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# HOW MUCH ADJUSTMENT?



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## Current Account Objectives: Who Should Adjust?

JOHN WILLIAMSON

Not long ago, an article in *The Economist* likened the world economy to an airplane that flies on only one engine, with the United States being the sole growth pole that was injecting additional demand into the global economy. More recently, a paper by Michael Dooley, David Folkerts-Landau, and Peter Garber (2003) pictured the Asian countries as constituting a fixed exchange rate periphery to the US role as the permanent-deficit center country of a revived Bretton Woods system.<sup>1</sup>

In both cases, the notion seems to be that any correction of the US current account deficit would risk global demand deflation because there is no other region able and inclined to substitute for the United States as the source of additional global demand. This chapter asks whether that is true and, if not, where the additional demand could come from.

The question of where sufficient additional demand would come from to keep the world economy expanding if and when the United States does initiate a serious effort to correct its external deficit is of course an important one. A US adjustment that did not have a counterpart demand expansion

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*John Williamson is a senior fellow at the Institute for International Economics. The author is indebted to C. Fred Bergsten and participants in the conference for comments on a previous draft and to Jacob Kirkegaard for research assistance.*

1. The United States actually had a current account surplus most years while the Bretton Woods system—one of whose basic rules was that a country was supposed to adjust its exchange rate if it was in “fundamental disequilibrium”—was in operation. What the authors appear to confuse with the Bretton Woods system is the Dollar Standard, which for a time looked as if it would emerge from the Bretton Woods system as the latter was breaking down. (In fact, this perversion of the Bretton Woods system did not last long.)

in the present surplus countries might succeed in correcting the US external deficit, but if so it would be at a severe cost in the level of global output. An adjustment achieved at the cost of global growth could be a cure worse than the disease.

This chapter therefore seeks a way to allocate the reduction in current account surpluses<sup>2</sup> among non-US countries that would be implied by a smaller US current account deficit. A successful adjustment process will require that these countries expand their internal demand by a sum greater by the programmed reduction of their current account balance than they otherwise would. Without such expansion, adjustment would come at the cost of net global demand deflation. (This may seem obvious to some, but there are still people who seem to believe that recognition of the importance of exchange rates in facilitating adjustment implies blindness to the importance of anything else. My view is the mainstream one that both relative demand and real exchange rates are important determinants of payments positions.)

There is no reason to expect that a reduction in current account surpluses would in general be undesirable to the countries in question. In a recent paper (Williamson 2003) that aimed to rationalize the notion of export-led growth, I postulated that growth depends on investment and that the desire to invest is stimulated by a more competitive exchange rate. This is the sort of mechanism that Dooley, Folkerts-Landau, and Garber appeal to as rationalizing the growth strategies of the East Asian periphery. But, unlike both them and the self-styled “Keynesians” at Cambridge, I also recognized that there is a potential disadvantage from the standpoint of growth in an undervalued exchange rate: that the resulting current account surplus diverts resources away from absorption into reserve accumulation. The desire to invest (demand side) may be greater, but the ability to invest (supply side) is diminished. The growth-maximizing exchange rate is that at which these two forces are balanced at the margin.

When (as in China) investment is already well over 40 percent of GDP, one may reasonably question whether it is desirable to increase investment further or whether the marginal productivity of investment is low because of a constraint on absorptive capacity. But even if one answers that further increases in investment are for that reason undesirable, it is difficult to believe that a country’s government is doing its citizens a service by investing so many resources in low-yielding reserves, rather than encouraging consumption of the current generation to rise faster. Future growth need be no slower, and current consumption could be higher, with a different macroeconomic strategy that resulted in a lower current account surplus or a shift into a deficit sufficiently small to be financed prudently. Certainly

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2. In principle, one should add “or increase in current account deficits,” because it is conceivable that some countries that already run current account deficits ought to aim at larger current account deficits.

