could induce the Federal Reserve to accelerate monetary tightening, with significant adverse consequences for the United States and the world economy. It can be argued that this is at least a part of the story of what happened in the early 1970s—a sharp downward correction of the dollar contributed first to a global acceleration of inflation, then to monetary tightening, and finally to global recession. It should also be noted that in 1979–80, when sharp depreciation of the dollar was associated with a more general collapse in confidence concerning US economic policy, the consequences for the United States and for the world economy were quite serious.

This experience embodies the vital lesson that the risk of a serious crisis arising from correction of the US external imbalance is critically dependent on the circumstances that underlie this imbalance and its prospective evolution. In particular, the growth of the US current account deficit during the 1990s appears to have been benign—even beneficial—in light of what was going on that helped to induce this deficit. Surely the acceleration of productivity growth in the United States was a good thing, even if it did not spread in equal measure to the rest of the world. The difficulties in other industrial countries and the catastrophic crises that afflicted emerging-market economies were not good things. But, given that these bad things happened, the widening of the US current account deficit and the appreciation of the US dollar were favorable developments from the perspective of the performance of the world economy. Moreover, the widening of the US external deficit in the 1990s was clearly not the result of an irresponsible and unsustainable US fiscal policy; the US government budget moved into significant surplus for the first time in three decades.

Looking forward, if the next decade looks like a repeat of the 1990s—with the US economy driven by rapid productivity growth and the US budget moving to surplus while much of the rest of the world economy is mired in difficulty—then continuing large US current account deficits, financed by large voluntary foreign capital inflows, would probably also be a good thing. (This would be more likely the case if the US external deficit were on a modestly declining or at least level path, rather than on a sharply escalating one.) In contrast, if US economic performance is modest while the rest of the world booms, and if large US current account deficits persist because of a failure to address US fiscal problems, then this will not be a good thing. Moreover, in this latter situation, foreign wealth holders would have good reason to become less enthusiastic investors in the US economy, with the result that the United States may experience significant difficulties in financing continued large external deficits.

Indeed, the greatest worry about a disruptive correction of the US external deficit probably derives from the potentially reinforcing character of the developments that might drive such a crisis—for example, weak

economic performance that impairs efforts to reduce the budget deficit, upward pressures on US interest rates because of growing worries about the longer-term fiscal situation that feeds back to restrain growth, further upward pressure on US interest rates because of increased concerns of foreign investors about the returns on and value of US-based assets, depreciation of the dollar that heightens these concerns but brings little (initial) apparent reduction of the US external deficit because of long lags (J-curve effects), and other adverse developments (such as very high world energy prices). Policy efforts to encourage an orderly reduction of the US external deficit—and thereby minimize the risk of a disruptive correction—should be particularly attuned to avoiding such a combination of mutually reinforcing adverse developments through actions that will begin to put the US external liability position on a more clearly sustainable path as soon as possible.

General Need for Exchange Rate Adjustment

Assuming that the relevant economic scenario for the next five years or so is between the extremes just described—and without endeavoring to be unduly precise—what would be a reasonable objective for adjustment of the US current account balance, and what would need to happen to bring this about?

As a starting point, it should be emphasized that achieving a zero current account deficit is not necessary in order to stabilize the US ratio of net external liabilities to GDP at a reasonable and sustainable level. With an annual nominal GNP growth rate of about 5 percent, the analysis described before indicates that reducing the current account deficit by 3 percent of GNP to a level of about 2.5 percent of GNP would stabilize the net foreign liability ratio at 50 percent of GNP. As just discussed, a net foreign liability ratio of 50 percent would appear to be sustainable for the United States. Moreover, because of a variety of technical problems that probably lead to some overstatement of the measured US current account deficit relative to its true value, it is likely that a true reduction of that deficit by somewhat less than 3 percent of GDP would be sufficient to stabilize the net external liability ratio at 50 percent.

As is clear from the description of the factors involved in the rise of the US current account deficit in the 1990s (and the earlier episode of the 1980s), achieving a reduction of about 3 percent of GNP in the US current account deficit will depend on complex interactions among the key macroeconomic forces shaping the evolution of the world economy. There is no unique combination of these forces that produces that prescribed result for the US current account; and, as noted earlier, there is no good reason to believe that this particular result is necessarily desirable independent of the forces that might produce it.

Nevertheless, there is a reasonably stable proximate relationship between the real exchange rate of the dollar and (with a lag of about two years) the US current account deficit. This relationship suggests that a substantial depreciation of the dollar will be an essential part of virtually any process that leads to a substantial improvement in the US current account (Bergsten and Williamson 2004, Wren-Lewis and Driver 1998). A variety of estimates of the sensitivity of the US current account to the dollar exchange rate are available. I assume that a 10 percent real effective depreciation of the dollar will be associated with an improvement of about 1 percent in the ratio of the current account to GDP. This is a somewhat larger response than suggested by many estimates, but it is not out of the ballpark and is consistent with both the precision of our knowledge and the spirit of this exercise. Using this estimate, it follows that a 30 percent real depreciation of the dollar would be needed in connection with an improvement in the US current account of about 3 percent of GDP.

