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Understanding Imbalances in a Globalised International Economic System

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This chapter provides an alternative approach to the traditional analysis of the problem of international imbalances and their implication for global financial stability. While the problem of imbalances is usually simplified by looking at bilateral imbalance between two countries, in the current case the US and China, or more broadly Asia, a global approach is more relevant to an understanding of the possible persistence of any individual bilateral imbalances.

Second, following traditional trade theory, there is a tendency to emphasise trade in domestically produced final goods between nations who specialise according to their respective comparative advantages. Actual international trade flows, however, tend to be dominated by intra-industry trade, and semi-finished intermediate goods rather than final goods, and these two trade flows have become the fastest source of trade growth. Integrated global production chains break the identity between countries, firms and trade flows, making analysis of imbalances more complicated.

This emphasis on domestically produced final goods has meant that financial flows are primarily considered as compensating flows required to offset trade deficits, rather than being the result of global investment and production decisions that determine the global pattern of trade in intermediate and final goods. Thus, the sustainability of the current imbalances is discussed in terms of the willingness of foreign lenders to continue to finance the US deficit, rather than in terms of whether

surplus countries are willing to continue to invest their surpluses in the US in order to finance their exports.

Balance of payments adjustment analysis is designed primarily to deal with imbalances across industrialised countries at roughly similar levels of development and presumes sufficient income and price elasticity to allow for reduction in domestic expenditures and expenditure switching. This lies behind the proposals for China to allow exchange rate appreciation or to increase wages sufficiently to reduce exports and allow consumers to import more from the United States. But, it may be the case that wage differentials are so high and the US production structure so inappropriate of Chinese consumption patterns, or that US companies have outsourced the production of those goods that China might choose to buy, that the impact occurs in some third country, rather than in recorded US imports and exports. Adjustment may thus depend more on the location of production and the location of the firms that direct globally dispersed production chains than on policies by countries.

Finally, it is important to recognise that international imbalances have been the rule rather than the exception in the post-war period, and that frequently they have been linked with the emergence of a newly industrialising developing country, such as Japan, and then Korea and the NICs, and then the little tigers and now the little dragons. The adjustment of imbalances between industrial countries may be qualitatively and quantitatively different from that between industrialised and developing countries that are following catching-up industrialisation policies. Thus, the important question may not be how can we eliminate imbalances, but rather how can they best be managed to support the policies of developing countries to achieve successful industrialisation.

Nonetheless, economists have been recommending more explicit global coordination of national economic policies in order to eliminate imbalances. This movement has culminated in the recent decision taken by the International Monetary Fund to extend its Article IV surveillance function to include multilateral assessments of the coherence and compatibility of individual countries' domestic policies with international stability. This response to international imbalances seems ill-conceived if we recognise that imbalances are usually the result of mutually incompatible domestic policy objectives. Implementing coordinated policies that would remedy global imbalances usually requires changes in domestic policies that produce politically unpalatable and unsupportable national economic conditions. Reactions to counter these conditions eventually take priority over any commitment to

international policy coordination, and the international incompatibility of national policies thus tends to be resolved through exchange rate crises and domestic recessions. This explains why coordination has not been generally accepted and when applied, has been less than successful in eliminating imbalances.

Today there is general agreement that large fiscal and external imbalances are unsustainable, but there is disagreement on the effects of their elimination. Many, including former Federal Reserve Chairman Greenspan, note that prior large international imbalances in industrialised economies have all been remedied without major disruption in domestic and international financial markets (Croke *et al.*, 2005). It is unclear whether he believes that this extends to developing countries. Others argue that the imbalances represent a clear and present danger of financial meltdown on a global scale that will be produced by a collapse of the dollar under the weight of the increasingly large US trade deficit.

In contrast to these positions, the analysis presented here suggests that past experience may not be a good guide to understanding the current imbalances. Instead, it suggests that they are the result of unique factors and conditions in which growing imbalances have made substantial differences in national policy preferences compatible. This means there will be little appetite to reduce them, while pressure to do so will require some countries to implement policies that they consider contrary to their national interest. However, there are some longer-term elements, in particular changes in income distribution, that may promote changes in domestic policies.

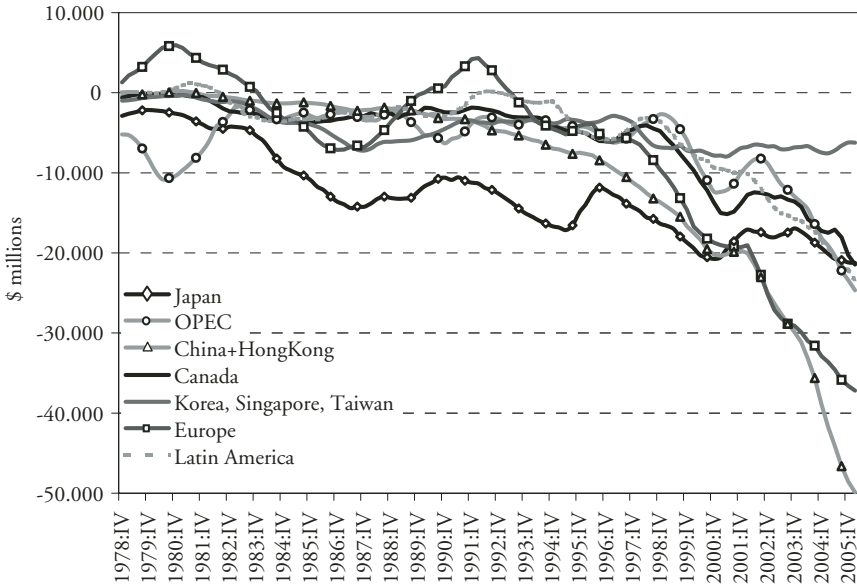
1 Why the Current Imbalances Are Unlike Any Other

The Imbalance is Multilateral

As previously noted, the post-war period has been characterised by imbalances that were generally bilateral: first between the US and Europe (post-war dollar shortage, then post-reconstruction dollar glut), then between the US and Japan, and then the US and OPEC. Today, the imbalance is multilateral, between the US on one hand and Europe, OPEC, Japan, China and the rest of developing Asia, and Latin America on the other. This situation is different in two respects. First, the imbalances include a much larger number of countries or regions.