**Table 2.1 Current account balances, 2004** (billions of dollars)

Economy, group, or region	IMF forecast	Change	Targets	GDP
<b>Advanced economies</b>				
United States	-496	246	-250	
Euro area	68	-68	0	9,266
Japan	144	-73	71	4,760
New industrial economies	77	-19	58	1,228
Other advanced economies	23	-23	0	6,167
<i>Total</i>	-184	63	-121	
<b>Developing economies</b>				
Africa	-8	0	-8	610
China	25	-24	1	1,583
Other developing Asia	26	-22	4	1,449
Middle East	44	-11	33	734
Western Hemisphere	-7	0	-7	1,978
<i>Total</i>	80	-57	23	
<b>Economies in transition</b>	6	-6	0	1,824
<b>Discrepancy</b>	-98	0	-98	

Sources: International Monetary Fund, *World Economic Outlook*, April 2004, appendix tables 26 and 28; assumptions described in the text; and IMF data bank for GDP figures.

it is difficult to conceive of a model other than the crudest Keynesian one, with no supply side, under which growth is increased by hoarding low-yielding reserves.

I therefore do not believe that reduced current account balances outside the United States need be inimical to the welfare of those countries. On the contrary, except in a situation of global excess demand (like the early 1970s) or excess supply (like the 1930s), my presumption is that countries' national interests are consistent. We have no rigorous way of establishing what an optimal pattern of payments imbalances would be, so the approach adopted here is to explore ad hoc rules that appear to give reasonable results that respect the interests of all countries in achieving sustainable payments positions and high-growth, high-employment domestic outcomes.

## Computations

The first set of numbers in table 2.1 shows the latest (April 2004) IMF forecasts of the current account balances of the principal economies and regions in the current year, 2004. The US deficit is projected as \$496 billion. That is more than 50 percent offset by surpluses in other advanced economies, which are disaggregated in the table into the euro area, Japan, the new industrial economies (Hong Kong, South Korea, Singapore, and Taiwan), and other advanced economies (consisting of Australia, Canada, Cyprus, Denmark, Iceland, Israel, New Zealand, Norway, Sweden, Switzerland,

and the United Kingdom). A further 16 percent of the US deficit finds its counterpart in net current account surpluses in the developing countries. After allowing for a small net surplus of the transition economies, there is a \$98 billion expected statistical discrepancy. This is the current account deficit that the world runs with itself because the statisticians are unable to figure out to whom \$98 billion in receipts is accruing (or, less probably, who is reporting larger payments than they are really making).

How large a correction in the US current account deficit would it be reasonable to seek in the coming years (say, within a time horizon of about three years)? Halving the measured deficit would seem a reasonable objective. That would still leave a substantial measured deficit, of nearly \$250 billion, or some 2.5 percent of GDP. This is probably equal to a real deficit (an increase in the net indebtedness of the United States toward the rest of the world, ignoring changes in asset values) of something over \$200 billion (a little under 2 percent of GDP), after attributing a reasonable proportion of the world statistical discrepancy to the United States. That would suffice to end the increase in the ratio of the US net international investment position (NIIP) to GDP at a reasonable value, even if in future years the statisticians do not revalue assets and liabilities in such a way as to offset much of the increase in the NIIP caused by the current account deficit, as they did in 2003.

Of course, this would not guarantee that the United States would not at some point encounter a crisis. Most crises arise from circumstances that are not foreseen, so one cannot assert with any confidence that a particular deficit is sustainable for a given length of time. What one can say is that the *probability* of a crisis increases as the debt/GDP ratio rises, in which case an end to the trend increase in the debt/GDP ratio would prevent a further increase in the likelihood of a crisis.

How could the counterpart deterioration in the current account balances of the rest of the world be distributed? In principle, there are of course an infinite number of ways, but consider the following approach. The two deficit regions (Africa and the developing countries of the Western Hemisphere) are not asked to participate in the adjustment process. The remaining regions' GDP totals \$29,599 billion. The \$246 billion target change amounts to 0.83 percent of that change. A change of 0.83 percent of their GDP would push the euro area, other advanced economies, and the economies in transition into deficit. These regions are therefore assigned a target of eliminating their current account surpluses. That provides for \$97 billion of the desired \$246 billion of adjustment.

There remains \$149 billion of adjustment to divide among the remaining areas, whose GDP totals \$9,754 billion. That is, countries on average need to adjust by 1.528 percent of GDP. If that is distributed proportionately to GDP, all these regions could remain in surplus (although the Chinese surplus would be marginal). That is the adjustment that is shown in the middle two columns of the table, with one column showing the changes and the other the proposed targets.

