Global Economic Prospects as of September 30, 2010: A Moderating Pace of Global Recovery

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Overview

Since the end of the great recession around the middle of 2009, the world economy has, as forecast, staged a quite vigorous, V-shaped recovery. Real GDP growth for 2010 is now expected to exceed slightly even my buoyant forecast of 4.5 percent. This result, however, embodies substantial divergence between the more-rapid-than-expected growth of most key emerging-market and developing countries (6.5 percent for 2010) and the somewhat disappointing pace of recovery in most of the advanced economies (2.8 percent for 2010).

Looking to 2011, it should be anticipated that the rate of global economic growth will moderate from about 4.6 percent down to 4.3 percent. This moderation reflects the waning of the very strong forces that helped to propel the initial stages of recovery in many emerging-market and developing countries (down to 6 percent for 2011), together with the expectation that growth in the advanced economies is unlikely to accelerate over the pace of the past year.

Macroeconomic policies are expected to be consistent with these growth forecasts. With a few exceptions (including Australia, Canada, Israel, and Sweden) monetary policies in the advanced economies are likely to remain very highly accommodative, while fiscal policies are generally becoming less supportive of growth. In some emerging-market and developing countries, monetary policies have already been tightened to resist rising inflation, but no general move toward substantially tighter policies should be anticipated in the face of somewhat more moderate growth rates.

Meanwhile, neither inflation nor deflation appears likely to become a significant problem any time soon, although the situation does differ somewhat across countries. For the world as a whole, consumer price index (CPI) inflation in 2011 is projected to be about 3.5 percent, up slightly from 2010, and with the advanced economies recording headline inflation rates of about half of the global average. Headline inflation rates will partly reflect rising commodity prices. Core inflation rates are generally expected to run about half of the headline rates, with core inflation rates in most of the advanced economies just below 1 percent (with Japan at about –1.5 percent).

A brief summary of the forecasts for key economies (which are presented in table 1) is the following:

For the United States, the pace of recovery recently slackened rather than accelerated as I had expected. Growth this year is now projected to come in at 2.9 percent, down a full percentage point from my forecasts of last April and of a year ago. The forecast for next year is also cut, from 4.1 percent to 3.3 percent.

For Western Europe, the results so far indicate that growth this year will come in at about 1.8 percent, below my April forecast of 2 percent but above the consensus forecast (of last April) of barely more than 1 percent. I expect that, despite strong efforts of fiscal consolidation in some West European countries, growth for 2011 will surprise on the upside and slightly exceed growth this year.

For Japan, strong results for the last quarter of 2009 and the first quarter of this year suggest that (year-over-year) growth for 2010 will modestly outpace my quite optimistic April forecast of 2.7 percent. The strengthening of the exchange rate of the yen and the prospect of some slackening of growth in key Asian trading partners, however, imply that growth in 2011 is likely to decline and continue about 1 percent below my April forecast of 3 percent.

Table 1 Global growth forecast, percent year over year growth rates of real GDP

Region/country	2009	2010	2011	2012
World (WEO PPP weights)	–1.1	4.6	4.3	4.4
Advanced Economies	–3.2	2.8	2.8	2.8
United States	–2.6	2.9	3.3	3.6
Japan	–5.2	3.0	2.0	1.8
Canada	–2.5	3.3	3.3	3.4
Western Europe	–4.2	1.8	2.0	2.0
United Kingdom	–4.9	1.7	2.4	2.3
Other non–euro area	–3.8	3.1	2.6	2.4
Euro Area	–4.0	1.7	1.9	2.0
Germany	–4.7	3.2	2.3	2.1
France	–2.5	1.7	1.9	2.1
Italy	–5.1	1.3	1.5	1.5
Other euro area	–3.8	0.8	1.4	2.0
Other non-Europe	–0.5	6.5	4.5	4.0
Emerging Market and Developing	2.8	6.5	6.0	6.1
Asia	6.9	8.8	8.0	8.3
China	9.1	10.0	8.7	9.4
India	7.4	8.7	8.3	8.0
Other Asia	0.5	6.1	5.8	5.7
Latin America	–1.8	5.2	4.0	4.0
Brazil	–0.2	7.5	5.0	4.7
Mexico	–6.6	4.7	3.7	3.6
Central and Eastern Europe	–3.8	3.0	3.7	3.7
Commonwealth of Independent States	–6.8	5.0	5.0	4.8
Russia	–7.8	4.8	4.5	4.0
Middle East and North Africa	2.5	4.2	4.5	4.5
Sub Saharan Africa	2.2	4.6	5.0	4.8