Figure 1 US Balance on Goods Trade

(quarterly data; 4-quarter moving averages 1978-2005)



Source: Bureau of Economic Analysis, US International Transactions Accounts Data, June 2006, Table 2b, US Trade in Goods.

Second, the imbalances include both industrialised countries, and OPEC, and rapidly industrialising Asian developing countries and, more recently, Latin America. Thus solving the problem involves more than adjusting an exchange rate, or coordinating policies between industrialised economies (US and Europe or US and Japan) with different policy preferences; it has the added dimension of policy differences between developed and developing countries.

These differences have important implications. First, because there are more countries in imbalance with the US, the size of the imbalance will be much larger. Second, the presence of a large group of newly industrialising countries adds another dimension – the integration of a group of developing economies amongst themselves and into the international trade and payments system. These changes are illustrated in Figure 1, which shows that while Japan has ceased to be the major cause of US trade imbalances, it remains important. Figure 1 also shows that Europe, which was once in deficit with the US, has now surpassed Japan and was until very recently as important as China in the US trade imbalance. If Korea, Singapore and Taiwan are added to

China and Hong Kong, it is clear that the policy differences between the US and developing Asia are as important as those between the US and Europe and Japan. Since it is likely that a different type of policy coordination would be necessary to solve the imbalance with the former group compared to the latter, no uniform coordination may be possible.

Capital Flows Dominate Trade Flows

The second difference in the current situation is the dominant role of capital flows in determining international trade and payments flows. Our existing external accounts were predicated on the Bretton Woods system of fixed exchange rates designed to support the expansion of international exchange of final goods and services through exchange rate stability. This required keeping private international capital flows, and the build-up of international indebtedness, to a minimum. The architects of Bretton Woods envisaged that any international capital flows would be under the control of governments through their central banks and the international financial institutions, rather than the internationally operating private sector.

Balance of payments accounts were thus based on the expectation of domestic policy management that would produce roughly balanced trade in goods supported by stable exchange rates, minimal private capital flows, low interest rates, and low international indebtedness. They were also based on the presumption that, after post-war European reconstruction, trade flows would be dominated by trade in manufactured goods between Europe and the US, with trade between industrial and developing countries concentrated in primary materials.

As a result, the treatment of international trade emphasised exchange of final goods, and virtually ignored the rise of semi-finished intermediate goods as well as the importance of private autonomous capital flows and their impact on factor service payments. The assumed absence of capital flows led to a theory of adjustment to external imbalances based on changes in domestic absorption via the Keynesian multiplier. In exceptional circumstances of “fundamental” imbalance, this mechanism could be supplemented by once-over exchange rate adjustments designed to produce expenditure switching through changes in relative prices of traded and non-traded goods.

The implication of these presumptions is that the current account can be represented by the movements in goods and services trade as

given by the commercial balance, and that this balance will remain in rough balance over time through appropriate demand management or exchange rate adjustment. In short, large global imbalances should not exist or persist in the presence of appropriate national macro management, with exchange rate adjustment used sparingly and only in exceptional cases. If external imbalance were to become persistent enough to threaten the preservation of fixed exchange rates, the IMF would intervene and force the implementation of the appropriate policies to bring the trade account back into balance.

However, the post-war environment has turned out to be rather different. Private capital flows have become the rule rather than the exception, and there have been massive accumulations of international debt. Moreover, exchange rates are no longer stable. Indeed, from this point of view the current environment looks much like the pre-Depression world that the architects of the Bretton Woods System were trying to banish from existence and in which it was commonly held that trade flows were determined by international capital flows. And earlier, in the 19th century, it was understood that British foreign lending existed in order to finance the export of British capital goods. Indeed, British exporters often organised the borrowing to support the lending themselves (Wilkins and Schroeter, 1998).

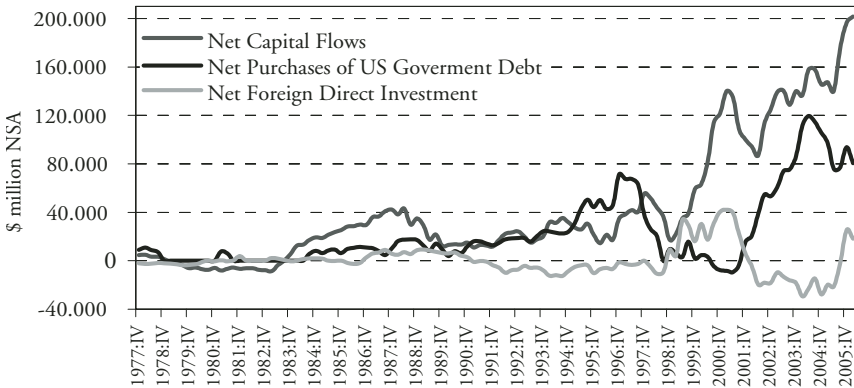
While some of the recent increase in global capital flows is associated with a similar process of geographical dispersion of production chains, it was preceded by a sharp increase in international financial flows driven by interest rate arbitrage and currency speculation and foreign portfolio investment. These flows were the result of the volatility in exchange rates after the breakdown of the Bretton Woods System. In addition, policies to support the liberalisation and deregulation of domestic banking markets led to a sharp increase in cross-border bank lending.

Figure 2 shows that net capital flows went from being negligible for the US until the beginning of the 1980s, to reaching a higher level through the mid-1990s, and then increasing steadily ever since, expanding by a factor of four since the late 1990s.

In addition to their rapid increase, what is interesting is that they go against the traditional view that international capital flows – when they exist – should move from developed countries, where capital is relatively abundant and thus facing declining returns, to developing countries, where capital is scarce and returns are higher. This is another reason why the imbalances should be seen in the light of the integration of developing countries into the global trading system, for the

Figure 2 US International Transactions

(quarterly data; 4-quarter moving averages 1977-2006:I)



Source: US Department of Commerce, Bureau of Economic Analysis, US International Transactions, Table 1.

large developing country surpluses are just the opposite from what was traditionally believed to be necessary to support development.