It should be emphasized that this estimate of a 30 percent required real effective depreciation of the dollar is no more than an educated guess—as is the assumption that a reduction of about 3 percent of GDP in the current account deficit is needed to stabilize the net foreign liability ratio at a sustainable level. If the current account deficit is more responsive to exchange rate changes than I have assumed, if an important part of the effect of recent depreciation of the dollar against most industrial-country currencies is yet to materialize, or if other factors (such as stronger growth of foreign demand for US exports or weaker world oil prices) help to reduce the current account deficit, then the extent of required dollar depreciation would be meaningfully less than 30 percent (but still significant). On the other hand, if the current account deficit is less responsive to exchange rate changes or if at present exchange rates that deficit is slated to grow significantly (as suggested by some plausible forecasts), then the magnitude of the needed dollar depreciation would likely be significantly larger than 30 percent.

To achieve a substantial downward adjustment in the real effective foreign exchange value of the dollar of about 30 percent, by how much should the dollar adjust against individual foreign currencies? There is really no clear way to answer this question. The simple baseline assumption is that all currencies would move against the US dollar in the same proportion—i.e., appreciation by a common 30 percent. However, there is some reason to believe that the responsiveness to exchange rate changes is larger for countries—notably Canada and Mexico—that have particularly close linkages to the US economy. This might suggest somewhat smaller exchange rate adjustments for these countries. Complexities arising from third-party effects might also be considered. However, because the appropriate evolution of various bilateral exchange rates will undoubtedly be influenced by a complex of economic factors that are not tightly related to a general improvement in the US current account bal-

ance, there is good reason not to try to be too precise about adjustments of individual exchange rates. Suffice it to say two things: On average, exchange rates of foreign currencies against the dollar will probably need to appreciate by about 30 percent; and virtually all significant US trading partners will need to participate significantly in this general appreciation against the US dollar.

Because of the general need for foreign currencies to appreciate against the dollar, it is tempting to suggest that this should be a subject for international policy cooperation. In my view, some international cooperation on this subject would be useful, especially in establishing better understanding of the likely need for substantial exchange rate adjustments as a critical element in the process of reducing external payments imbalances. As discussed below, international attention might also usefully be focused on the specific issue of exchange rate adjustments by Asian emerging-market economies (and Japan), where official policies have sought to resist aggressively strong market pressures in favor of appreciation against the US dollar.

However, considerable skepticism is warranted about any grand design to coordinate global exchange rate adjustments.[3] At this stage, no one can be highly confident about the general extent of dollar depreciation that will be needed to help reduce the US external deficit to a sustainable level or, even more so, about the magnitudes of the appreciations of individual foreign currencies that would be appropriate in this regard. Moreover, even if economic analysts could establish reasonably precise estimates for these magnitudes, it is exceedingly doubtful that policymakers could or would agree on concerted efforts to attempt to enforce the estimated exchange rate adjustments. For a considerable time, there has been broad agreement among policymakers in most industrial countries (including the United States and most of Europe) that market forces should be allowed wide latitude in setting exchange rates and that official efforts to influence exchange rates should be limited to relatively extreme situations where market forces appear to be pushing exchange rates well beyond the ranges consistent with underlying fundamentals. The consensus on this approach has been sufficiently strong that substantial appreciation of most industrial-country currencies against the US dollar has been accepted since early 2002, despite concerns about the negative short-term impact of these appreciations on economic growth. Presumably, if driven by market forces and provided it does not occur too rapidly, further significant dollar depreciation against most other industrial-country currencies would be similarly acceptable; and there might be some advantage in international policy cooperation that confirms this general approach. However,

3. I share these sentiments with a number of my colleagues at the Institute for International Economics, in particular Morris Goldstein and Edwin Truman. Others are more enthusiastic in their support for policy cooperation directed at influencing significantly the behavior of exchange rates, in particular C. Fred Bergsten and John Williamson.

efforts to agree that the official sector should promote specific exchange rate adjustments (for example, a 20 percent further appreciation of the euro against the dollar) would almost surely be rejected—and rightly so.

Three exceptions to this general rule should be noted. First, many important emerging-market economies, especially in Asia (and including Japan), do not allow market forces to determine exchange rates and have recently engaged in massive one-sided official intervention to resist currency appreciation against the US dollar. As discussed below (and in Morris Goldstein's chapter in this book), these policies need to be changed substantially to accord with the general principle that even pegged or heavily managed exchange rates need to adjust to reflect economic fundamentals. Second, for most industrial countries that generally allow market forces wide latitude to determine exchange rates, it should be recognized that if the dollar were to appreciate significantly from the present level and/or remain so strong that there was a clear international consensus that the dollar needed to come down (as there was at the time of the Plaza Agreement in September 1985), then it would be appropriate for the official sector to send a strong message to private markets about the need for and desirable direction of exchange rate adjustments. It does not make sense, however, to attempt to build such an international consensus when, like now, it clearly does not exist. Third, if the dollar fell precipitously and to an extent that appeared to be a significant threat to economic performance and/or financial market stability, then the official sector should act forcefully, in a clearly coordinated manner, to resist unduly rapid dollar depreciation. Channels of communication and the mechanisms of international cooperation that would support such an emergency operation should be kept in working order. However, more specific contingency planning about what to do in a possible crisis—the nature and circumstances of which are difficult to foresee—impress me as unlikely to be fruitful.

Finally, on the general issue of exchange rate adjustments necessary to contribute to a reduction of the US external deficit to sustainable levels, it is essential to recognize the fallacy that a substantially weaker dollar is generally good for the US economy and bad for the rest of the world. This may be true for the short run. Specifically, when there is significant excess capacity in the US economy, a weaker dollar will usually help to accelerate the return of output to potential by adding to the growth of demand for US output (or, at least, by reducing the demand drag from continuing deterioration in US net exports). Similarly, in the short run, when there is excess capacity in the rest of the world, currency appreciation tends to slow the return to potential output by weakening net exports.