## Are the Targets in the Interest of the Adjustees?

Would those targets be reasonable ones, in the sense that they give “reasonable results that respect the interests of all countries in achieving sustainable payments positions and high-growth, high-employment domestic outcomes”? Or are there reasons to think that their pursuit would impose unreasonably onerous obligations on some of the countries or regions, either because it would preclude their achieving full employment or high growth, or because it would interfere with their legitimate external objectives? The chapter proceeds to consider each of the countries or regions in turn.

### Euro Area

The euro area has been a surplus region for most of the past decade, the exception being 2000, with the nine-year average surplus being \$47 billion. But it would face no external problem if its external surplus were to vanish. A reduction of \$68 billion would amount to under 1 percent of GDP, a sum that most economists probably believe could easily be offset by a relaxation of monetary policy to expand internal demand by \$68 billion. (However, the model of the European Central Bank, or ECB, apparently attributes almost no impact on internal demand to changes in the interest rate, which in that model achieves its impact almost entirely by influencing the euro’s exchange rate. Perhaps this implausible modeling explains why the ECB has been so reluctant to cut interest rates during the recent recession.) I therefore see no difficulty in Europe making its suggested contribution to the adjustment process.

### Japan

In contrast, Japan has experienced severe problems in expanding internal demand during the past decade. However, the Japanese economy is now recovering from its prolonged bout of weakness (see chapter 8 in this volume), and so the factor that has for some years argued for exempting Japan from full participation in the adjustment process is no longer present. Taking William Cline’s central estimate that each 1 percent appreciation in the yen’s real effective exchange rate reduces the Japanese current account surplus by \$2.3 billion (Bergsten and Williamson 2003, 192), a \$68 billion decline in Japan’s current account surplus would require an appreciation of just over 30 percent in the real effective exchange rate. If many of its trading partners also appreciate against the dollar, then the yen’s rate against the dollar will need to appreciate by substantially more than this (although a part of the adjustment has already occurred). Even so, these are very large changes, and so it may be important to treat such a target as a longer-run one than most of the others discussed in this chapter.

## **New Industrial Economies**

The new industrial economies were more or less in current account balance before the Asian crisis. However, one of the messages they took from that crisis was that they needed to build up their reserves to a much higher level to avoid any danger of a repetition. They have now abundantly accomplished that objective: Their collective reserves rose from \$263 billion in 1996 to over \$540 billion in late 2003. Accordingly, it would now be quite consistent with their continued economic security to stop stockpiling reserves and revert to a policy that would involve something close to current account balance. The decline in external demand that would need to be replaced by expanded internal demand would be more than 6 percent of their collective GDP if they were to go over time to this objective. The adjustment that is proposed in the short run (the next two or three years) is much smaller than this. While it would be sensible for them in due course to stimulate their internal demand so as to replace a much larger proportion of their external surplus, one might not want to envisage such a large adjustment in the short run.

## **Other Advanced Economies**

One would look to the surplus countries in the motley group of other advanced economies (Canada, \$17 billion, projected in 2004; Denmark, \$6 billion; Norway, \$31 billion; Sweden, \$20 billion; and Switzerland, \$34 billion—a total of \$108 billion) to generate the reduction of \$23 billion to put the group as a whole in current account balance. That would require a reduction in their collective surplus of only 21 percent, and an offsetting expansion in internal demand of less than 1 percent of their GDP. This seems eminently feasible.

## **Africa**

The “target” for Africa is a collective deficit of \$8 billion (the projection of the International Monetary Fund for 2004), which may be compared with the average deficit of the region of a similar sum over the past nine years. There is nothing obviously infeasible here.

## **China**

The target involves virtual elimination of China’s \$25 billion current account surplus.<sup>3</sup> This is, if anything, on the modest side, because (1) the

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3. Its bilateral surplus with the United States is, of course, totally irrelevant to this exercise.

current account surplus would be larger were it not for the fact that the Chinese economy is currently overheated; (2) the surplus is likely to grow in coming years as a result of the elimination of the Multi-Fiber Arrangement; and (3) China's capital imports (mainly of foreign direct investment) have on average been quite significant in recent years (on average, something like \$40 billion). China would do itself a favor if it were to reduce its buildup of the low-yielding US Treasury bills that are forming the base of the speculative bubble that is growing and that constitutes the main threat to continued rapid Chinese growth. The adjustment asked of them is less than 2 percent of GDP, which should be a welcome (though possibly inadequate) way to relieve excess demand rather than something that needs replacing by more stimulatory policies.

