
Comment

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To begin, it is good to note how much progress appears to have been achieved by leading academic researchers in the short time since September 2002. At a meeting at that time, I had remarked on the fact that quite a lot of the analysis had been stuck in the style of the 1980s, not recognizing the dramatic changes that had taken place in the world economy and US trade relationships around the world.

All three chapters in part II of this volume recognize these changing patterns, as evidenced by not having the euro and yen as the only counterparts to further dollar adjustment. It is important to recognize these issues. As can be deduced from table II.1, the modern trade-weighted dollar for the Group of Seven (G-7) currencies has a weight of 51.4 percent, with many developing countries now becoming increasingly important. The combined weight of the Chinese renminbi and the Mexican peso, at close to 22 percent, is bigger than the weight of the euro. In this context, moves in the dollar against each of these currencies might be just as important as moves against the euro in the effect of dollar adjustment.

To illustrate how further changes in this direction are likely as time passes, figure II.1 depicts how the world may look in the future. This figure envisages a world in which China is the largest economy and India is third, with the United States sandwiched between them.

Most European countries are somewhere behind. Of course this is only dreaming, but dreams can sometimes become true. Already, some aspects of

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Table II.1 Trade-weighted US dollar, 2004

Economy or region	Weight	Economy or region	Weight
Euro area	18.53	Thailand	1.43
Canada	16.50	Australia	1.28
Japan	11.13	Philippines	1.16
Mexico	11.03	Sweden	1.09
China	9.78	India	1.08
United Kingdom	5.23	Israel	1.05
South Korea	3.86	Indonesia	0.99
Taiwan	3.05	Russia	0.75
Malaysia	2.28	Saudi Arabia	0.63
Singapore	2.17	Chile	0.51
Hong Kong	1.98	Argentina	0.44
Brazil	1.86	Venezuela	0.40
Switzerland	1.43	Colombia	0.37

Source: US Federal Reserve data.

China's and India's influence on the world are becoming clear, and it is vital to consider their role in any fundamental assessment of dollar adjustment going forward. In this regard, it was especially pleasing to see the scope and vision of Agnès Bénassy-Quéré and her colleagues in chapter 4.

Chapter 2 by Williamson

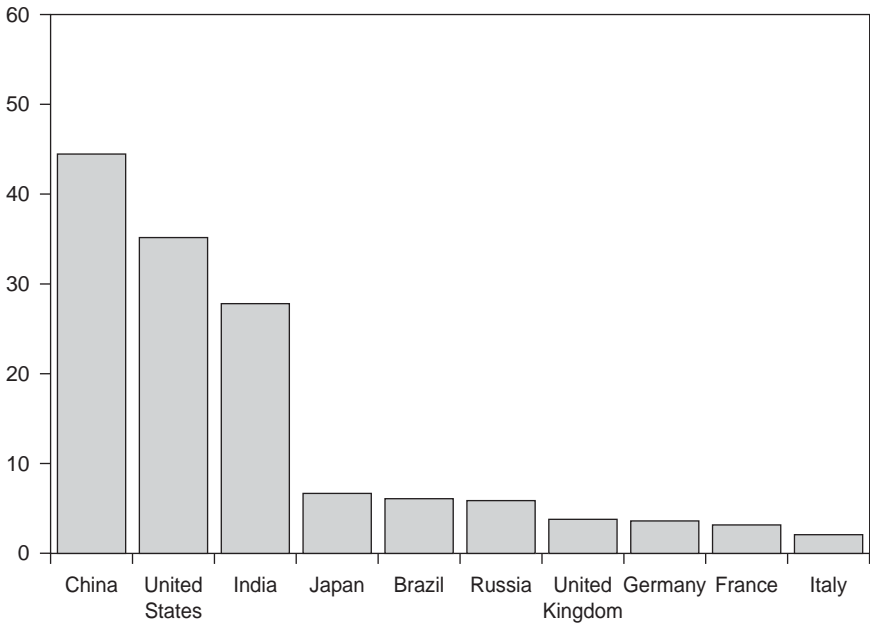
Turning to each chapter individually, I strongly support the basic contention in chapter 2, by John Williamson, that a decline in the dollar does not necessarily have to be deflationary for the world. Indeed, on the contrary, the dollar's decline since early 2002 has been one of the main reasons that the world has been in somewhat better shape. Its decline has contributed to a much-needed improvement in US financial conditions and pressurized other major nations into more accommodative policies to provide an offset. According to the Organization for Economic Cooperation and Development, financial conditions have been easier since the dollar started its decline (figure II.2).

