A Return to Global Imbalances?

C. Fred Bergsten says that a weaker euro and an undervalued Chinese renminbi threaten to magnify the US current account deficit and undercut the G-20's pledge not to revive global imbalances.

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Steve Weisman: Is there a new danger of currency misalignments leading to a resurgence of the global imbalances that contributed to the crisis of the last couple of years? This is Steve Weisman at the Peterson Institute for International Economics, delighted to be joined today by Fred Bergsten, director of the Institute, to talk about this. Thanks, Fred.

C. Fred Bergsten: Good to be here.

Steve Weisman: Starting out, is there a new danger of currency misalignment as the world recovers from the recession?

C. Fred Bergsten: I think the new element is the spillover effect from the European phase of the economic crisis that we have just been through. The outcome of the European crisis is a further weakening of economic growth in Europe as a number of its member countries undertake contraction of fiscal policy. That's most dramatically important in Germany, which—though it's the strongest country in the eurozone—is also tightening fiscal policy to meet the requirements of a balanced budget amendment over the next five years. So the result is going to be weaker European growth, partly for that reason and partly because of the lack of confidence in Europe coming out of the crisis.

The exchange rate in the euro has also weakened dramatically. It's gone down about 20 percent against the dollar over the last six months. It's gone down at least half that much on a trade-weighted average basis, probably a little more. Combining the weak euro and the weak European growth, I think we can anticipate a big new global imbalance: namely, a big increase in Europe's trade and current account surplus. They've been roughly in balance and therefore, somewhat outside the debate about global imbalances.

Now they will start running surpluses of several hundred billion dollars a year within the next two or three years. That, coming on top of renewed growth in the Chinese and Asian surpluses, could push the US deficit to new record highs over the next two or three years.

So, the global imbalances are back with a vengeance. They are probably going to be bigger than before. That raises some serious threats to the global economic future, not to mention violating directly the rebalancing strategy that the G-20 has painstakingly worked out over the last couple of years.

Steve Weisman: Is Europe consciously trying to export its way out of this slump? Are they overly reliant on the US as consumer of last resort, as in the recent past? If so, should President Obama take this up at the G-20 meeting in Canada at the end of June?

C. Fred Bergsten: I would not accuse the Europeans of competitive currency devaluation. In some sense, their whole rescue package for Greece and the other threatened economies within the eurozone was intended to protect the euro and prevent it from going into a free fall. At the same time, the weak euro is an inherent outcome of the policy course they have chosen. Most of the Europeans I talk to are quite comfortable, indeed quietly pleased, with the weaker euro and therefore, the boost to European trade competitiveness.

The bottom line is that Europe will be depending on substantial increases in its trade balance to recover even modestly from the crisis. European growth is going to be very weak. It will probably be under 2 percent, maybe even 1 percent for this year and next, and maybe even below that. Most of that growth will probably come from the increase in their trade balance. Domestic demand will be stagnant. That means they will not be adding anything to global economic performance, and whatever growth they get via stronger trade positions will be at the expense of domestic demand created elsewhere.

Given the way the world economy works, most of that increased European surplus will show up as an increased US deficit. Only the United States can finance big imbalances. Only the United States—in the past at least—has shown willingness to run big imbalances; other countries take action to prevent that. We've been willing in the past to be consumer and borrower of last resort. Our government has said it does not want to go back to that. The G-20 has solemnly sworn that the world should not go back to that and will not do so, but I'm afraid we're headed in that direction. That will pile up risks for the future, for the financial markets and the globe as a whole—and it certainly will detract from US growth and require us to keep running big budget deficits and/or promoting debt financed consumer demand if we're going to keep our own growth going.

Steve Weisman: It sounds like you're saying we almost have no choice.

C. Fred Bergsten: It's a very tough choice for the United States. Traditionally, the United States has been willing to run big external deficits and borrow from the rest of the world to finance them, partly because it was attractive to the United States itself in the short run. We were living beyond our means, and that's always fun as long as you can do it, but we also provided what economists call a global public good. The United States was willing to accept big deficits and debt in return for keeping the world economy going, accommodating to other countries' preferences and avoiding a slowdown, which would be the alternative had we not accepted that—and/or trade restrictions if we tried to resist it in that way.

So US global leadership was partly implemented through a willingness to accommodate other countries' desires to export their way to faster growth. The question now is whether it's really responsible for us to do that again in terms of the risks that pile up for the world, including those countries that are benefiting from it in the short run. It also puts our own future more at risk as we pile up more foreign debt and external deficits.

I think the rest of the world will only change its stripes if they really see that we're changing ours. I think the United States will have to demonstrate convincingly to other countries that we do intend to put our house in order and not rely on debt-financed consumer demand, nor go back to being consumer of last resort.

