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Policy Recommendations for the US, Europe and Asia: By Way of Epilogue

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The contributing authors to this book have discussed the US deficit and global imbalances problems by looking at the functioning of the world economic system as a whole and at three distinct regions that are considered to be the main actors in the global imbalances issue: the United States, Europe and Asia.

Let me say a few words about the two developing regions that are considered less important in resolving global imbalances, Latin America and Africa. Latin America, discussed briefly by Barry Eichengreen and Yung Chul Park, and more extensively by Barbara Stallings, comes out in this volume as a region that can contribute little to solving the problem but will suffer greatly from a dramatic unwinding of the US deficit. Africa is not discussed in this volume, but will be dealt with in the second volume that emerges from a conference held in The Hague on February 27-28, 2006.

I want to highlight policy recommendations made by the various authors for each of the three regions and add a few comments. I begin with the region that, in my view, bears the greatest responsibility for the imbalance problem, the United States. I then discuss the region which, as important economic actor, could do a lot to help resolve global imbalances but does little: Europe. And I conclude with Asia, the region that is becoming a major player in the world economy but can do less to solve global imbalances than many think – among other reasons, because large parts of it are still relatively poor.

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The Responsibility of the United States

Barry Eichengreen and Yung Chul Park (Chapter 2) hold the United States primarily responsible for its large deficits and contribution to global imbalances. The authors argue that the US deficit is untenable, and they urge the US to reduce its current account deficit, preferably by saving more. The US could save more, they suggest, by reducing government expenditures, raising taxes and reducing tax cuts. These measures sound reasonable and feasible, but the authors observe that there is no political will in the US to implement them. They stress that the US ought to address the domestic roots of its deficits, and warn emerging market countries that they cannot afford to wait for the US to act and should, instead, take their own measures.

Barbara Stallings (Chapter 3) agrees with the policy recommendations by Eichengreen and Park, but stresses that more discussion is needed about the lack of political will to carry them out. She observes that it is certain that the Bush Administration will not follow their advice and that the Democrats are unlikely to cut the deficit in a serious way either. "So what do we do? Just wait for a crisis, or is there perhaps an international bargain to be struck?"

Jane D'Arista and Stephany Griffith-Jones (Chapter 4) share the notion that the US is to blame for its deficits. However, they stress that the US deficits are not only the result of over-spending by the US, but also of an international monetary system that uses the dollar (and a few other national currencies) as an international store of value, thus generating debt in the key currency country – the US. Their analysis implies that the US could contribute to resolving its debt problem and global imbalances by supporting international initiatives aimed at making countries, particularly developing countries, less dependent on the dollar as payments and investment currency. The initiatives they suggest include the promotion of GDP-linked bonds and local currency bonds.

Fan Gang (Chapter 5) sees the international monetary system as the main cause of the US deficits and global imbalances. The fundamental problem is not in US policies, he stresses, but in the global currency system which allows the US to run high deficits and print as much money as it needs. US policymakers do not see it as "their problem" that they run high deficits and print more money when the bad consequences become the "others' problem", says Fan. He reminds that the international problems created by the "US dollar standard" currency system have been debated before. In the 1960s there was a debate with Europe,

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in the 1970s and 1980s with Japan and now with China. "The repeated similarities in the history just show it is not the problem of policies, but the problem of institutional arrangements," argues Fan. He favours a reform of the international monetary system that ends the hegemony of the dollar. "The US dollar is no longer a stable anchor in the global financial system, nor is it likely to become one: thus it is time to look for alternatives," observes Fan. In his view, the ideal system should be one that is independent of self-interests of participating countries, and provides common benefits to all. "It should not be a currency of any particular country no matter how strong or dominant that country is in the world market."

Jan Kregel (Chapter 9) presents an alternative explanation of global imbalances. In his view, they largely result from the fact that too many countries are using export-led growth strategies (including Europe) and that firms are investing and producing transnational while balances of payments are national. Both Europe and Asia (and other countries) continue to finance US deficits, says Kregel, because this allows the US economy to absorb a large part of their exports and, equally important, to remain an attractive economy for investments by European and Asian transnational corporations. Kregel's implicit argument is that one can blame the United States for living beyond its means, but Europe and Asia are equally to blame for maintaining domestic policies that finance US deficits. As he stresses in his chapter, "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 United States".

I find Kregel's analysis of how the global investment and production system contributes to global imbalances interesting, and I agree with him that Europe and Asia have an interest in maintaining US deficits. However, this does not absolve the US from its own responsibility for running large deficits. I also agree with D'Arista, Griffith-Jones and Fan, who say that the current world monetary (non)system facilitates and promotes US deficits and global imbalances. In fact, I think all of the authors are right. But maybe they do not place enough emphasis on the responsibility of the US. Since powerful countries determine the rules of the world's monetary system and since the US is still the major power in the system, it has a major responsibility. Moreover, as I already related in my introduction (Chapter 1), the US has been the major force opposing the much-needed reform of the international monetary system.