Japan is an especially interesting case. As Fred Bergsten remarked to me 20 months ago, there was considerable debate about whether Japan was in a position to cope with the yen's strength. Today, it can be argued that the persistent pressure for an ever-strengthening yen could have been a major contributor to the more expansive policies pursued by the Bank of Japan and has added to the evidently healthier economic environment in Japan.

This illustration may also be pertinent to the current case of the eurozone and its ability to cope with more dollar weakness. Superficially, I—probably like many others—respond with suspicion to the idea presented in Williamson's chapter that as a counterpart to the proposed (and assumed

Figure II.1 The world economy in 2050

GDP (in trillions of 2003 dollars)



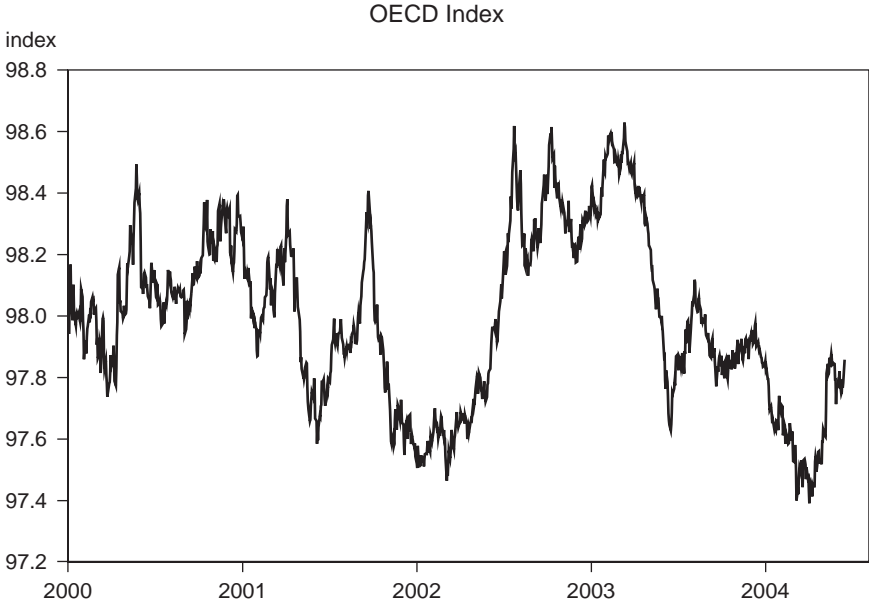
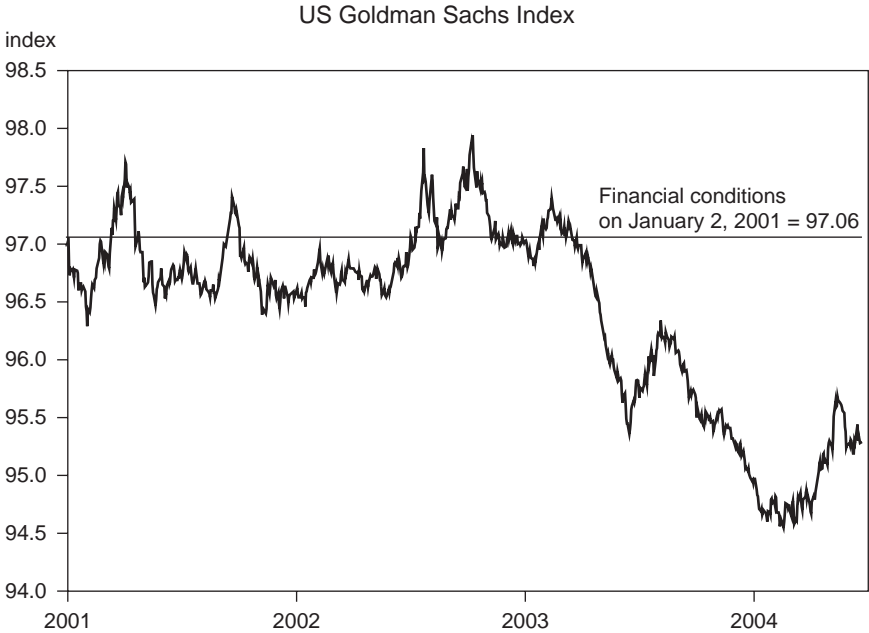
Source: Wilson and Purushothaman (2003).