Steve Weisman: And budget deficits, I presume.

C. Fred Bergsten: I was going to say that. That would mean taking action now to convincingly reduce our budget deficits—not immediately but phased in over several years as recovery from the recession plays out.

In my view, it means taking convincing and credible action that requires actual legislation now to deal with things like the longer-run sustainability of the Social Security system. Until and unless the United States actually takes those actions, other countries can be justified in assuming that we'll be willing to go back to being consumer of last resort, and they can exploit our domestic demand growth to export their way out of their problems. So something of a confrontation may be looming here, and the United States will have to take some tough domestic steps in order get the others to do so as well.

Steve Weisman: Let's turn for a second to China, the fastest-growing region in the world. Chinese currency continues to be undervalued in your view and the view of our colleagues at the Peterson Institute. But there are some new numbers on that. What progress, if any, is the administration making on getting China to rebalance its economy and address the currency misalignment problems?

C. Fred Bergsten: The Chinese currency is still largely pegged to the dollar. That has had one modestly favorable effect lately: the dollar, as I mentioned before, has been going up against the euro, so the Chinese renminbi has been riding the dollar up against the euro. That means they've strengthened against that particular part of the world, which amounts to a modest, maybe 2 percent, rise in the trade-weighted value of the Chinese currency. So they are revaluing a little bit.

But the points I was making before about Europe greatly strengthen the case for a substantial Chinese revaluation. The reason is that Europe is now about to start running big trade surpluses—in a way, understandably, because that's about the only way out of their crisis. If the Asian and Chinese surpluses stay as large as they are, or even worse grow further, then the US deficit is pushed to new high record levels—and the global imbalance has become much worse.

So in an almost paradoxical way, the strengthening of the European trade surpluses—reflecting the weakness of their currency—substantially increase the need for China to let its currency go up, not just against the euro but against everybody. It will take a substantial increase in the value of the renminbi in order to bring down the Asian component of the imbalances and to make room for the European surpluses without adding greatly to the US deficit and the global imbalances as a whole.

The Chinese sometimes see it the other way. They say: "Well, Europe is now weak, its growth is modest, its currency is down; so that makes it tougher for us. We don't want to let our currency go up," whereas the need is the opposite. That, I think, will be another source of conflict.

We have done some recalculations here based on the fact that the Chinese trade surplus did come down for a couple of years—the effect of their currency going up a bit against the dollar, and against the euro—

Steve Weisman: A couple of years ago, right.

C. Fred Bergsten: Yes. Our latest calculation is that the trade-weighted average of the renminbi needs to go up about 15 percent; its bilateral rate against the dollar needs to go up about 25 percent. Those numbers are considerably lower than we were suggesting a year or so ago. That's on the basis of trying to get China's surplus, not eliminated, but down to about 3 percent of its economy. If you thought it ought to be eliminated, which is reasonable, the numbers would still be about double that. So it depends on your goal—how much you'd like to bring the surpluses down. But even if you get them down only to about 3 percent, the Chinese need to let their currency go up 15 percent on average, 25 percent against the dollar.

I think if they do not do that pretty soon, they're going to have a lot of pushback here in the United States and elsewhere. Everybody gave them a couple of months when they signaled a little while back they were going to act. That window came to an end with the G-20 summit, and they announced that they would let the rate start moving again. But if they do not let the rate naturally move by a good deal, I'm afraid there'll be a lot of pushback here in the United States, by the administration as well as by the congress. That will then make it harder for the Chinese to move, because then they would seem to be moving directly under the foreign pressure.

I should add that this is precisely the right time for China to let its currency go up substantially in purely domestic terms. The Chinese are now worried about a renewed overheating of their economy. Producer price inflation is now up to 7 percent at an annual rate. They're worried about inflation. They're worried about new property bubbles, in part because of capital inflows—speculating on a stronger currency. There are all sorts of purely domestic reasons for the Chinese to let their currency rise significantly, and it remains a great mystery why they are unwilling to do so.

Steve Weisman: Mystery—but there's a lot of internal infighting over this issue, no doubt.

C. Fred Bergsten: As always, there is debate about currency moves. Some of the state-owned enterprises and other export interests of course prefer the status quo, but the Chinese authorities themselves have said for five years: "We intend to rebalance; we don't intend to keep running current account surpluses." You could maybe excuse their not moving during the Great Recession. But now they have led the world out of the Great Recession. They were first out. They're [the] strongest out. They've got the strongest economy in the world. They've got the biggest trade surplus in the world and it's going up again. They're worried about inflation. It's a textbook case for letting your currency go up considerably.