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Is Europe Powerless?

In Chapter 1, I quoted Dutch central bank president Willem Duisenberg and UK central bank governor Mervyn King, who both said it was absurd that poor countries are financing the richest country of the world, the United States. I also quoted Robert Triffin, who related that European policymakers were choosing sides with the US in their opposition to international monetary reform in order to safeguard the Atlantic Alliance. Duisenberg added that the maintenance of the US dollar as the key currency allowed the US to fight a war in Vietnam that "was in fact not financed by the United States, but by other countries".

These days the US is still fighting wars and those wars are still financed by other countries – including those of the European Union. Even though some European countries sometimes criticise US military interventions abroad, as a military ally of the US, Europe remains faithful to US leadership in international political and military affairs.

Kregel (Chapter 9) offers an additional reason why European governments and transnational corporations have an interest in continuing their lending to and investments in the US. Not only does their financing maintain the US as a major market for exports and investments, but a reduction of European lending would also likely produce a further appreciation of the euro, thus reducing the competitiveness of EU exports. Moreover, observes Kregel, euro appreciation would also reduce the domestic currency value of profits of US subsidiaries of European corporations in the US.

These "vested interests" of European firms and policymakers in maintaining the dollar as the key currency of the system and continuing the financing of US deficits indicate that Europe's alliance with the US is not only political, but also economic. Does this mean that Europe cannot do anything by itself to help resolve global imbalances and the US deficit?

No, obviously not.

Of the contributing authors, Kregel is the only one who deals with the question of what Europe could do, both because he was asked to address this question and because his analysis led him to dwell on Europe's role. According to Kregel, Europe's 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 … the odd men out in the new international development pattern and are currently paying the cost in terms of low economic growth." In his view, Europe should shift its policy from restricting inflation and promoting exports to promoting

domestic demand. Such a policy shift would be the best way for Europe to help resolve global imbalances, says Kregel.

Possibilities for Asia

When the role of Asia in global imbalances is discussed, the focus (and blame) is often directed toward China. The authors in this book do not share that simplistic, China-bashing view. Given the increasingly important role China is playing in the world economy, we asked several authors to dwell on the "China question". What policy recommendations do they suggest?

Barry Eichengreen and Yung Chul Park (Chapter 2) say that China's annual surplus is now roughly a third the size of the US deficit, which in their view suggests that China should do something to reduce its surplus. The authors argue that the best way for China to reduce its current account surplus would be to reduce its savings. They observe that, in the long run, Chinese savings will go down in a natural way, but suggest that given the need for short-run measures, China's government should increase spending on education, health care, social security, urban infrastructure, and modern housing. However, Eichengreen and Park stress that since the Chinese economy is only a fraction the size of the US economy, fiscal expansion in China can only offset a fraction of the fiscal contraction needed in the United States. Therefore, according to them, China is only a small part of the global adjustment story.

Fan Gang (Chapter 5) does not think China saves too much or invests too little. He stresses that China invests up to or even more than 40 percent of its GDP in industrial capacities, housing, and public infrastructures. He also stresses that China's high saving rate has little to do with the global imbalance problem. He observes that during 2003-2004, China even over-invested and registered trade deficits for almost 11 months. Moreover, China did not have such large net national savings in recent years, says Fan, only about $30-40 billion per year.

Zdeněk Drábek (Chapter 7) echoes repeated calls from US and Japanese authorities as well as academics for substantial appreciation of the Chinese renminbi, even though he softens this plea by talking about the need for "some" revaluation of the Chinese currency. In his view, this would not only help to resolve global imbalances, but also slow down the inflow of speculative capital and help reduce inflationary pressures in China.

Wing Thye Woo (Chapter 6) disagrees with the recommendation by "foreign economists" that China should let its currency float. In his view,

it misses the basic point that free-market tools can work only in a free-market environment. Given China's capital controls, a freely floating currency regime could mean a value for the renminbi that would be greatly over-appreciated compared to what its value would be under free capital flows, and would therefore reduce economic growth significantly. Freeing capital flows is not an option, says Woo. The weakness of the balance sheets of China's state-owned banks, the considerable embezzlement of state assets that has occurred, and the experience with the Asian financial crisis of 1997-98 caution strongly against allowing the free movement of capital in the medium term. China can stem the inflow of speculative capital by imposing credit quotas on the banks, and by using existing capital controls. And the best way to let the renminbi appreciate would be to engineer a series of small revaluations, recommends Woo.

