Global Imbalances – Where Are They and Do They Matter?
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It is hard to recall a time when the state of the world economy looked better than it does today. True, Europe continues to grow too slowly, and some of the accession countries have worrisome macroeconomic imbalances. And Sub-Saharan Africa is still mired in poverty, compounded by crop failures and deadly political strife.

But most of the rest of the world economy is performing remarkably well, due partly to the success of central banks in anchoring expectations of low inflation in the face of rapidly rising energy prices.

It is equally hard to foresee a sharp acceleration of world inflation or a lapse into global deflation. I will argue later, however, that we may see slower growth ahead – a slowdown somewhat sharper than the one foreseen in the IMF's *World Economic Outlook.* We would all agree, moreover, that there are big imbalances in the world economy, as well as some very large longer-run challenges.

We are all aware of the need to deal with the fiscal consequences of the demographic changes that lie ahead, including the very large increase of pension and health-care costs. Yet we have not begun to contemplate the economic costs of dealing with global warming if, as now seems likely, it will occur more rapidly and have more virulent effects than had been anticipated a few years ago. Consider the cost of protecting low-lying coastal areas from higher sea levels and the cost of relocating people as well as agricultural production away from newly arid regions. These costs may impose far larger budgetary burdens than aging populations.

But let me return to the main theme of this meeting – existing imbalances in the world economy and the best way to reduce them in an orderly way. Subsequent sessions will deal intensively with these issues, but I want to say more about one of them, at the risk of poaching on other participants' turf.

Some months ago, the State Administration for Foreign Exchange (SAFE), the agency that manages China's foreign-exchange reserves, posted a statement on its website that led some people to believe that China might start to diversify the currency composition of those reserves. It said that it would seek to improve "the operation and management of its foreign exchange reserves" by optimizing the currency and asset structure of its huge holdings. This was widely taken to mean that China would sell U.S. dollars for euros and other currencies. Shortly thereafter, however, a senior official of the People's Bank of China offered this clarification: China, he said, was not likely to reduce its existing dollar holdings, but it might diversify at the margin by investing some newly acquired reserves in other currencies.

If, of course, China bought euros or yen rather than dollars with all of its newly acquired reserves, it would cease to accumulate U.S. government securities, and there could then be an increase in U.S. interest rates, although the effect might be fairly small.

But what would happen to exchange rates? Some people concluded incorrectly that China would cease to buy dollars in the foreign-exchange market, as it would buy euros instead. The dollar would then depreciate vis-à-vis the renminbi – a result that would help to rectify the transpacific imbalance. But China, they said, would suffer a large capital loss on the renminbi value of its existing dollar reserves.

Yet that's not what China would do – and may already be doing, although we have no way to know, because China does not disclose the currency composition of its official reserves. China will still buy dollars in the foreign-exchange market to stabilize or limit the appreciation of the renminbi vis-à-vis the dollar. But it then can be expected to re-enter the market to sell some of the dollars for euros, yen, and other currencies. Hence, diversification at the margin may have very little effect on the renminbi-dollar rate (although it may still produce higher U.S. interest rates.) This sort of diversification, however, cannot but strengthen the euro vis-à-vis the dollar. I can, indeed, conceive of conditions in which the European Central Bank would be compelled to intervene to limit the appreciation of the euro -- in which case, it would presumably buy some of the U.S. government securities that China had ceased to buy, limiting the increase of U.S. interest rates. The transpacific imbalance would then be financed by a transatlantic imbalance.

Note that some of the major oil producers may do what China is likely to do. They are not apt to unpeg their currencies from the dollar. But they may begin to buy euros and other nondollar currencies with some of their newly acquired dollars, and they may already be doing that.

Let me note one further consequence of the scenario I have just described. If the dollar began to depreciate vis-à-vis the euro, the renminbi could well depreciate in effective terms. The outcome would depend on the weights employed by the People's Bank of China in defining its currency basket – the one it ostensibly uses for guidance when making exchange-rate policy – and on the operational importance it attaches to the basket. But a large depreciation of the dollar vis-à-vis the euro would presumably induce the PBOC to let the renminbi depreciate along with the dollar, albeit by a lesser amount. (The larger the weight of the dollar in the basket and the greater the importance attached to the basket, the larger the likely depreciation of the renminbi vis-à-vis the euro and other non-dollar currencies.)

And let me add a footnote to my scenario. The principal risk of a 'run' on the dollar – a disorderly adjustment of exchange rates derives from the likely behavior of the private sector, not from reserve diversification by the official sector. The recent and prospective narrowing of interest-rate differentials has been widely cited as the reason for the sharp fall in the dollar last week. While one week does not make a trend, especially in the foreign-exchange market, I venture to predict that the foreign demand for dollar assets is likely to fall in the months ahead, increasing the urgency of the need to reduce the U.S. current-account deficit.