In the longer-term, however, the US economy does not consistently operate below potential; indeed, during the past 30 years, high inflation, which is symptomatic of lack of excess capacity, has been more of a policy problem for the US economy than sustained high levels of unemploy-

ment. In the long run, on average, a weaker dollar will not generally imply higher levels of output and employment in the United States. Instead, the long-run effect of a weaker dollar will be felt in the adverse real income effects of a lower relative price of US exports and a higher relative price of US imports. For a given path of potential and actual real output, residents of the United States will have to contract their real consumption and investment in order to supply increased real exports to the rest of the world in exchange for (a possibly reduced quantity of) more expensive imports. The rest of the world stands on the other side of these developments—enjoys gains in real consumption and investment from the increased relative value of their exports when exchanged for imports of goods and services from the United States. Thus, it is fundamentally wrong for the United States to believe that a weaker dollar directly improves its long-run economic welfare. The correct view is that a weaker dollar is needed in the long run—despite its adverse effects on US real consumption and investment—because the United States cannot continue to run very large current account deficits that will ultimately raise its net foreign liabilities to unsustainable levels.

Industrial-Country Policies to Contribute to Orderly Reduction of External Imbalances

In the usual targets and instruments approach to the analysis of economic policy, the standard procedure is first to identify the desirable objectives of policy and then to enumerate the policy adjustments that should be made to meet these objectives. In examining the role that economic policies should play in addressing present global concerns about payments imbalances, however, a simple version of this targets and instruments approach is not very useful. As the preceding discussion has made clear, the US external deficit and the corresponding external surplus of the rest of the world are not developments that can be viewed in isolation from broad macroeconomic forces shaping the course of the world economy. Nor are there policies (with the exception of some narrow elements of exchange rate policy) that can be directed specifically at the objective of reducing external imbalances. Rather, the objective of securing an orderly reduction in external imbalances needs to be a consideration—but generally not the dominant consideration—in the design and implementation of key economic policies whose principal objectives relate to other purposes.

Fiscal Consolidation in the United States

In particular, for the United States, a gradual and cumulatively substantial tightening of fiscal policy is clearly necessary to achieve longer-term

fiscal sustainability, especially in view of the fiscal strains arising from an aging population. In particular, recent analysis by the Congressional Budget Office suggests that under plausible assumptions about the evolution of government policies (including preservation of most of the Bush tax cuts, scaling back of the alternative minimum tax, substantial winding down of the present level of expenditures related to Iraq and Afghanistan, and growth of other federal discretionary spending in line with the growth of nominal GDP), the federal fiscal deficit in 2010 would run in the range of $450 billion to $500 billion. In nominal terms, this would be up modestly from the $412 billion deficit recorded in fiscal 2004; as a share of GDP it would be down by about one-half percent, from 3.6 to 3.1 percent. With federal deficits running roughly 3½ percent of GDP, the public debt to GDP ratio would rise moderately from 37.5 to about 44 percent by 2010.

Beyond 2010, the federal deficit and debt situation begin to look much more bleak.[4] With the retirement of the baby boom generation and the general escalation of health care costs, federal outlays on Social Security and Medicare benefits will rise from 6 percent of GDP in 2004 and nearly 8 percent of GDP in 2010 to something in the range of at least 15 percent to more than 25 percent of GDP by 2050. The extremely wide range of uncertainty about the costs of these key entitlement programs in the long term reflects primarily great uncertainty about the expense of government-supported health care, under the impact of continually improving medical practice, as an increasingly large share of the population is retired and lives longer. Clearly, important decisions will need to be made about how to balance the advancing benefits and rising costs of medical care for the elderly and about how to share those costs. These decisions will need to be made over time, as the relevant options become clearer, by the people (both beneficiaries and taxpayers) whom they will primarily affect. What is clear at present is that this is not a time when the US government should normally be running substantial fiscal deficits outside of the operation of the Social Security and Medicare entitlement programs (which still show "off-budget" cash surpluses). In particular, while continuing federal deficits of around 3½ percent of GDP and a rise in the ratio of visible public debt to GDP from 37.5 percent today to about 44 percent by 2010 do not, by themselves, seem very threatening, they are not a sound or sensible fiscal policy in light of the enormous longer-term challenges facing the federal budget.

Moreover, reduction of the federal deficit to below 1 percent of GDP by 2010—on a cyclically adjusted or "structural" basis—is an economically feasible as well as a desirable goal. There is still some slack in the US econ-

4. Peter G. Peterson provides a passionate exposition of the grave long-term dangers facing the US government budget is his new book, *Running on Empty: How the Democratic and Republican Parties Are Bankrupting Our Future and What Americans Can Do About It* (New York: Farrar, Straus and Giroux, 2004).

omy that probably added at least one-half percent of GDP to the federal deficit in fiscal 2004. As the US economy recovers more fully, this cyclical component of the federal deficit should disappear. Beyond this, structural fiscal consolidation of one-half of 1 percent of GDP each year, on average, for the next six years would cut the federal deficit cumulatively by another 3 percent of GDP, with the implication that overall fiscal balance would be achieved in fiscal 2010 assuming that the US economy was operating at potential. And structural fiscal consolidation at that pace of one-half of 1 percent of GDP per year should not unduly burden the US economy in achieving its potential output. Between 1992 and 2000, the actual federal deficit was transformed from a deficit of 4.7 percent of GDP to a surplus of 2.4 percent, with the structural fiscal improvement amounting to about 5 percent of GDP. The US economy boomed in this period, notwithstanding both the substantial fiscal consolidation and the drag from a significant deterioration in US net exports.