necessary) halving of the US current account deficit to 2.5 percent of GDP within 3 years, the eurozone would need to lose 0.83 percent of GDP through trade. At the time we met for the conference on which this book is based, it was just a week or so after Germany reported that the value of its March nominal retail sales was lower than 11 years ago (figure II.3). This is a rather incredible outcome that most would presume impossible in a developed economy, highlighting Europe's difficulties in coping with US current account adjustment.

Nonetheless, the notion that this necessarily always has to be the case is clearly incorrect. Given the size of Europe—supported by the European Union's expansion—it is quite possible, as well as appropriate, that the eurozone will develop more ambitious fiscal and monetary policy regimes, and it should certainly not persist with inward-looking ones. If the US current account is to adjust, the eurozone clearly needs to serve as a counterpart.

What is one to make of Williamson's basic premise that a reduction of the US current account by half is necessary? Goldman Sachs has strong sympathies with this notion. Early in 2004, it published a paper by the present author and Hatzius arguing that a US current account deficit of 3 percent of GDP might be more sustainable (O'Neill and Hatzius 2004). Under such a

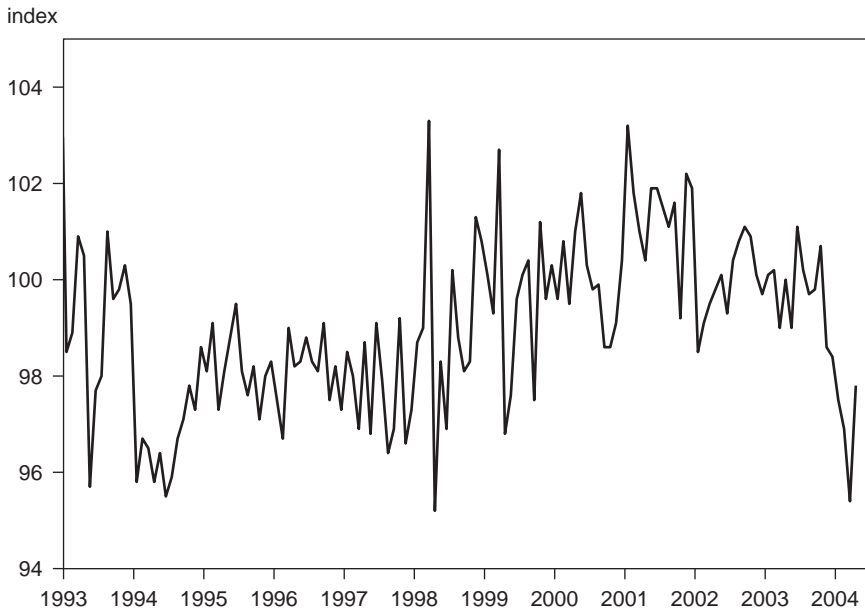
Figure II.2 US Goldman Sachs Financial Conditions Index and OECD Financial Conditions Index



Rise = tightening conditions

Source: Goldman Sachs.

Figure II.3 Nominal retail sales in Germany, 1993–2004



Source: Bundesbank.