WEO = World Economic Outlook
PPP = purchasing power parity

The advanced economies that have done relatively well this year (Australia, Canada, Israel, and especially Singapore, South Korea, and Taiwan) should continue to do relatively well in 2011. But, growth rates will undoubtedly decline from the spectacular results this year for Singapore and (to a lesser extent) South Korea and Taiwan. The more modest contribution from these countries will offset somewhat stronger growth in the larger advanced economies and hold the aggregate growth rate for all of the advanced economies to 2.8 percent in 2011.

Among the key emerging-market economies, China's growth is likely to slow from 10 percent this year to a little below 9 percent next year. Even with this modest slowdown, China will still account for one-quarter of the growth of the entire world economy.

For India, a smaller slowdown, from 8.7 percent growth this year to 8.3 percent next year is anticipated. In contrast, Brazil's growth will likely slow from 7.5 percent in 2010 to a still-vigorous 5 percent in 2011. Elsewhere, the story is mixed, with a general tendency for growth rates in emerging-market and developing countries forecast for 2011 to be somewhat below results now expected for this year.

It should be noted that the forecasts reported in table 1 are generally toward the top end of the range of recent private and official forecasts, but (unlike my forecasts of a year ago) are not above the top end of those ranges. For 2010, this mainly reflects the reported results for growth in the second half of 2009 and the first half of 2010. In a few cases, such as the United States, I have had to temper my relative optimism in light of actual performance that has been somewhat below forecast. But more generally, other forecasts have had to be revised up toward my earlier views in light of growth that has exceeded expectations.

For 2011, I remain somewhat more optimistic than the average predictions of other forecasters. However, there is less reason now than there was a year ago to expound forecasts above the range of other informed opinion. The general regularity is the Zarnowitz rule that deep recessions tend to be followed by relatively steep recoveries. And there has been a marked tendency for forecasts to substantially underpredict the pace of such recoveries. Now that the world economy is past the initial stage of a moderately strong, V-shaped recovery, there is no strong reason to believe that most economic forecasts are decidedly biased toward the downside.

Table 1 also reports preliminary projections for growth in 2012. These projections reflect my perception that there is not now any strong reason to expect an early end to the present global economic expansion. In the advanced economies where margins of slack generally remain, growth is projected to be in line with or somewhat above potential growth rates, with accommodative monetary policies supportive of stronger growth and fiscal restraint tending to operate in the other direction. For most emerging-market and developing countries, margins of slack have already been considerably reduced, and growth rates for 2012 are projected to be close to potential.

As always, there is a significant range of uncertainty surrounding any economic forecast. Forecasts need to account for this uncertainty by leaving reasonable room for results to surprise on either the upside or the downside. But, I would not now agree with the frequently heard complaint that these are highly uncertain times in which it is especially difficult to forecast the economy. This was true in 2008 as an exceptionally deep recession began to develop and in 2009 when the timing and pace of recovery were difficult to foresee. Not now. We are in a global expansion, and with suitable respect to the usual uncertainties on both the upside and the downside, it is reasonable to expect that that expansion will continue for at least a while.

The Recent Slowdown in the US and Reasons for Acceleration

As recently recognized by the National Bureau of Economic Research, recovery in the United States went off-schedule in the middle of last year. During its first three quarters of recovery, growth proceeded at a 3.6 percent annual rate. This was somewhat above my April 2009 forecast and only slightly below my September 2009 forecast, but well above most other forecasts of similar vintage.

In the second quarter of this year, despite a rise in the annualized growth rate of real domestic demand from 3.9 percent to 4.9 percent, the estimated growth rate of real GDP fell to only 1.6 percent. This reflects an exceptionally large surge in real imports that overpowered a significant gain in real exports and left net exports subtracting 3.4 percentage points from annualized real GDP growth in 2010Q2.