In sum, even without any reference to the objective of reducing the US external deficit, a strong case can be made that cumulatively significant fiscal consolidation is desirable for the United States over the next few years as an essential contribution to placing US fiscal policy on a sound and sustainable path for the longer term. The need to reduce a large external deficit means that fiscal consolidation (which is desirable for more basic reasons) can also play a useful role in constraining the growth of domestic demand relative to domestic output. Part of the reduction of growth of domestic demand falls directly on imports and thereby tends directly to improve the trade and current account balances. A larger part of the reduction of domestic demand growth falls on US products and services, but the impact of this is offset by the shift of foreign demand toward US output occasioned by downward correction of the dollar and other forces. The entire reduction in growth of domestic demand relative to output is a reduction in national spending relative to national income and, therefore, an improvement in the US net savings/investment balance—an essential counterpart to an improvement in the US current account balance. The improvement in the US national savings/investment balance associated with fiscal consolidation also corresponds to a reduction in the foreign capital inflow necessary to finance this imbalance. This smaller foreign capital inflow, in turn, is associated with diminished enthusiasm of foreign investors to acquire US-based assets and, accordingly, with downward adjustment in the foreign exchange value of the US dollar.

This prescription that US fiscal consolidation should make an important contribution to the orderly reduction of external imbalances does not rely on the simplistic notion that the US fiscal deficit and the US current account deficit are closely related "twins" and that reduction in the fiscal deficit will automatically result in an essentially simultaneous, one-for-one reduction in the current account deficit. As in the 1990s, it is possible that despite determined fiscal consolidation (or perhaps partly because of

it), investment in the US economy may be particularly buoyant, contributing to continued strong growth of domestic demand. At the same time, foreign wealth holders might remain especially enthusiastic about shifting capital into the United States, thus helping to keep the dollar unduly strong. The result could then be little or no improvement in the US current account, despite significant US fiscal consolidation. And this could go on for some time until foreign wealth owners ultimately become persuaded that further rapid accumulation of US-based assets is no longer desirable—or even safe.

With this possibility in mind, it is relevant to emphasize that US fiscal consolidation is not a surefire cure-all for the US external deficit. Nevertheless, fiscal consolidation is clearly needed for its own sake, and it should normally be expected to aid in the reduction of the US external deficit over the medium to longer term.

For US monetary policy, the fundamental objectives are to keep inflation low while supporting sustainable growth of output and employment. Fiscal consolidation implies that monetary policy should be able to achieve these fundamental objectives by pursuing a course for policy interest rates that is lower than it would be in the absence of such fiscal action. Other things being equal, an easier course for monetary policy should normally mean a lower path for the foreign exchange value of the US dollar. A cheaper dollar, in turn, should help to bring both an improvement in the US external balance and a positive (or less negative) contribution from net exports to output and employment growth in the United States. The latter effect will help to offset the short-run negative impact of fiscal consolidation on output and employment.

Enhancing Growth in Japan and Europe

In the rest of the world, the main macroeconomic adjustments necessary to achieve a smaller external surplus are essentially the reverse of the adjustments needed in the United States—i.e., an increase in domestic demand growth relative to output growth (and a corresponding deterioration in the savings/investment balance and a reduction in net capital outflows) and real currency appreciation to help shift demand away from domestic output to US output. Unfortunately, the macroeconomic situation in much of the rest of the world is not the reverse of that in the United States; and the policies that would contribute to reducing the rest of the world's external surplus, while maintaining sustainable noninflationary growth, are somewhat difficult to prescribe.

In particular, in Japan and most of western Europe, margins of slack are generally wider than in the United States, while the medium- and longer-term need for fiscal consolidation is generally no less pressing. This implies that fiscal expansion cannot generally be prescribed in these coun-

tries as a means for stimulating domestic demand growth in order to offset the loss of effective demand inevitably associated with declining external surpluses. As a consequence, monetary policy faces an increased responsibility for sustaining adequate growth of domestic demand—especially if fiscal policies are oriented toward consolidation rather than mere neutrality.

After more than a decade of disappointing growth and five years of outright deflation, facing a large fiscal deficit and a massive buildup of government debt, and with policy interest rates effectively at zero, Japan confronts particularly difficult challenges in designing policies to achieve sustainable growth while contributing appropriately to the reduction of global payments imbalances. Indeed, this particularly difficult situation of Japan in recent years provides a relevant rationale for their highly aggressive policy of resisting rapid appreciation of the yen through massive foreign exchange market intervention. From a global as well as a purely Japanese perspective, the key priority has been to get the Japanese economy back onto a sustainable growth path, and to rebuild the business and consumer confidence that is essential to that result. Resistance to rapid yen appreciation that could have undermined the present Japanese recovery has contributed to the success so far achieved—even if it has retarded exchange rate adjustments that are needed in the longer term to contribute to the reduction of global payments imbalances.