External Accounts Respect National Boundaries, Production Does Not

The third important difference is the change in the productive structure of the US economy – the geographical dispersion of different parts of the production process around the globe, or the existence of geographically integrated production and supply chains. For the US, this is largely the result of the restructuring of US manufacturing after the profits crisis of the 1980s, the increased role of capital flows in the global economy after deregulation and the fall of Bretton Woods, and the opening of developing economies to trade after the Uruguay Round, which sharply reduced their tariffs. This has meant that the most important components of trade are no longer final goods, but trade in semi-finished intermediate inputs required by the production processes of transnational corporations, predominantly American. These corporations have geographically dispersed their production processes across various national economic systems.

In this process, the design and marketing of internationally traded goods has tended to remain in the developed countries, while the various stages of the actual production process are spread across low-wage developing economies. Whereas Japan had built its industrialisation on

the purchase and import of technology that provided the basis for domestic expertise in new technological development through reverse engineering and learning-by-doing, in the 1990s there was relatively little technology transfer or technological development in developing countries.¹

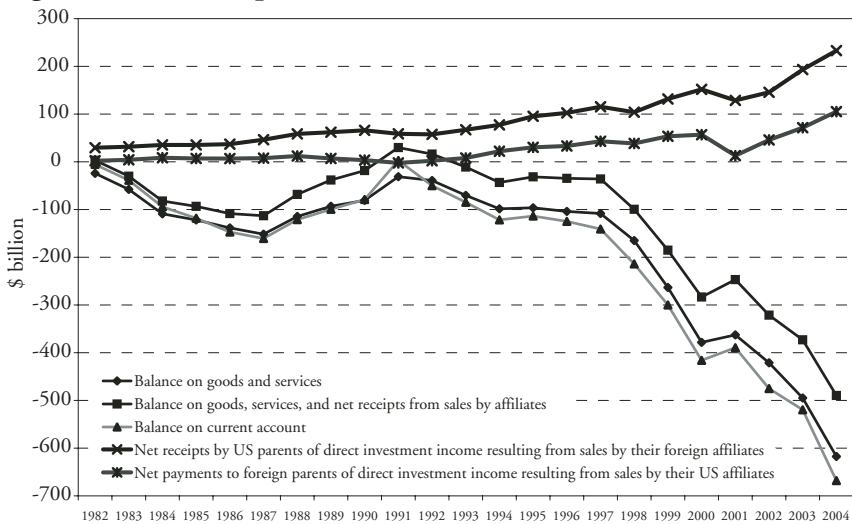
This has also distorted recorded trade figures since the export of a single traded good may now be represented by a series of passages across national boundaries at various stages in the production process of its various components, each recorded as an import and export, thus inflating the rate of growth of trade volumes and values.²

But this geographical dispersion of production creates an additional misrepresentation of trading relations. If a US transnational company undertakes foreign direct investment through the creation of a foreign subsidiary to produce goods it had formerly produced in the United States, the balance of payments shows a capital outflow from the US to establish the foreign subsidiary and records the imports of the foreign subsidiary produced goods and services. If the increased profits that result from the lower production costs in the foreign subsidiary of the US corporation are not repatriated, they are recorded as a credit in the factor services balance offset by foreign direct investment of an equal amount. Rather than appearing as the export of technology, what appears is the profit of the foreign affiliate of the US company in the capital services account.

Alternatively, if a US corporation develops a production design that it sends via electronic means for fabrication by a foreign owned production facility and imports the produced output into the US for final sale, the accounts would record the imports of the final goods incorporating the design or the technology, valued at only the foreign value added – i.e. its low wage costs. Rather than appearing as the sale of fashion design or industrial design or use of technology abroad, the value of the design technology only appears in the increased domestic profit reported by the US company arising from the difference between the low foreign production cost and the domestic selling price. The accounts only record the deterioration in the trade balance; they don't reflect the non-recorded exports of technology or the improved earnings of the

¹ Although this may be changing as both India and China are building research and design capacity.

² The problems raised by re-export in the case of Chinese trade through Hong Kong are analysed in Schindler and Beckett (2005).

Figure 3 Ownership Based Current Account 1982-2004

Source: US Department of Commerce, Bureau of Economic Analysis, Ownership-Based Framework of the US Current Account, 1982-2004.

US company and the increase in wealth to its shareholders. Thus it is possible for the deterioration of the recorded US trade balance to be highly profitable for US companies operating in the global market. These accounting problems are further complicated by the influence of national taxation regimes on the location of profit accrual.

When national corporations operate their activities as if there were no national boundaries, keeping external payments accounts on the basis of national boundaries may not provide a good representation of the sustainability of trade imbalances. One attempt to measure the US external account that takes the earnings of US companies operating abroad into account is presented in Figure 3. As might be expected, the US external imbalance is reduced by over \$127 billion when the overseas operation of US companies is taken into account. It is interesting to note the accelerating trend after the 2000-2001 recession.

Further, as a result of the increased influence of capital flows on trade and the geographical dispersion of intermediate stages of production, the current account in many countries is increasingly determined by capital factor incomes representing interest, profits and dividends on foreign production, and borrowing and lending. All of these capital factor incomes are fully recorded by national origin, while goods and factor services balances are no longer representative of real underlying flows.

Paradoxically, in the modern world, capital flows may no longer represent transfer of resources or the financing of productive activity and goods flows may no longer represent production of final goods for import or export.

The US Department of Commerce provides data on the impact of foreign corporations operating in the US and US corporations operating abroad. They show that on average for the years 2000-2003, the last year for which data are available, around 40 percent of US imports are accounted for by the export sales of US companies' foreign affiliates into the US market (US Department of Commerce, 2006, p. 45). As direct investment continues to grow and outsourcing continues to increase, we can expect that this distortion in the external accounts will increase and that exchange adjustment will be slow to reverse it.