In 2006, the U.S. current-account deficit amounted to more than six per cent of U.S. GDP, an unprecedented level, and there are reasons to believe that it will go on growing in the absence of strong remedial measures. For many years, U.S. investors earned more on their foreign assets than foreign investors earned on their U.S. assets, even though foreign investments in the United States were larger than U.S. investments abroad. The favorable balance on these investment-income flows helped in part to offset the U.S. trade deficit, but the investment-income balance has been shrinking steadily, and recent data indicate that it is now negligible. The shrinkage is due in the main to the deterioration in the investment position itself – the ineluctable fact that a current-account deficit has to be matched by a net capital inflow, including in the U.S. case the very large inflow of foreign official funds reflecting the growth of the dollar reserves held by the East Asian countries but also the growth of the dollar reserves of the oil-exporting countries and of some middle-income developing countries elsewhere in the world.

The chief cause of the U.S. current-account deficit is, of course, the trade deficit, which has grown hugely in the last few years. In 2005, U.S. merchandise imports were almost twice as large as U.S. merchandise exports, and the gap is growing, because U.S. imports have been rising faster than U.S. exports. Last year, for instance, merchandise exports grew by 10.5 percent, whereas merchandise imports grow by 13.7 per cent.

Some economists maintain that this situation is sustainable. Their view derives from their belief that the growth and domestic stability of China require that country to increase its exports. Otherwise, it cannot create the huge number of jobs needed to absorb its vast rural population who live close to poverty. In their view, China cannot permit the large appreciation of the renminbi that would be needed to limit the growth of its exports and thereby reduce its current-account surplus. It will perforce accumulate additional reserves.

But I am safe in saying that the majority of economists disagree with this benign assessment. They say – and do I – that the situation is unsustainable and must soon be rectified. Otherwise, the transpacific imbalance could end in a very disorderly way, with a self-fulfilling loss of confidence in the U.S. dollar, a flight from dollar-denominated assets, and enormous damage to the international financial system.

What are the measures required to achieve an orderly end to the transpacific imbalance? There must be an increase of private and public saving in the United States, a decrease of saving elsewhere in the world, especially in China, and an increase of investment in Latin America, together with a large depreciation of the dollar vis-à-vis the currencies of the East Asian countries. Absent a large depreciation, higher saving in the United States would depress domestic economic activity and lower saving in China could lead to high inflation. The depreciation of the dollar is needed to shift Asian expenditure toward the United States and shift U.S. expenditure away from Asia.

The U.S. corporate sector is doing its part; corporate saving is high, perhaps unsustainably high. And the U.S. household sector may be forced to do its part if, as I fear, we may face a fairly sharp fall in housing prices rather than stabilization somewhat below present levels. We are nearing a time at which many home-owners will face a very large increase in their carrying costs – an abrupt increase of interest rates on adjustable-rate mortgages and the addition of amortization payments to interest-only mortgages.

On a personal note, I have been startled by an eruption of 'for sale' signs across the river in Hoboken, where we own a small condo – our way to avoid the slow train trip from Princeton to New York – and have noticed that view of those signs have been removed.

Unhappily, I see little likelihood of a significant increase in public saving – an early or rapid reduction in the U.S. budget deficit. Not with a tight congressional election a half-year away, nor in the last two years of the current administration. Nor do I see much likelihood of an exchange-rate realignment of the size required to play a significant supporting role in reducing the transpacific imbalance.

And I am compelled to end my remarks with some more pessimistic comments:

First, I see little chance of a fall in oil prices and a nasty chance of a further rise, not only because of the precarious situation in the Middle East, instability in Nigeria, and other problems specific to individual oil-exporting countries, but mainly because there is – and will continue to be – insufficient spare capacity to meet the foreseeable growth in demand driven by the growth of incomes in emerging-market countries.

Second, I am deeply pessimistic about the outlook for the Doha Round, and I fear in addition an intensification of protectionist pressures, not only in the United States but also in Europe and Latin America. It may take different forms in different places – Congressional retaliation against China for refusing to let the renminbi appreciate quickly or substantially, further attempts to protect national champions in some EU countries, despite the efforts of the Commission to defend the single market, and restrictions on foreign direct investment in some of the Andean countries.

And though my pessimism does not lead me to foresee an acceleration of inflation or the advent of deflation, I do fear slower growth ahead – slower than the rather reassuring forecasts in the IMF's *World Economic Outlook*.

Finally, I share one concern expressed by the IMF. Several major countries, not just the United States, are running budget deficits too large to give them room for fiscal flexibility in the event of slower growth – a constraint exacerbated in some cases by high and rising ratios of debt to GDP.

I'd be glad to be wrong on these and other matters about which I am presently pessimistic, and I hope to hear more cheerful talk before the day is over.