However, now that the Japanese economy appears to have regained substantial forward momentum, massive intervention to resist further orderly appreciation of the yen is not a desirable or defensible policy. The decision of the Japanese authorities to refrain from massive intervention since March of 2004 appears to recognize this point; and this decision has appropriately been given international endorsement. Nevertheless, it is relevant to recognize that sudden and substantial appreciation of the yen (say below 95 to 100 yen to the US dollar) could be destabilizing, and official resistance to such a development could be warranted in the near term. Over the next five years or so, it is reasonable to expect that the Japanese yen (along with the currencies of most other Asian economies) should appreciate substantially against the US dollar. Persistent and determined resistance to such appreciation, in the context of a generally improving Japanese economy, would not be appropriate.

With significant margins of slack remaining in the Japanese economy (despite some official estimates to the contrary) and with no signs of a resurgence of inflation, Japanese monetary policy should continue to pursue a course of unusual ease for a considerable period. This, in turn, will tend to imply a somewhat weaker course for the foreign exchange value of the yen than would likely prevail with a more robust Japanese economy. If driven by the market, such yen weakness—unlike weakness artificially induced by official intervention—is appropriate in light of Japan's economic situation and should not be subject to international criticism. In the longer

term, as the Japanese economy recovers its traditional strength, substantial further real appreciation of the yen against the US dollar should reasonably be expected as part of the process of gradually reducing global payments imbalances. This prospective real appreciation of the yen against the dollar, however, does not apply equally to the real effective foreign exchange value of the yen against all of Japan's trading partners.

For industrial countries other than Japan, exchange rate adjustments since the peak of the US dollar in 2000–02 are already quite substantial. In general, these adjustments should be enough to achieve some part (although not the entire amount) of what is needed to restore a sustainable pattern of international payments. In three key US trading partners—Canada, the United Kingdom, and Australia—demand growth in recent years has also been sufficient to achieve reasonable output growth. For these countries, further fiscal expansion cannot generally be recommended as a responsible means to augment demand growth (especially not in the United Kingdom). But longer-term fiscal prospects appear to be sound without the need for substantial consolidation—implying that fiscal contraction will not add to problems of sustaining output growth in the face of some deterioration of net exports. In addition, monetary policies in Australia, Canada, and the United Kingdom have all been tightened somewhat since the end of the global recession of 2001, and this leaves significant room for monetary easing, should that seem needed to ward off excessive weakness in output growth.

In the euro area, economic performance since the mid-1990s has been better than in Japan but somewhat worse (especially in terms of domestic demand growth) than in Australia, Canada, and the United Kingdom (as well as the United States). Fiscal deficits and government debt burdens are generally not as large in Japan but are more of a concern than in Australia, Canada, and the United Kingdom. Monetary easing by the European Central Bank (ECB) to combat recent sluggishness has cut policy interest rates down to only 2 percent, compared with zero in Japan (and 1 percent in the United States). But, for good reason, there has not yet been any move by the ECB to begin the cycle of monetary tightening already under way in Australia, Canada, and the United Kingdom (and more recently in the United States). Thus, it is fair to say that economic policy in the euro area retains greater room for maneuver to address issues arising from the correction of external imbalances than in Japan, but less so than in Australia, Canada, and the United Kingdom. Moreover, it is relevant that, unlike Japan, authorities in the euro area have not intervened at all to resist the substantial appreciation of the euro against the US dollar that has occurred since early 2002. Indeed, significant euro appreciation (at least to parity with the dollar) has been welcome as a reversal of the earlier excessive weakness of the euro and as a factor tending to reduce inflationary pressures in the euro area.

Looking forward, however, economic policy in the euro area faces critical challenges that will not be made easier to meet by the need to contribute to the reduction in global payments imbalances. Substantial fiscal deficits and government debt burdens and the fiscal demands of aging populations do not allow much room for expansionary fiscal policies to prop up domestic demand growth in order to offset declining net exports. Indeed, unlike the United States, desirable medium-term adjustments of fiscal policies to meet their primary objectives are not the adjustments that would likely have the side benefit of contributing to the orderly reduction of international payments imbalances.

Moreover, monetary policy for the euro area does not provide a reliable escape from of this conundrum (even if the ECB were willing to recognize this possibility). Facing prospective weakness in domestic demand growth (especially if fiscal consolidation is pursued), as well as weakness in output growth from deterioration of net exports, monetary policy would normally be expected to follow a somewhat easier course in order to properly serve its basic objectives. But an easier course for monetary policy should normally be expected to work against the exchange rate adjustments (i.e., further appreciation of the euro against the US dollar) that are needed to facilitate the reduction of external imbalances.

From the perspective of reducing external payments imbalances, it may be regarded as fortunate that euro area fiscal authorities show little inclination toward significant fiscal consolidation and that the ECB is fixated on the objective of price stability and is generally unwilling to acknowledge virtually any responsibility for output growth. However, like the attitudes of some key US policymakers who effectively deny the need for specific expenditure and revenue measures to bring about actual fiscal consolidation, the cherished illusions of too many European policymakers threaten to generate outcomes that are below the best that their economies are capable of achieving.

With respect to the issue of reducing global payments imbalances, these illusions bite primarily in the absence of a reasonable strategy to achieve sustainable demand and output growth. Structural reform is rightly seen as the most important element in the strategy to strengthen growth over the longer term; and progress is being made in this area even if it is less rapid than desirable.[5] But structural reform is clearly not the whole answer to the issue of maintaining adequate and appropriate demand growth. Exhortations about the need for more rapid structural re-

5. An extensive and insightful discussion of these issues is provided in Baily and Kirkegaard (2004). As they emphasize, after many years of controversy, a broad consensus has been reached among analysts and most policy leaders that deep structural reforms are needed to enhance longer-term growth in most of western Europe and to help to address the challenges posed by aging populations. Significant progress in some key areas of structural reform has been made in a number of these countries; but much remains to be done.

form should not be the excuse for the fiscal and monetary authorities to ignore their responsibilities in demand management.