For European companies operating affiliates in the United States, the figures for 2003 show that for countries such as the UK, Netherlands and Germany, the direct sales of their affiliates producing in the US are around 40 times the value of their direct goods and services exports to the US market (Zeile, 2005, p. 214). Thus, direct exports of European goods for sale in the US have been increasingly displaced by the production and sale of goods produced by affiliates of European companies operating in the US.

However, the problem is made more difficult by the fact that on average, foreign affiliates operating in the US import semi-finished inputs for use in production. Figures for 2003 show that for all countries affiliated company imports in value terms were nearly double the value of their exports. For Europe it was around 1.8 times and for Asian companies the ratio was well over three to one.

These factors are important for policy purposes because as noted above, under the Bretton Woods scheme, the most important policy variables were domestic income growth and relative prices of traded and non-traded goods. However, if the production and trade in goods is dominated by international capital flows, these variables have only limited impact, and monetary variables such as relative wages, productivity, interest rates and profit rates become much more important. For example, a fall in domestic income will have little impact on the capital factor services balance of the current account represented by debt service; nor will it have much impact on the decision of a corporation to manufacture abroad and import, rather than producing domestically. For foreign companies operating affiliates in the US, the initial impact of exchange rates is thus primarily on the translation of dollar profit

remittances, and thus on the bottom line of the parent company's balance sheet, rather than on the flow of imports of goods and services. Since it takes much more time and it is much more costly to close a foreign production operation than to divert exports from one market to another, it is unlikely that these foreign affiliates will be closed even if dollar depreciation induces large increases in the costs of their imported inputs. Depreciation is thus unlikely to have much impact on the European share of the US bilateral deficit accounted for by these operations.³

Taking all these factors into consideration, it becomes clear that any analysis of the impact of the international imbalances on economic performance of countries and on the performance of currencies should take into account the fact that we do not have a good idea of the dimension of the problem. Second, it becomes clear that we need to analyse the impact of the increasing dominance of international investment flows on the behaviour of the current account, the changes in the structure of international goods flows and, finally, the existence of a much larger area than Japan in the Far East that is using a policy of export-led development to support full employment policies and stable real exchange rates.

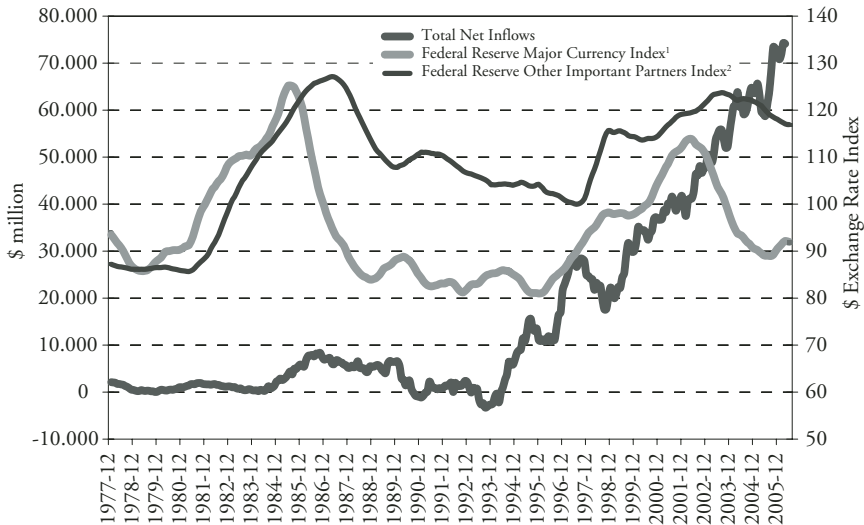
2 Analysing Regional Imbalances Through Regional Policy Choices

To simplify the discussion and avoid some inessential regional differences, consider the world as represented by three regions – the US, Europe and developing Asia. Although most of the attention in the discussion of international imbalance is given to the US-China bilateral imbalance, this is not the most important in understanding the global imbalances. Broadly, Asia – China, South, South East and North Asia – represents developing countries that are applying domestic policies that create export surpluses to support domestic demand and employment growth, and thus generate domestic savings. Europe is applying restrictive domestic fiscal and monetary policies to keep demand repressed at the level that keeps the economy from growing more rapidly than 2 percent with 2 percent inflation, the resulting excess capacity creating

³ The figures quoted are elaboration of data available in US Department of Commerce (2006).

Figure 4 Net Foreign Acquisition of US Long-Term Securities and Exchange Rates

(1977-04 to 2006, monthly data, 12 month moving averages)

*Notes:*

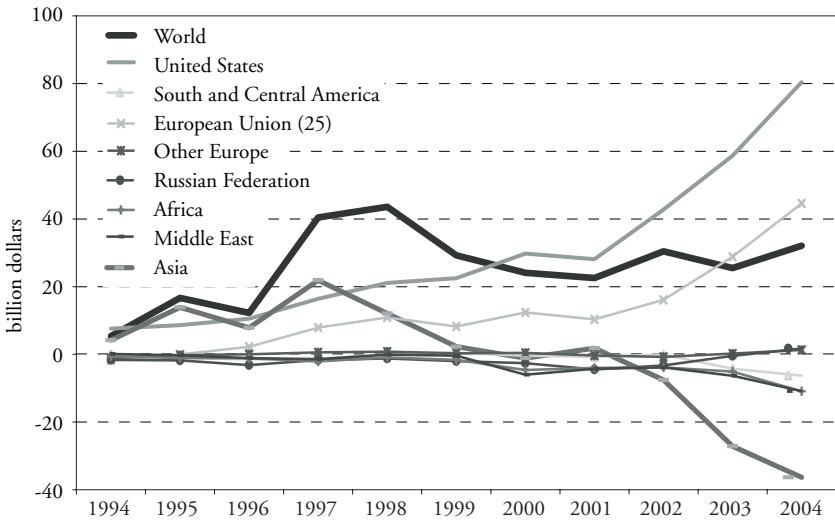
- ¹ *Major Currency Index* includes a trade-weighted average of the euro, the Australian and Canadian dollars, Japanese yen, Swedish krona, Swiss franc, and British pound.
- ² *Other Important Partners Index* includes the currencies of Argentina, Brazil, Chile, Colombia, Mexico, Venezuela, China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand, Israel, Saudi Arabia and Russia. Since the dollar has depreciated or remained stable against most of the non-Asian currencies in the index, it may overstate the depreciation against these currencies.