Monthly data indicate that the surge of imports in the second quarter is partially being reversed in the third quarter, with the implication that real net exports may well make a positive contribution to real GDP growth in second half of 2010. In any event, persistently sluggish real GDP growth (or even a double-dip recession) cannot plausibly result from persistently large increases in real imports that equal or outstrip strong gains in domestic demand—the marginal propensity to spend on imports is well below unity.

The observed and projected slowdown in growth during the final three quarters of 2010, however, reflects more than a temporary surge of imports. A comparison of my projections for the main components of GDP a year ago with what I am now projecting reveals some of the reasons for the slowdown. Specifically, table 2 reports the projected changes in real GDP and contributions of its main components measured in 2005 real (chain-linked) dollars over four time periods: (1) the forecast of the changes over the six quarters from 2009Q2 to 2010Q4 that was made a year ago in September 2009; (2) the changes that have been reported from 2009Q2 through the most recent estimate for 2010Q2; (3) the changes that are now being forecast for the six quarters from 2009Q2 to 2010Q4; and (4) the present forecast of the changes from 2010Q4 to 2011Q4.

For real GDP the increase so far since 2009Q2 is R$382 billion and the projected rise through 2010Q4 is now R$570 billion. This is only two-thirds of the gain of $838 billion that was forecast a year ago (corresponding to a cumulative rise of real GDP over six quarters of 4.4 percent rather than a rise of 6.5 percent).

Clearly, the shortfall in the growth of consumption spending (relative to forecast) accounts for the bulk of the shortfall (so far and projected through the end of 2010) in rise in real GDP. This is partly due to increases in the household saving rate that were a little greater than forecast. (Consumption was forecast to rise by half of the rise in real GDP, implying a decline in the ratio of consumption to GDP. So far consumption has risen by only 40 percent of the rise in real GDP since 2009Q2.) It is mainly due to household income growing less rapidly than forecast. This, in turn, can be attributed to two factors: (1) other components delivered less impetus to real GDP growth than had been projected in my forecast; and (2) increases in government transfer payments provided somewhat less support to household disposable income than I had projected (either because the stimulus package failed to deliver as much as promised or because I misunderstood what the stimulus package would do).

Table 2 Contributions to changes in US real GDP for selected periods in real (chain-linked) 2005 billions of dollars

Change in	2009Q2 2010Q4 (a)	2009Q2 2010Q2 (b)	2009Q2 2010Q4 (c)	2010Q4 2011Q4 (d)
Real GDP	838	382	570	470
Consumption	411	153	253	240
Gross private domestic investment	433	334	362	310
Nonresidential structures	–50	–58	–78	20
Equipment and software	154	142	181	215
Residential	106	17	31	75
Inventory investment	210	225	232	5
Net exports	–50	–103	–48	–29
Government purchases	51	18	31	–20

(a) refers to my forecast of September 2009; (b) refers to the results reported as of September 27, 2010; (c) is based on my current forecast through 2010Q4; (d) is my forecast for 2011.

Among the other components of real GDP, the increase in inventory investment has already outpaced its large assumed contribution of the recovery of real GDP. Gains in private investment in equipment and software are also on pace to exceed their projected contributions. Private investment in non-residential structures has fallen a little more than anticipated. Real net exports, as previously discussed, have deteriorated more than forecast, but this is projected to be reversed by the year's end. Government spending has risen even less than projected, perhaps partly due to shortfalls in implementing the stimulus package—but this is a minor factor. The largest shortfall is in residential investment, which bottomed out but has not yet begun the moderately vigorous recovery that I was anticipating.

Looking forward, the projections in the final column of table 2 suggest the rationale for expecting some acceleration of growth during 2011. The R$470 billion projected rise in real GDP implies 3.5 percent growth on a fourth-quarter-to-fourth-quarter basis (consistent with 3.3 percent growth on a year-over-year basis). The rise in consumption spending is assumed to equal half of the rise in real GDP. Households are presumed to pursue only modest further increases in saving and the government is assumed not to impose significant net increases in personal taxes that would slow disposable income growth.