Clearly, western Europe and Japan have the most to gain themselves from policies that will promote stronger economic growth, both in the near term and in the longer run. But success in this endeavor also has important likely benefits for the rest of the world. Stronger growth in other industrial countries means stronger growth of their demand for exports from the United States and from developing countries. This, in turn, should mean less need for dollar depreciation to help bring improvement to the US current account (and accordingly smaller real terms of trade losses for US residents), as well as somewhat less adjustment by developing countries as the counterpart of improvement in the US current account.

The main impetus for policies to promote more rapid growth in other industrial countries must inevitably come from within these societies. It is they that must face up to the sometimes difficult trade-offs and special interest pressures that often oppose growth-promoting reforms—just as the United States must face up to the critical choices in tax and expenditure policies needed to achieve fiscal consolidation. However, experience suggests that cogently argued external advice can play a positive role in supporting policies that have global benefits while also serving the fundamental national interests of the countries that are advised to adopt them.

More specifically, going back to the Carter and Reagan administrations, US officials have pressed both Europe and Japan to adopt more growth-oriented policies. Arguably, the record regarding demand management policies is somewhat mixed. Some praise while others condemn the effort from the Bonn Summit of 1978 to get western Europe (especially Germany) and Japan to pursue more expansionary demand policies in exchange for a rationalization of US energy policy. During the second Reagan administration, initial US advice favoring demand stimulus to offset the short-term contractionary impetus from dollar depreciation on western Europe and Japan was probably correctly timed. But persistent advice to Japan to maintain easy fiscal and monetary policies extending into the administration of President George H. W. Bush probably contributed to the rise of the "bubble economy" in Japan and to the difficulties stemming from its subsequent collapse.

On international advice concerning structural reform policies, the record is clearly not one of immense and immediate success. Over time, however, a consensus has built up in western Europe and, more recently, in Japan about the important benefits to be derived from key structural reforms. International advice has played a constructive role in helping to build this consensus. In my view, this is primarily because the advice, by and large, has been substantively correct and because that advice has been reinforced by careful and steady work at key international institutions, including the OECD and the IMF. Western Europe really did have

(and still has) important structural impediments to more rapid economic growth, especially in its labor-market and related policies. Following the collapse of the bubble, the Japanese financial system and the financial situation of many Japanese businesses really was a horrendous mess—a mess that Japanese officials and political leaders appeared more intent on ignoring than on addressing. Careful analysis and persistent advice on these problems from (relatively) unbiased international institutions has helped to make an increasingly persuasive case that these problems need to be seriously and vigorously addressed—not because of American pressure, but because this is very much in the national interests of the countries themselves.

Key Issues for Developing Countries in the Orderly Reduction of International Imbalances

For developing countries, the nature and timing of the macroeconomic and policy adjustments necessary to contribute to an orderly and successful reduction of external imbalances differs considerably across regions and specific countries. Indeed, the contrast between most of emerging Asia and much of Latin America is particularly striking. Aside from the brief setbacks associated with the global recession of 2001 and the SARS scare of the spring of 2003, economic growth in virtually all of emerging Asia has been very strong since recovery from the Asian crisis began in late 1998. In contrast, several key Latin American countries have experienced considerable economic weakness in recent years. In particular, Argentina and Venezuela have had catastrophic recessions, Brazil has experienced significant difficulty in achieving robust growth following the moderate recession of 2003, and even Mexico has not avoided recent economic sluggishness despite robust recovery in the United States.

Another important difference between Asia and Latin America is that Asian emerging-market economies have recently generated large current account surpluses and, in many cases, substantial capital inflows that have put upward pressure on exchange rates and led to massive accumulation of official foreign exchange reserves. In contrast, in Latin America, recent current account surpluses, where they have occurred, have mainly been the consequence of large market-induced exchange rate depreciations and (in some cases) sharp declines in domestic demand arising from economic and financial crises.

Clearly, in considering the roles that developing countries should play in the general reduction of international imbalances, it is important to keep in mind the differing circumstances of different countries. Nevertheless, taking account of these differences, three general points should be made about the necessary role of developing countries.

Need for Aggregate Current Account Adjustment

First, it is important to recognize that nearly 40 percent of US trade now takes place with developing countries and that a significant fraction of the deterioration of the US external payments position since the mid-1990s corresponds with the improvement in the aggregate current account position of developing counties. From these facts, it is apparent that substantial reduction of the US external deficit must correspond with a significant movement in the other direction of the external balance of developing countries as a group, as well as with a significant movement toward deficit for the aggregate of all (other) industrial countries.

This does not mean that on a bilateral, country-by-country basis the US trade balance should be expected to improve against all individual developing countries. Indeed, it would be a serious error of economic logic and of economic policy to attempt to target specific reductions in bilateral imbalances as the means for allocating responsibility for the counterpart of an improvement is the US external balance. Leaving aside the nettlesome issue of the changes in the global current account discrepancy, the aggregate improvement in the US external balance must correspond to the aggregate deterioration in the external balance of the aggregate of all other countries. But the allocation of this aggregate deterioration among individual countries depends on complex and shifting economic forces and cannot be prescribed on an a priori basis.