Source: Elaboration of US Treasury, Treasury International Capital System (TIC) Database, July 2006 and Federal Reserve System, Foreign Exchange Rates, Table G.5

positive trade balances. The Asian developing countries traditionally, and currently, favour stable intra-regional exchange rates and relative to their major extra-regional export market in the US. Thus, since the Japanese yen and the euro fluctuate relative to the dollar, Asian developing countries have a *de facto* dual exchange rate policy – flexibility relative to the yen and the euro, and relative stability against the dollar and within the Asian region.

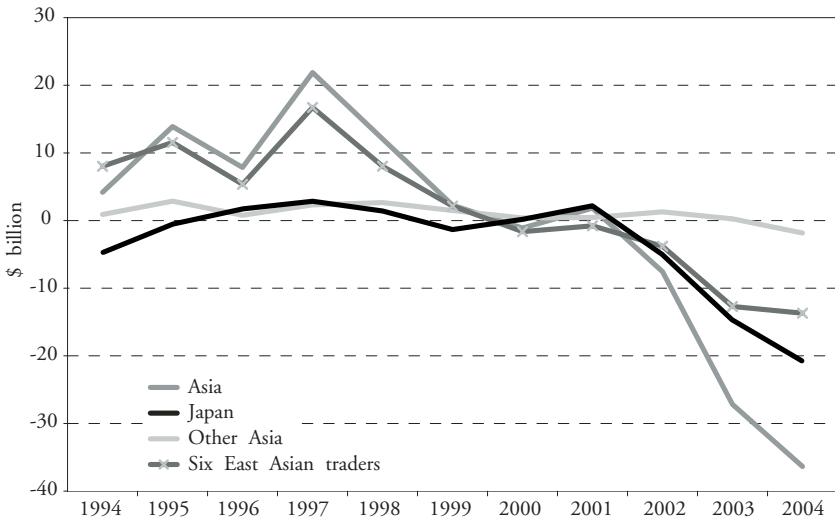
The results of these Asian and European domestic policies on bilateral regional exchange rates can be seen in Figure 4. It shows that over the last four years, substantial dollar exchange rate adjustment has taken place in the euro-dollar exchange rate – while the US-Europe bilateral trade balance has continued to deteriorate. It also shows the relative stability of the exchange rates of Asian developing countries

Figure 5 China Merchandise Trade Balances



Source: World Trade Organization, International Trade Statistics 2005, Table A19.

Figure 6 China's Asian Trade Balance



Source: World Trade Organization, International Trade Statistics 2005, Table A19.

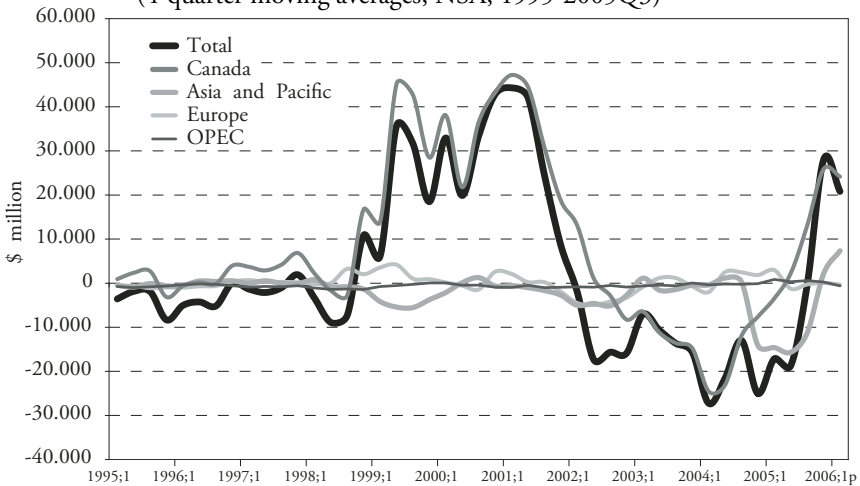
relative to the dollar – while the US trade balance with these countries has also continued to deteriorate.

In both Europe and the developing Asian countries, the trade surpluses are balanced by capital outflows that generate counter flows of capital service earnings; these earnings provide further increases in their positive current account balances.

As mentioned above, global imbalances can be understood as the global outcome of various national policy objectives. The primary aim of Asian developing countries is to preserve their internal expansion and employment growth, as well as to insure their economies from the volatility of international capital flows that produced crisis in 1997. In particular, China seeks to preserve the market-based, export-led transformation of the state sector into a market economy. There are two standard methods of supporting domestic activity – domestic or foreign borrowing through government expenditure deficits, or foreign lending through export surpluses. For structural production reasons, developing countries cannot borrow domestically to finance demand. However, when foreign borrowing has been used, financial crises have tended to eliminate any domestic benefit. Thus, Asian countries from Japan onwards have used foreign lending to support export surpluses in order to achieve their domestic policy objectives. In the absence of alternative extra-regional final export markets, the Asian economies would have to give up their policies to support domestic employment if they wanted to reduce their rate of increase in lending to the US. They are unlikely to do this. Lending to the US to support demand for exports can thus be seen as a substitute for public sector domestic borrowing to support increased domestic expenditure. It is clear that this cost is considered less onerous than the cost of domestic or external borrowing. Indeed, if this cost is measured by the difference between domestic interest rates and external rates earned on reserves, the low level of interest rates in countries like China, Malaysia and Thailand suggests that their reserves may have negligible costs or even provide net earnings. For countries such as India and Korea, with higher interest rates, costs could be in the range of a half percent of GDP (Genberg *et al.*, 2005). The recent increases in US interest rates will further reduce the costs of excess reserves, while any further depreciation of the US dollar would increase them. In the presence of policies to keep currencies stable against the dollar, or if US interest rates provide support for the dollar, the former factor should offset the latter. In any event, the objective function of the government is clearly to maximise employment, with any foregone earnings on its

Figure 7 US Net FDI Flows

(4-quarter moving averages, NSA, 1995-2005Q3)



Source: US Department of Commerce, Bureau of Economic Analysis, US Direct Investment Abroad: Country and Industry Detail for Capital Outflows and Foreign Direct Investment in the US: Country and Industry Detail for Capital Inflows, various years.

foreign exchange holdings considered as an acceptable cost.