Government spending is projected to decline three-quarters of 1 percent during 2011, as the stimulus winds down and as state and local governments only gradually come to see recovery in their tax revenues. Real net exports are also projected to make a modest negative contribution to real GDP growth. This leaves private investment as the essential driver of real GDP growth (including its multiplier effects on consumption).

Private investment in nonresidential structures is plausibly expected to show a modest gain during 2011, following two and a half years of substantial decline. Investment in equipment and software is forecast to show another very large gain—partly justified by the assumption that President Obama's recent proposal of a one-year move to full expensing of business investment will gain the necessary political traction.

More important on a somewhat longer-term basis is the projection that residential investment will begin a sustained period of substantial recovery. The projected gain during 2011 amounts to only barely half of a percentage point of real GDP. The plausible medium-term gain would take the share of residential investment up by five times that amount to a level still well below the peak share of over 6 percent at the end of 2005.

In this regard, it is important to recognize that new housing starts have recently been running at only one-third of the annual rate (about 1.7 million units) necessary to make room for the normal growth of 1.2 million in the number of independent households plus replace the half million units that are annually removed from the housing stock. Clearly, temporary factors including a large overhang of foreclosed and vacant properties, difficulties with mortgage finance, and the recession-induced decline in the number of independent households have so far held back a substantial recovery in residential investment. At some point, plausibly during 2011, these difficulties will begin to abate and housing construction can begin a substantial and sustained recovery.

Concerning macroeconomic policy in the United States, arguably it should be reassuring that the stimulus package appears to have had a somewhat disappointing effect in driving recovery. This suggests that the winding down of the stimulus package should be expected to have a relatively mild effect in retarding recovery.

For monetary policy, the Federal Reserve has recently signaled that it is prepared to resume quantitative easing out a substantial scale if the pace of recovery remains sluggish. Joseph Gagnon will discuss this issue in some detail. I indicate only briefly my doubts that this is a wise policy. Indeed, the concept of a "monetary policy" involves the fundamental notion that there is a calibrated relation between the settings of the monetary policy instruments (the federal funds rate and the size and composition of the Federal Reserve's balance sheet) and the condition in and prospects for the economy (including real growth, employment, inflation, and the risks untoward outcomes).

Under such a policy, in the desperate circumstances of late 2008 and early 2009, with genuine concerns that the financial system was collapsing and the economy might be headed into depression, it made sense to move monetary policy to an exceptionally easy stance. Arguably, it makes sense to continue with that exceptional easy policy setting, as the Federal Reserve has indicated, until the recovery is firmly established (provided that inflation is not becoming a problem). However, in my view it is not responsible to move to an even more aggressively easy policy stance than was adopted at the height of the crisis merely because the pace of the present recovery is somewhat disappointing. Sound medicine does not administer addictive pain killers to give an artificial high to patients who crave it. A responsible central bank should not practice monetary policy as Michael Jackson's physician reportedly practiced medicine.

Fiscal Consolidation and Recovery in Europe

Economic forecasts for Europe were written down six months ago when worries arose about a possible sovereign default by Greece that might spread to other countries with large government deficits and/or high public debt ratios. The crisis calmed when a large international support package was put together for Greece (conditional upon Greece's commitment to reduce substantially its fiscal deficit) and a far larger package of conditional support was promised for other European countries that might get into sovereign financing difficulties. Partly in response to these developments, most European countries, even those like Germany that were not likely to face financing difficulties, announced significant programs of fiscal consolidation. This, in turn, has led to concerns that economic recovery in Europe may be significantly retarded by efforts at fiscal consolidation.

My colleague Jacob Kirkegaard will explore the situation in Europe in greater detail. I limit my remarks to the observation that substantial efforts at fiscal consolidation pursued simultaneously by many European countries will have some effect in retarding recovery, but this effect should not be exaggerated.