Nevertheless, developing countries as a group are far too large a fraction of "the rest of the world" for anyone to reasonably believe that a substantial reduction in the US external deficit could occur without a significant movement in the other direction in the aggregate external payments position of developing countries. For the mooted improvement in the US external balance of about 3 percent of US GDP, no one can confidently say whether the counterpart for developing countries would be more or less than about one-third. But the need for developing countries as a group to participate significantly as the counterpart of a substantial improvement in the US external balance is undeniable.

Exchange Rate Policies of Developing Countries

Second, as with (other) industrial countries, the decline in the net external payments balance of developing countries that is the necessary counterpart of the improvement in the US external balance requires—as one essential ingredient—real depreciation of the US dollar against the currencies of developing countries. For developing countries, however, this required exchange rate adjustment poses policy difficulties that do not generally arise in industrial countries. With the notable exception of Japan,

industrial countries generally allow the exchange rates of their currencies to fluctuate freely against the US dollar in response to market forces—without resorting to massive official intervention or other policies to influence the exchange rate against the dollar. Over the past two years, these floating exchange rate policies have allowed substantial real appreciations of most industrial-country currencies against the US dollar—real appreciations that will help to achieve a more sustainable pattern of international payments positions.

In contrast, for most developing countries, there has been very little real currency appreciation against the US dollar during the past two years. Indeed, on a real effective basis (i.e., for exchange rates against the weighted average of trading partners), many developing countries have experienced at least modest real depreciations. This is not generally the result of market forces operating on market-determined exchange rate (although it may be so in some cases, such as Mexico). Instead, it is primarily the result of exchange rate policies of many developing countries that either peg the exchange rate against the US dollar (de jure or de facto) or aggressively limit fluctuations in the exchange rate against the US dollar.

One important manifestation of these exchange rate policies is the massive buildup during the past three years of official foreign exchange reserves by several key Asian emerging-market economies (and the similar buildup of official reserves by Japan). In this regard, China is the country whose exchange rate policy and reserve accumulation are most often cited as issues of concern; and this book appropriately has a chapter (by Nicholas Lardy) devoted to these specific concerns. But, important as the Chinese case is, the issues about exchange rate policies and reserve accumulation apply much more broadly than just to China. Indeed, combined official reserve accumulation since 2001 by the main Asian surplus economies other than China has been more than double the reserve accumulation of China, and the combined current account surpluses of these countries are much larger than China's surplus both in absolute terms (measured in US dollars) and relative to GDP (table 6.1).

Because exchange rates are—by definition—exchange values between different national currencies, no country can logically claim exclusive property rights in "its" exchange rate. And, especially because present concerns about external imbalances are fundamentally global concerns, exchange rate adjustments necessary to reduce these imbalances need to be assessed and addressed from a multilateral and global perspective.

The importance of a multilateral and global perspective on exchange rate issues is well illustrated by the case of China. As convincingly advocated by Goldstein and Lardy (see Lardy's chapter in this book), an appreciation of the Chinese renminbi by 15 to 25 percent against the US dollar, together with repegging to a basket of the dollar, the euro, and the yen and allowance for a wider band of market-determined exchange rate fluc-

Table 6.1 Key comparative data on external payments: Japan, China, and other emerging Asia

Country/region	GDP, 2003 (billions of dollars)	Current account balance, 2003 (billions of dollars)	Current account as percent of GDP, 2003	International reserves at mid-2004 (billions of dollars)	Change in reserves since 2001 (billions of dollars)	Change in real exchange rate versus dollar from average, 2000–01 (percent)
Japan	4,750	150	3.2	808	420	–7
China	1,400	45	3.2	480	260	–5
Other emerging Asia	1,870	120	6.4	860	350	–6

Notes: Other emerging Asia (with estimated 2003 GDP in round figures) consists of Hong Kong ($160 billion), India ($500 billion), Indonesia ($180 billion), Malaysia ($100 billion), Singapore ($90 billion), South Korea ($500 billion), Taiwan ($300 billion), and Thailand ($140 billion). Changes in real exchange rates are calculated by adjusting nominal exchange rate changes for changes in consumer prices indices (CPIs) (minus the change in the US CPI). GDP weights are used to aggregate real exchange rate changes for other emerging Asia.

tuation, is a reasonable response to the clear need for a significant modification of Chinese exchange rate policy. However, the Goldstein-Lardy proposal makes much more sense if (as they intend), it is part of a broader modification of exchange rate policies of most Asian emerging-market economies (and Japan). Appreciation of the renminbi against the US dollar means much less in terms of effective appreciation against all Chinese trading partners if it is accompanied by significant appreciations of other Asian emerging-market currencies (and the Japanese yen). Similarly, for other Asian emerging-market economies, upward adjustments in the foreign exchange values of their currencies will appear much more digestible if they are not pursued in isolation but rather as a part of a general upward adjustment in the value of Asian currencies against the dollar. And this general upward adjustment in the values of Asian currencies against the US dollar—rather than isolated exchange rate adjustments by individual Asian economies—is really what is needed as an essential contribution to the gradual process of reducing global payments imbalances.