As noted above, most attention in the international imbalance discussion has focused on the bilateral balance between China and the US. However, this is particularly misleading in a multilateral trading system given the role that China increasingly plays as the centre of regional trade growth and integration as a result of its increased processing trade, importing goods from the rest of the region, especially Japan, and exporting to developed country markets. Since China has partially taken on the role of Asian export platform for multinational firms, the direction of Japanese trade has shifted from exporting final goods to other developed countries to exporting components and importing final goods from China.⁴ In Figure 5, China's trading position with its major extra-regional partners shows a marked difference from its trade within the region. While it is running increasing surpluses relative to the US and Europe, it has run nearly offsetting deficits with its regional trading partners. Figure 6 shows the increasing integration of China within the region.

⁴ For a more detailed analysis of the changes in the segmentation of production of multinationals operating in Asia and its impact on regional trade flows, see Gaulier *et al.* (2006).

Table 1 Firms with Foreign Capital in China's Trade with Selected Partners 2002
(percentage of total flows)

	World	EU-15	US	Japan	Hong Kong	Singapore	Korea	Taiwan
China's Total Exports	100	100	100	100	100	100	100	100
FFC* Total Exports	52	50	58	62	63	65	49	57
FFC Processed Exports	41	40	48	47	54	54	35	45
China's Total Imports	100	100	100	100	100	100	100	100
FFC Total Imports	54	49	48	67	63	61	63	67
FFC Imports to Process	32	12	21	39	53	36	41	49

Note:

* Firms with Foreign Capital.

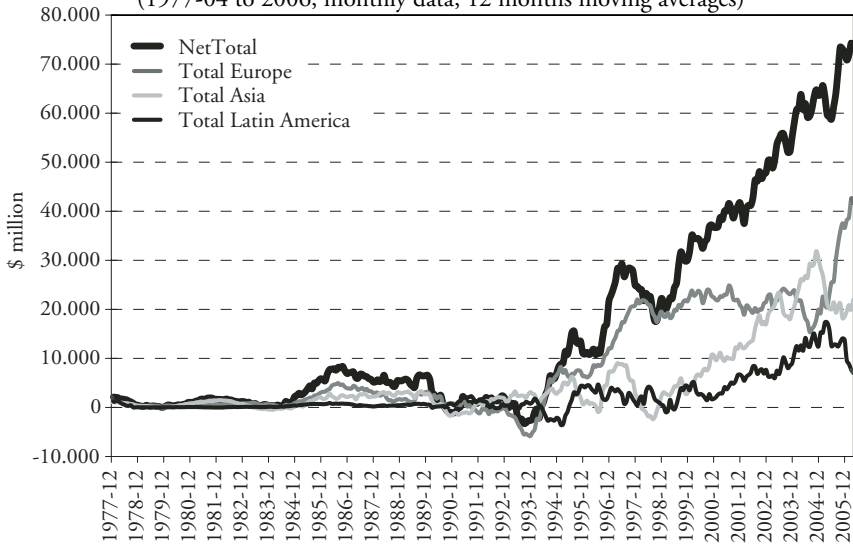
Source: Gaulier *et al.* (2006).

The extent to which this processing trade is through the integrated production chains of international companies can be seen from Table 1, with around 50 percent of China's total exports accounted for by processed exports of firms with foreign capital participation. The extremely high share of processed exports in total exports (over 40 percent) and the extremely high import content of those exports (around two-thirds) means that exchange rate adjustment will have a much different impact than represented by simple expenditure switching in a world where final goods are wholly domestically produced for export.

Policy in Europe, on the other hand, no longer has any formal or informal employment goal or domestic demand support policy; rather, policy is guided by an inflation target and a fiscal and public sector borrowing target. Given these targets, along with free capital flows, the euro area can have no formal exchange rate policy. As a result, Europe has adopted the same policy as in Asia; net exports are required to support demand. If the Stability and Growth Pact and the monetary target prevent government borrowing to support domestic demand, and private demand is insufficient to produce growth that provides stable employment growth, the only alternative is foreign lending to support

Figure 8 Net Non-Resident Acquisition of US Long-Term Securities

(1977-04 to 2006, monthly data, 12 months moving averages)



Source: US Treasury, TIC Database, July 2006.

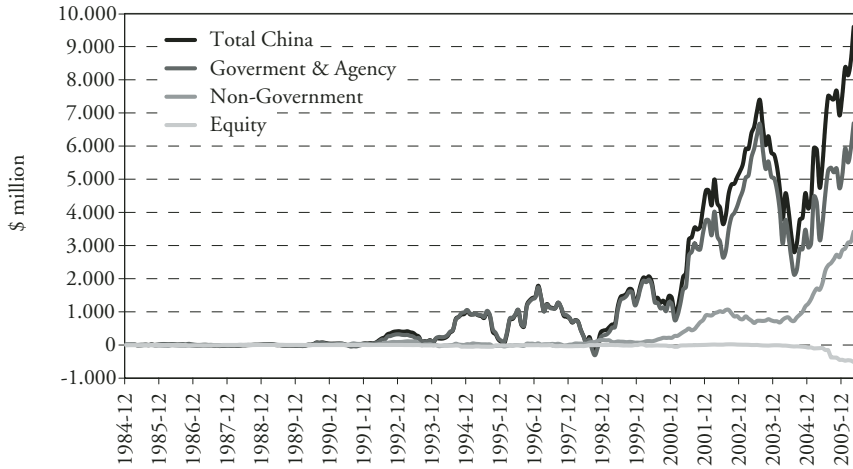
acquisition of European exports or the acquisition of foreign companies that can produce exports. Thus, European lending to the United States has been supported by European firms and investors acquiring US assets and US technology firms. These investments were driven on the one hand by the recognition that European companies could not recover the information technology gap except by buying the technology by taking over US companies. On the other hand, they were driven by the attempt of European firms to use their US subsidiary corporations to export technology to low-cost foreign producers whose products are then imported to Europe or the US. Figure 7 shows the dominant position of European direct investors in the 1990s until the falloff in their direct investments after the collapse of the dot-com bubble. But, recently, driven by the weakness of the dollar, direct investments are again increasing, as opposed to US exports to Europe recovering.