In the case of Germany, fiscal consolidation plans are quite moderate, amounting to planned improvements in the structural fiscal position of about half a percentage point of GDP per year for four years ultimately resulting in a modest budget surplus. In view of the likely power of the German recovery (aided by the structure of the German economy and its cost competitiveness relative to other euro area countries), the policy measures together with the operation of the automatic stabilizers may well deliver the ultimate objective ahead of schedule. As in most countries, the actual emergence of budget surpluses is likely to cool even German ardor for fiscal consolidation.

For France, announced fiscal measures are not overly aggressive and focus on reforms that are unlikely to have much of a negative effect on aggregate demand. In particular the increase in the retirement age for public sector workers has important fiscal benefits in the longer term without any negative effect on demand. Indeed this reform is likely to boost output and employment growth in the longer term by encouraging people to work somewhat longer. It is a delusion (and not uniquely a French delusion) to believe that inducing workers to retire early creates net new jobs and reduces unemployment. (It should also be noted that the forecasts for real GDP growth in France are below those in Germany because France suffered a smaller recession than Germany and because the French economy is less oriented toward manufacturing that is benefiting from a global rebound.)

For Italy also the announced measures of fiscal consolidation are not overly aggressive and should not provide an important barrier to recovery. The main concern that leads to relatively low forecasts for Italian economic growth is the cumulatively substantial erosion in the cost competitiveness of the Italian economy relative to other euro area countries (especially Germany) since the euro was introduced in 1999. While part of this erosion may be attributed to the unwinding of the effect of Italy entering the euro area at an over-depreciated exchange rate, most of it appears to be due to persistent rises in unit labor costs in Italy relative to the rest of the euro area.

In Spain, the spillover effects from the Greek crisis to spreads on Spanish sovereign bonds have made fiscal consolidation urgent, and the effects of a suitably ambitious program will meaningfully retard Spanish growth for at least this year and next. Beyond that, it is difficult to say. In the decade that preceded the recent crisis, Spain benefited substantially from lower interest rates that were a product of membership in the euro area. The Spanish real estate boom was a virtually inevitable consequence, despite laudable efforts by the central bank to assure that Spanish commercial banks were not overly exposed to risks in this sector. This fed into a general boom in the Spanish economy, which saw a considerable loss of cost competitiveness and the emergence of a large current account deficit. There cannot now be a return to this type of boom; and, aside from fiscal consolidation, it remains to be seen how effective other policy reforms will be in restoring Spanish cost competitiveness.

Among the smaller economies in the euro area, Greece, Ireland, and Portugal face substantial fiscal challenges while most other countries do not. For Greece, I suspect that the drama is not over. By a year from now, I suspect that it will be increasingly clear that the Greek sovereign will not yet be in a position to return to private credit markets for the bulk of its longer-term financing. Either there will be a sovereign debt restructuring or, far more likely, there will be a revised program of international support for Greece featuring more funding and stronger commitments to fiscal reform. Ireland, which has shown great determination in facing its fiscal problems, is unlikely to share Greece's fate. Portugal is more worrying, although not in the same class as Greece. Unlike Ireland, which enjoyed a long period of very strong growth, Portugal's growth for the past two decades (and longer) has been anemic, and there is no strong reason to expect much improvement. On the other hand, Portugal does not need to contend with the collapse of a huge housing boom and of a very large bank which are both on the plate of the Irish authorities.

Outside of the euro area, Iceland is a disaster but too small to matter for the region as a whole or for the world at large. The main concern is with the United Kingdom. The Labor government that began life a dozen years ago as a fiscal conservative ended it last year as a fiscal profligate. The new Conservative-led coalition government faced the immediate challenge of dealing with a huge deficit that had been further enlarged both by the automatic stabilizers and by policy measures adopted to combat the recession. In such a situation, it is politically impossible to announce a policy that rigorous fiscal consolidation will begin in a year or two once economic recovery is firmly established. That is not credible. The only viable policy is to announce strong immediate consolidation measures with more to follow.