Moreover, much experience indicates that, even when the case for a policy change is quite apparent, it is often difficult to persuade national authorities to alter their exchange rate policies—especially when adjustment involves changing a well-established exchange rate peg in either a downward or an upward direction. This generally difficult task, however, cannot be made easier by suggesting that national authorities should act in isolation, when the true need is for coordinated adjustments by several countries that reduce the risks for individual countries and that properly share the responsibility for necessary exchange rate policy adjustments with the international financial community.

Dealing with Potential Financial Crises

Third, while a number of developing countries (especially those with large current account surpluses and favorable access to global capital markets) have considerable policy flexibility to meet the challenge of sustaining adequate demand growth in the face of deteriorating external payments positions, others are not so fortunate. This is particularly so for developing countries that are potentially vulnerable to external financing crises, such as those that afflicted many emerging-market economies during the 1990s.

At present, with global economic recovery under way, with policy interest rates in industrial countries still quite low, and with global financial markets still taking a relatively benign view of the risks in emerging markets, these vulnerabilities appear less worrying than they did a few years ago. Nevertheless, some countries (notably those with relatively high government and external debt ratios and histories of financial turbulence) are viewed with some concern. And, as suggested by the increase in spreads for several emerging-market borrowers since early 2004, these concerns appear to be on the rise.

Over the next couple of years, as interest rates in industrial countries probably rise and as the global expansion probably loses some of its recent robustness, it is not unlikely that one or more emerging-market country will have to face a potential external financing crisis. As occurred in the 1990s (and in earlier episodes of emerging-market financial crises), it is also not unlikely that a financial crisis afflicting one emerging-market economy will spread through a variety of mechanisms to affect others. In contrast with the 1990s, however, a rapidly expanding US current account deficit (supported by particularly rapid growth of domestic demand in the United States) is unlikely to provide the necessary counterpart for emerging-market countries seeking rapid improvements in their current account positions under the pressure of external financing crises.

This concern also applies in reverse. Emerging-market financial crises that generate the need for rapid improvements in the external payments positions of these countries will tend to interfere with the orderly reduction of the US external payments deficit. And the effects of this problem will not be limited to emerging-market countries and the United States. If expansion of the US external deficit is to be less of a counterpart to crisis-induced improvements in the external payments positions of emerging-market countries, then adjustments in the external positions of other industrial countries will need to shoulder more of the load—and this will be in addition to, not as a substitute for, adjustments that are needed as the counterpart of improvements in the US external position.

Thus, it is fair to say that all countries have a self-interest in avoiding or ameliorating possible future emerging-market financial crises—as one

element in the broader strategy to secure orderly reductions in international payments imbalances. Of course, the primary responsibility for reducing vulnerabilities to a crisis inevitably rests with an emerging-market country itself—and there is much that countries can do in this regard. But the international community also has an important role to play in reducing the risk of crises and in ameliorating the consequences when crises occur (see the chapter by Morris Goldstein).

Conclusion: Virtues of Some International Policy Cooperation

The preceding discussion has emphasized that large persistent US external payments deficits—on the order of 5 percent or more of US GDP—are not sustainable in the longer term and that important macroeconomic adjustments will be needed, in the United States and in the rest of the world, in order to bring these external imbalances down to sustainable levels. Achieving these necessary adjustments, while also securing maximum sustainable economic growth and minimizing the risk of a disruptive foreign exchange or financial crisis, poses important challenges for the conduct of economic policies around the world. The interconnectedness of these policy challenges implies that the strategies for meeting them ought to be a key subject for international economic policy cooperation.

Indeed, the importance of such cooperation has been emphasized especially with regard to exchange rate adjustments by Asian emerging-market economies (and Japan) and reform of the international financial system to deal more effectively with the potential problem of emerging-market financial crises. International cooperation among the industrial countries on exchange rate issues is also important, and it should confirm that for most industrial countries with generally market-determined exchange rates, official policies should not aggressively and persistently resist further market-driven depreciation of the US dollar. International cooperation should also insist that for countries that more actively manage their exchange rates (in particular, Japan and most Asian emerging-market economies), a similar principle should apply. Efforts beyond this to establish particular levels or ranges for exchange rates to be actively pursued by the official sector strike me as unwise, unwarranted, and unlikely to be adopted. Rather, attention on international cooperation regarding industrial-country exchange rates should be limited to two contingencies: (1) recognizing the possibility that, if the dollar were to appreciate significantly and/or remain excessively strong, there might be at some future time broad international consensus to encourage dollar depreciation; and (2) recognizing that there is some risk of a crisis involving large and excessively rapid depreciation of the dollar and being prepared to deal forcefully with such a crisis when and if it threatens.

In other areas of economic policy, there is surely no harm in the rest of the world's pressing the United States on the importance of moderate-paced and cumulatively substantial fiscal consolidation. Similarly, there is no harm in the United States' pressing other countries to maintain adequate growth of domestic demand and to vigorously pursue structural reforms that will strengthen growth in the longer term. There should be no illusion that in both cases, domestic considerations and political pressures will largely determine the outcomes. But, as in the past, cogent external advice and encouragement can play a useful role when the direction of policies is right from both national and global perspectives.

Finally, on issues of international economic policy cooperation at the global level, the participation and leadership of the United States are essential; and the effectiveness of the United States in this area of international cooperation spills over to affect other important areas. This means that key US officials need to devote attention to improving international economic policy cooperation both as regards key substantive issues and with respect to the mechanisms and modalities of cooperation. Other chapters in this volume, particularly those by Jan Boyer and Edwin Truman, William Cline and John Williamson, and Morris Goldstein, provide further food for thought on these subjects.

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