As Figure 8 shows, European flows have not only been in direct investment, they have also been in long-term US securities, being surpassed by Asia for only a short period after 2001.

In difference from Asia, any reduction in EU lending to the US would likely produce further currency appreciation of the euro, relative

Figure 9 China Composition of Acquisition of US Long-Term Securities

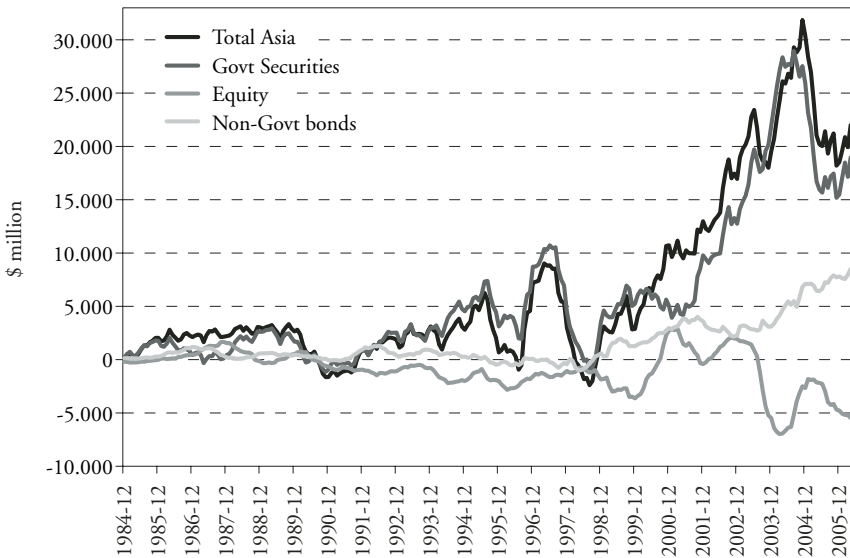
(1984-04 to 2006, monthly data, 12 month moving averages)



Source: US Treasury, TIC Database, July 2006.

Figure 10 Distribution of Asian Net Purchases of US Securities

(1984-04 to 2006, monthly data, 12 month moving averages)



Source: US Treasury, TIC Database, July 2006.

to both the US and to developing Asia, which represents the only growing alternative export market. Not only would this reduce the competitiveness of EU produced exports, undermining domestic demand, but given the large presence of European corporations in the US, it would also reduce the domestic currency value of their US subsidiaries' profits. If this feeds through into lower domestic share prices, it could dampen investment.

If the US would raise interest rates, the impact of the increased capital service earnings on the European current account could further reinforce the upward pressure on the exchange rate. Were Asian countries to decide to diversify away from the dollar into EU assets, as predicted by those who expect a sharp dollar collapse, this would further aggravate the pressure on the exchange rate and export competitiveness. Paradoxically, in these conditions, maintaining support for European net exports on domestic demand would require even greater lending to the US. Indeed, it is interesting to note that Figure 7 shows that European direct investment flows to the US tend to increase with appreciation of the euro.

However, to the present time, instead of diversifying investment out of the dollar, Asia has diversified its holding of dollar assets, in particular increasing holdings of non-government securities as can be seen in Figures 9 and 10.

3 The Imbalances Are Likely to Persist Unless Regional Policies Change

Thus, as long as both Asia and Europe continue to use positive net exports to support their differing domestic policy goals, and to employ stable and flexible exchange rates respectively, achieving those goals requires that both regions continue to lend to the US. This means that as long as these policy goals are maintained, a sharp decline of the dollar is unlikely since this would mean a change in either the Asian development strategy or the European insistence on inflation targeting and low fiscal deficits. It also means that the desired national policies of Asia and Europe are mutually consistent with continuing international imbalances, which are thus unlikely to be eliminated quickly. In short, the imbalances could only be eliminated if one of the three regions changed its domestic policy preferences.

4 Are There Medium-Term Forces that Can Undermine Policies?

However, there are forces at work that might undermine this locally stable position. As noted, if current policies are continued, Asia must continue to accumulate foreign reserves and Europe must continue to see its competitiveness deteriorate relative to its major developed and developing country trading partners. Also, with the maintenance of current policies in the US, Asia and Europe, the US external imbalance will continue to rise. Since there is little reason for the US to take measures to change its policy, adjustment will have to come from the other two regions.

One of the main consequences of the geographical dispersion of production has been a sharp recovery of profitability in US corporations, accompanied by stagnation in real wages. This has been in part offset by the falling prices of most general consumer goods imported from abroad, and the ability of households to borrow at extremely low interest rates or to convert rising house prices into equity, allowing them to maintain consumption patterns. However, the recent battle over an increase in minimum wages in the US suggests that eventually there will be some pressure coming from the increasing inequality of income distribution. A recent study on the impact of the globalisation of production on wages in the US suggests that of the two major scenarios for the US labour market – the impending shortage of high-tech workers leading to higher real wages, and the global surplus due to undeveloped country labour driving down wages – it is the latter that is most likely to prevail (Freeman, 2006). As the study shows, US wage behaviour depends on wages in the developing world.