### **Other Developing Countries of Asia**

The other developing countries of Asia are another region that developed a surplus in the wake of the Asian Crisis (it was in significant deficit before that). The reserve buildup that resulted was a sensible precautionary move, but it has surely now gone far enough in most of the countries: Reserves increased from \$134 billion at the end of 1996 to more than \$250 billion in late 2003. Accordingly, it seems reasonable to ask this group of countries to accept a \$23 billion deterioration in their collective current account position, which would be equivalent to less than 2 percent of their collective GDP. Most of them could use these resources productively in increased domestic investment, although there may again be the odd case in which, like China, it would make more sense to expand consumption.

### **The Middle East, Including Turkey**

For 2004, the IMF is projecting an \$8 billion deterioration in the current account surplus of the Middle East, including Turkey, to a \$44 billion surplus. This is above the nine-year average of this group of countries, which suggests that it would be reasonable to adopt a smaller figure for the medium-run target. As long as the oil price stays unusually high, however, one should encourage this group of countries to maintain a current account surplus as a way of saving for the day when conditions turn more adverse.

### **The Western Hemisphere**

The IMF is projecting a current account deficit of \$7 billion for the countries of the Western Hemisphere in 2004, which is substantially less than the nine-year average of a \$46 billion annual deficit. One can certainly argue (e.g., see Kuczynski and Williamson 2003) that in the past these countries

have allowed themselves to become excessively dependent on foreign savings, and accordingly that a substantially lower target than the actual past medium-term average is called for. A somewhat larger deficit than the target of \$7 billion would, however, seem consistent with prudence.

## **Economies in Transition**

The IMF projection has the economies in transition maintaining a small collective current account surplus in 2004, which is a little above their nine-year average of a small (\$2 billion) current account deficit. There seems every reason to regard current account balance as a sustainable medium-term position. Indeed, it may be that with continuing capital inflows a number of additional countries could benefit by moving into current account deficit.

## **Conclusions on the Feasibility of Adjustment**

In sum, it seems difficult to justify the agony about whether the rest of the world could adjust to a lower US current account deficit. The adjustment that I postulated could be accommodated rather comfortably by the rest of the world, with the possible exception of Japan.

Of course, certain conditions would need to be satisfied for such a benign outcome to materialize. First, it would be necessary for the counterpart adjustment to be widely distributed, as in the above scenario, rather than concentrated on a handful of countries. In particular, this means that the Asian countries now need to be brought into the adjustment process, instead of it all being concentrated on Europe and the old dominions of the British Commonwealth. This need not be difficult for them if they move collectively, but so far all one hears is that change is impossible in the absence of a move by China. Second, it would be necessary for the countries that would lose foreign demand (except perhaps China, which currently has a problem of excess demand) to be able and willing to replace the lost demand by deliberately expanding domestic demand.

Indeed, a somewhat larger adjustment could be envisaged without imposing unreasonable burdens on some countries. The new industrial Asian economies could, and indeed should, contemplate a bigger adjustment in the medium term. Some of the other advanced economies, like Canada, Scandinavia, and Switzerland, could afford lower surpluses and would not have any difficulty in expanding internal demand. China and other developing economies in Asia could, and probably should, go into deficit rather than simply eliminating their surpluses. And as was pointed out above, there is scope for more adjustment by the Western Hemisphere.

A *much* larger adjustment, however, could be problematic, especially in the absence of much stronger economies in Europe and Japan, or else larger

capital flows to emerging markets that both authorities and markets were confident would be sustained over time. These things may come to pass in due course, but a prudent adjustment strategy for the next few years should concentrate on reducing the US deficit to a level that does not imply an ever increasing debt/GDP ratio in the United States. In the absence of this, it is all too easy to imagine a scenario in which at some point the dollar collapses due to some shock or other and the United States is thus forced into precipitate adjustment. This might pose dangers to the US economy, for example, from the inflationary pressures that would arise. But perhaps the graver danger is that the rest of the world would not be able to accommodate the counterpart adjustment, thus creating a world recession. This chapter has argued that it does not have to happen that way.

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