This is what the new government has done. It remains to be seen, as more specific measures and the timetable for implementation are announced, whether the government will overdo it and kill the recovery. I think that this is unlikely, but even appropriately vigorous fiscal consolidation will likely restrain economic recovery. The saving grace is that the exchange rate of sterling and British monetary policy are not locked in by participation in the euro area. Indeed, sterling has depreciated substantially against the euro (and the US dollar) since 2007 offering relief for Britain's long beleaguered manufacturing sector. The Bank of England has moved very aggressively to monetary easing, well ahead of the actions of the European Central Bank and even arguably ahead of the Federal Reserve. Indeed, while the Bank of England still worships at the altar of inflation targeting, it has continued to ease aggressively in the face of an inflation rate running above target. This, of course, is explained away as not a divergence from the true faith, but the revealed truth is that the Bank of England, like any sensible central bank, knows when the economy—rather than inflation—has become the dominant concern and it also knows that the government and the public will, in such situations, readily forgive a little sinning by the clergy.

Global Rebalancing

The great global recession of 2008–09 demonstrated once again that emerging-market and developing countries cannot escape damage when the major advanced economies suffer serious economic and financial difficulties. Some Asian countries, most notably China, India, and Indonesia, avoided outright declines in output during the global recession but suffered slowdowns in growth before staging vigorous rebounds. More generally, emerging-market and developing countries (and the advanced Asian economies other than Japan) suffered output losses during the global recession but subsequently have recovered quite strongly despite fairly weak recoveries in the main advanced economies. The world economy has not decoupled, but the couplings between the advanced and emerging-market economies have become more elastic as the as the relative economic importance of the latter has risen in recent decades.

This longer-term trend is likely to continue as emerging-market countries enjoy real growth rates double or triple those of the main advanced economies. Looking to the current economic recovery, this implies that increased attention needs to be devoted to the role of emerging-market countries in achieving a reasonably balanced global recovery. The ascendance of the G-20 and the decline of the G-8 as the key international forum for discussing such issues pays witness to this ongoing development.

In this connection, it is noteworthy that the global recession and the global recovery, at least so far, have been associated with an important reduction in global payments imbalances, especially the current account deficit of the United States and the current account surplus of China. Will this continue or will the problem of substantially widening imbalances plague the global recovery and, at some point, possibly threaten its continuation?

The answer at this stage is far from clear. What is clear is that national economic policies need to be generally supportive of the market forces that normally both drive national economic recoveries and coordinate developments in different national economies. This includes allowing real effective exchange rates to adjust with sufficient speed and flexibility to avoid the reemergence of unsustainable international payments imbalances. The situations of Japan, the United States, and China and a few countries that also run very large current account surpluses are especially important in this regard.

After a hiatus of more than six years, the Japanese authorities this month resumed official intervention to drive down the foreign exchange value of the yen. The operation was at least initially successful in that the yen appreciated by a couple of percent against the US dollar. The rationale for adopting this new policy (or returning to an old one) is clear.

Despite notable lack of involvement of Japanese financial institutions in the global financial crisis, Japanese real GDP was hit harder by the global recession than that of any other G-7 country. This reflected the Japanese economy's dependence on manufacturing and its exposure to the collapse of world trade in manufactured products. Resurgence in 2009Q2 and two strong quarters of recovery in late 2009 and early 2010 brought Japan up from the depths, but still left real GDP 4 percent below its pre-recession level.

Meanwhile, by the end of 2009, the Japanese yen had appreciated by 35 percent against the US dollar from its 2007 low. In real effective terms (for which there are several measures), the yen's appreciation by end 2009 from its 2007 average was about 20 percent. These exchange rate movements were not surprising in view of the highly depreciated level of the yen in 2007 and the fact that monetary policy in Japan became much less easy **relative** to the monetary policies of other major countries, most notably the United States. From a medium- to longer-term perspective (with all economies performing normally), it cannot reasonably be argued that the Japanese yen was overvalued at the end of 2009. Nevertheless, the substantial appreciation of the yen over the preceding two to three years was a factor tending to blunt the Japanese recovery when recovery was far from complete. This situation worsened as the yen began to appreciate again during the summer of this year, at the peak up by almost 10 percent against the US dollar and by a somewhat smaller amount in real effective terms.