Fan Gang observes that China's currency may be considered undervalued by about 1 percent per year given that urban wages have risen slower than productivity growth, but that China, before anything else, has the task of reducing poverty and raising the living standards of its rural poor. "From this point of view, the 'managed floating' is a right exchange rate regime for a country like China", says Fan.

Jan Kregel (Chapter 9) finds it misleading that most attention in the international imbalance discussion has focused on the bilateral balance between China and the US. Since China has partially taken on the role of Asian export platform for multinational firms, it is running increasing surpluses relative to the US and Europe, while it has nearly offsetting deficits with its regional trading partners. Around 50 percent of China's total exports are accounted for by processed exports of firms with foreign capital participation, observes Kregel. But, most importantly, says Kregel, it is unfair and unwise to suggest that China should either let its currency revalue or increase domestic incomes and consumption. Allowing domestic incomes and domestic consumption to increase, warns Kregel, 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. Given continued rapid growth in labour supplies, internal political stability requires that growth will have to continue at its present pace, implying that China's need for increasing exports will not diminish substantially.

What about Japan? Eichengreen and Park say that Japan is the other important Asian country that has been running large current account surpluses, reflecting the weakness of investment and consumption demand

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associated with the country's decade-long slump. Eichengreen and Park suggest that the most important thing Japan can do to help resolve the problem of global imbalances – and contribute to a shift of Asian demand from extra-regional exports to exports to the region itself – is to sustain its recovery.

Yonghyup Oh (Chapter 8) also explicitly refers to Japan's role in the global imbalance issue. According to Oh, given Japan's important position in East Asia and the world and the high macroeconomic interdependency across the region, East Asian monetary cooperation should include Japan (Eichengreen and Park make this point as well). Oh sees such cooperation as an important step toward helping to resolve global imbalances since it would facilitate the creation of a regional capital market (implying that Asians would invest their capital in Asia rather than in the US). Moreover, it would facilitate coordinated exchange rate adjustments by each of the East Asian economies.

What about the other Asian countries? Eichengreen and Park say that there is little disagreement that an across-the-board appreciation of East Asian currencies would constitute an important component of the resolution of global imbalances. However, if China sticks to limited flexibility, other East Asian countries are not likely to let their currencies appreciate vis-à-vis the renminbi since China has emerged as their export competitor in regional as well as global markets. This creates a problem of collective action and an argument for policy coordination, say Eichengreen and Park.

East Asian monetary coordination is an issue addressed by Fan Gang and Yonghyup Oh.

Fan Gang reports on the possible establishment of an Asian currency unit (ACU), which would represent a weighted average of several of the key regional currencies. The ACU is not meant to be a real currency to replace the regional currencies, as is the case of the euro, explains Fan. It is meant to be a guide for the Asian countries to coordinate and manage their exchange rates. In other words, it might become a viable "currency" for Asian countries to denominate their export prices, cross-border loans, and cross-border bond issuance; thus weaning themselves away from their current total reliance on the US dollar.

"This is no ivory tower academic exercise," says Fan. "Both China and Japan are very serious about it." To illustrate their seriousness he points at a meeting in Hyderabad in May 2006, where the finance ministers of China, Japan, and South Korea met with their counterparts from ASEAN and announced that they would sponsor a research project

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entitled "Towards greater financial stability in the Asian region: Exploring steps to create regional monetary units".

Yonghyup Oh (Chapter 8) relates that around the time of the Asian crisis of 1997-98 East Asian countries became capital exporters. Instead of investing in more risky assets at home or in the region, East Asian capital went to safer US treasury bonds and foreign reserves. Oh observes that even though it is now less attractive to keep purchasing US government securities given the already high level of foreign reserves in most East Asian economies, investing in East Asian securities is not yet attractive enough because of underdeveloped Asian capital markets. East Asia needs to create regional financial markets for Asian capital, he stresses.

Concluding Remarks

The contributing authors to this book have provided highly interesting analyses and policy recommendations. Their analyses are geared toward both the functioning of the world economic system as well as at the question of what individual countries and regions can do to resolve the US deficit and global imbalances problems. Several authors have reminded us of the need of more in-depth analysis of the causes of global imbalances.

Experience tells us that in order to incite policymakers to action good analyses are a necessary but not a sufficient condition. Moreover, democratic decisionmaking requires that more people are involved in designing and assessing economic strategies than just the academic and the policymaker.

I hope that, in addition to the experts, the non-experts will read this book as well. I also hope that the experts will help increase the understanding of the non-professionals and present the full range of policy choices that are available and thinkable to resolve the problems of US debt and global imbalances.

This book tells only a part of the US debt and global imbalances story. The story will be continued in the next volume and include additional policy suggestions.

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