China faces a similar problem. The inflationary threat of rapid reserve accumulation and the potential for speculative external inflows on domestic monetary conditions does not appear great, given large, and currently increasing excess labour supplies. Indeed, the problem has more frequently been one of deflation, and speculative pressure appears to have been dampened by very marginal adjustments in exchange rate determination. However, the suggested alternative to exchange adjustment, allowing domestic incomes and domestic consumption to increase,⁵

⁵ It is important to note that from 1993 to 2003, the contribution of household consumption fell, and in 2004 represented only 40 percent of GDP, contributing less than a third to demand growth. See Asian Development Bank (2005), pp. 120-23.

would further exacerbate the wage differential between urban and rural residents that has widened from 2.9 to 1 in 2001 to 3.2 to 1 in 2005 as China faces the traditional development problem of declining terms of trade between agriculture and industry. Further, as increasing profitability has allowed the build-up of an entrepreneurial class, it is likely that they will seek increased representation in government policy determination. Thus, just as in the US, widening inequality in income distribution may be the most pressing force for change in Chinese policy.

European policy, on the other hand, could eventually be undermined by the fact that given stability in Asia, most of the exchange rate adjustment from global imbalances will fall on the euro. Such a euro appreciation will have to be countered by downward adjustment of domestic wages and prices that would be required to preserve competitiveness, eventually producing a politically unsustainable situation. This has already started in some countries such as Germany, where real wage increases have been minimal.

In the 1980s, Japan was able to withstand the impact of yen appreciation on international competitiveness through domestic measures and wage flexibility linked to the bonus system, but eventually the cost pressures led to the outsourcing of production – the “hollowing out” of the Japanese industrial base shifting production to the US and to South-East Asia. It is unclear that Europe can be more successful in defending against appreciation than Japan. Whatever strategy is adopted, it will not provide support to domestic growth and employment.

Further, the trend towards reducing social safety nets in the European welfare systems, along with policies to increase labour market flexibility to reduce costs, will only increase pressure for a policy change. In the absence of a policy to increase domestic demand, there is little option except continued direct investment and portfolio investment in dollar assets – providing continued support for the dollar.

The basic problem facing Europe is that the development strategy adopted by Asia, and increasingly in South America, is to generate domestic demand and financing through external surpluses. As noted above, this reverses the traditional approach of developed countries using their external surpluses to transfer resources to developing countries. If developing countries follow this alternative path, it changes the role of their development partners to providing markets for their goods and running external deficits. European policy, much like Japan's, is a policy for developing countries, and needs to be changed to one of growth through internal demand. Europe and Japan are thus the odd

men out in the new international development pattern and are currently paying the cost in terms of low economic growth.

There are internal problems to Europe that will make this transition to greater reliance on domestic demand problematic. For example, Germany has been much more successful than some other euro-zone countries in countering euro appreciation with reductions in real wages and unit labour costs and thus preserving external demand. Increasing internal demand uniformly across the zone, made difficult by the lack of centralised fiscal policy, is not likely. In particular, countries like Italy and Greece that have been less able to control costs and face higher fiscal and debt ratios, would be less able to expand domestic demand. Indeed, some have suggested that this euro-constraint might eventually create sufficient domestic pressure for an exit from the euro, the costs in terms of lost growth having become too onerous (Goodhart, 2006). Of course, the simple solution to this problem would be to consolidate the government debt of all euro-zone countries into a common European debt issued by a central fiscal policy authority.⁶ There are some countries that would clearly prefer the exit solution for the marginal countries and to block access by the new accession countries.

The US will have difficulties of a different nature in sustaining internal demand. In the 1990s, the external capital inflows were financing increased consumer borrowing and especially increases in the ratio of investment in the high technology area, leading GDP to historic highs and allowing the fiscal deficit to go to surplus. Currently, the financing is going to fund the budget deficit that is financing war expenditure and tax reductions for the highest income levels. While the rate of productivity growth generated by the investment in the 1990s has remained sustained, in the absence of continued investment it is questionable that it can continue. The lack of investment may cause the decline in capital inflows required to fund the external deficit.

As mentioned above, the key to the present analysis is the continued resolve of China to complete its transformation to a centralised, regulated market economy and the increasing integration in the region. Although this process has been particularly rapid, it is likely to take another 10 to 20 years to complete. In the meantime, given continued rapid growth in

⁶ I have long argued that the greatest impediment to the euro becoming a full-fledged alternative to the dollar as an international currency lies in the persistence of nationally segmented and regulated capital markets. See, for example, Kregel (1999) and (2003).

labour supplies,⁷ internal political stability requires that growth continues at its present pace, implying that its need for increasing exports will not diminish substantially.

Of additional concern is the trend in a number of Latin American countries to adopt similar export-led policies. The global economy cannot support developing countries' attempt to integrate into the global trading system through export-led development and eliminate international imbalances if developed countries also use export-led growth. The real problem is how to transform developing countries that use exports to achieve successful development into developed countries that rely on internal demand to support their continued growth. This is a problem that Europe has to face and Japan is still trying to resolve. Having a single currency across a system with segmented fiscal policy and thus segmented capital markets certainly makes this adjustment more difficult.

Thus, the alternative view of the current global imbalances suggests that they will not be eliminated rapidly in the short term since they are the result of mutually compatible domestic policy preferences. Coordinated policies on exchange rates and domestic demand are unlikely to be effective given the peculiar features of the global trading system. It is more likely that medium-term forces linked to the distributional consequences of globalisation, and in particular the global segmentation and dispersion of production chains, will produce changes in domestic policies to reverse the current trend of rising income inequality. Such change of policies may help in a more effective way to resolve global imbalances.

⁷ The Asian Development Bank (2005), pp. 121-22, notes, "As a result of fast growth in the labour supply and a decline in the amount of employment for every percentage point of GDP growth, urban unemployment and underemployment have become a serious concern for policy makers. According to the National Development and Reform Commission, urban areas will need to create around 25 million jobs in 2006 to soak up newcomers to the labour market. Of these 25 million people, about 9 million will be joining the labour market for the first time (including some 4 million new graduates), 3 million will be migrants who have recently moved to cities, and the remaining 13 million will be workers made redundant by their employers, mainly state enterprises. It is worrying that the Commission's estimates suggest that the economy will be able to create only about 11 million jobs for these workers. Fast growth will be needed to create jobs and to minimize the social risks that a growing number of unemployed and underemployed workers could present."

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