The Japanese authorities, rightly concerned about their economy and facing political pressure, felt that they had no alternative but to send a meaningful signal that—from their perspective—yen appreciation had proceeded too far too fast. Officials in other major advanced economies, however, were not enthusiastic and there was no coordinated support for the Japanese intervention.

This episode illustrates a key problem in achieving a globally balanced recovery, specifically as it relates to exchange rates. In 2007 a very weak yen could be tolerated (if not welcomed) by other countries because the Japanese economy was relatively weak while most of the world was operating at or near full employment. In 2010 with a much stronger yen, Japanese intervention to resist further appreciation is problematic for many other countries because margins of slack are generally quite high.

For China and a few other countries that have been persistently running large current account surpluses and intervening actively to resist appreciation of their currencies (including Malaysia, Singapore, Switzerland, and Taiwan) the concern about the role of exchange rate policy in achieving a globally balanced recovery is more intense than in the case of Japan. Specifically for China there has been some real effective appreciation of the yuan since July 2005 (when the Chinese authorities began a three-year period where the nominal rate was allowed to appreciate at a modest pace against the dollar). Also in connection with the world recession and the collapse of world trade, China's current account surplus as a share of GDP was cut in half from a peak of nearly 11 percent in 2007. However, the concern is that without significant real effective appreciation, the current account surplus is likely to widen substantially again as rapid productivity growth in China continues to drive up the equilibrium value of the real exchange rate.

Senior Chinese officials retort, somewhat inconsistently, that (1) there is no real evidence that the exchange rate affects the current account balance and (2) that allowing substantial appreciation of the exchange rate would seriously undermine China's economic growth. Like most of my colleagues at the Peterson Institute, I find these arguments to be fundamentally nonsense. Yes, the exchange rate (and associated policies that keep the exchange rate from appreciating in the face of clear market pressures) are not the only factor that can influence the evolution of the current account. And, yes, exchange rate appreciation that is very large and concentrated in a relatively short period can undermine growth. But, moderate real exchange rate adjustments are generally required to keep current account imbalances within reasonable bounds and are especially important in present circumstances to help assure a balanced global recovery.

It is not essential to resolve this intellectual dispute in order to deal with the key policy issue. The key policy point is that in a situation where many countries suffer substantial margins of slack, no country can legitimately claim the arrogant privilege to pursue its growth objectives at the expense of other countries by following policies that generate large and ever-widening current account surpluses. At about 5 percent of GDP, China's current account surplus is already very large for such a large and diversified economy. If the Chinese economy can grow without widening this surplus and without allowing significant exchange rate appreciation (or adopting policies that harm other countries' growth), then so be it. However, if Chinese insistence on avoiding significant exchange rate adjustment is again reflected in a substantially widening current account surplus then this policy should be subject to international condemnation and to whatever countermeasures injured parties may deem appropriate.

The United States is not the only country that might suffer from inappropriate exchange rate policies of large surplus countries. Most of the other advanced economies, including Japan, are in this situation, and most emerging-market countries that allow reasonable flexibility in their own exchange rates (including Brazil, India, Indonesia, Mexico, South Africa, and Thailand) are in it as well. Their recoveries from the great global recession could be inappropriately retarded if a few countries insist on exchange rate policies that promote widening current account surpluses. The United States stands out because it has the largest economy and, despite its sizable decline since 2007, has the world's the largest current account deficit. The US dollar is also the currency against which most surplus countries tend to limit the adjustments of their nominal exchange rates.

Recently, President Obama proposed the policy objective of doubling US exports within five years and his administration has promoted this as key to generating more high-paying jobs. Higher net employment, however, is more closely linked to **net** exports (i.e., exports minus imports) than to exports alone. If one recognizes that US imports typically grow faster than output and often faster than exports, then President Obama's proposal may be understood as an effort to avoid a net loss of jobs by avoiding most of the deterioration of net exports that usually accompanies business cycle recoveries in the United States. This is consistent with the US position that the world economy needs a globally balanced recovery. However, if the proposal is really intended as an effort to generate substantial net new employment in the United States by pushing export expansion well ahead of import growth, then the proposal is open to similar objections that have been advanced against China's exchange rate policy. A balanced global expansion needs to be balanced for everyone.