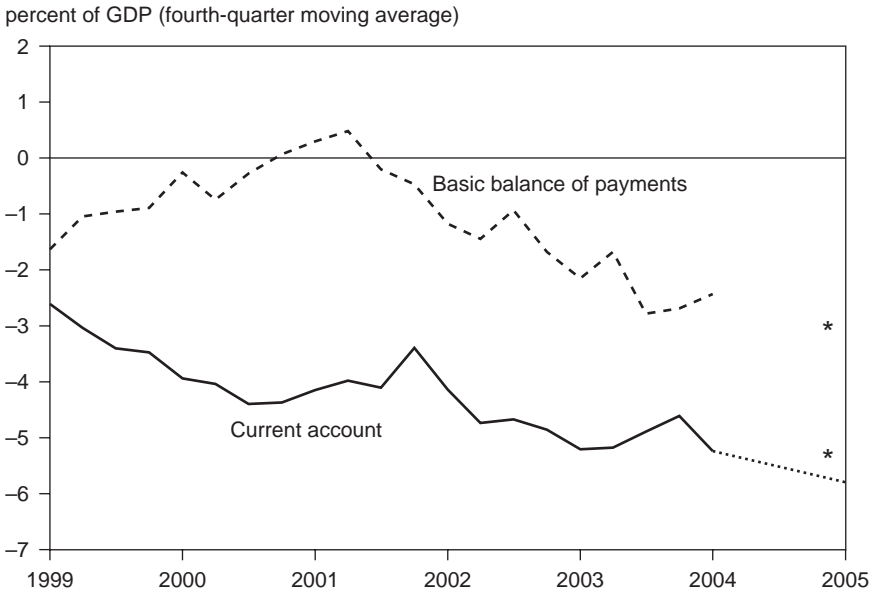
scenario, the deficit would be matched by long-term capital flows. A decline from 5 to 3 percent is necessary to maintain a balance in the broader US “basic” balance. I defined a broad basic balance above as the current account balance plus net foreign direct investment (FDI) plus net portfolio flows, bonds, and equities. The sustainable current account is presumably the one that matches net FDI and portfolio flows over the longer term and that does not rely on hot capital short-term flows or foreign central bank intervention. Currently, the broad basic balance of payments is in deficit, and therefore either the current account deficit needs to decline or FDI and portfolio flows need to accelerate (figure II.4).

Given that the combined FDI and portfolio flows have averaged about 3 percent of GDP since the early 2000s, a slightly bigger current account deficit than Williamson suggests might be sustainable for a while. However, 0.5 percent of GDP is not of material difference.

Chapter 3 by Wren-Lewis

As a general comment on the potential size of a further dollar decline necessary to reduce the current account deficit to a sustainable level, our research is rather consistent with the tone of all three chapters in part II, and specifically with the results presented in chapter 3, by Simon Wren-Lewis. O’Neill

Figure II.4 United States: Basic balance of payments versus current account, 1999–2005



* = forecast for 2004

Sources: US Department of Commerce; Goldman Sachs.

and Hatzius concluded that the dollar, at a level of about 10 percent below its broad trade-weighted peak, may need to fall further by the same amount to reduce the current account deficit to 3 percent of GDP (O'Neill and Hatzius 2004). Such a decline might be spread across a different set of currencies from those that the dollar has declined against so far, and here O'Neill and Hatzius would broadly agree with the numbers implied by Wren-Lewis. It is particularly pleasing to see his conclusions that some revaluation of the Chinese renminbi is a necessary part of the adjustment process.

It was surprising to read that Wren-Lewis estimates the underlying current account surplus in the eurozone in 2002 to be as high as 3.1 percent of GDP. He explains that this estimate is consistent with the current account that might have prevailed if the euro had not strengthened sharply, and though a larger surplus might have existed, this estimate seems rather too high. There was little anecdotal evidence at the time to suggest that such a large surplus was in the making.

Another peculiarity of Wren-Lewis's chapter is the inclusion of research on both the Australian and New Zealand dollars. Although his results are interesting, it is unlikely to be the case that either is important to a dollar adjustment and the US current account deficit.

Figure II.5 US core consumer price index, 2000–04



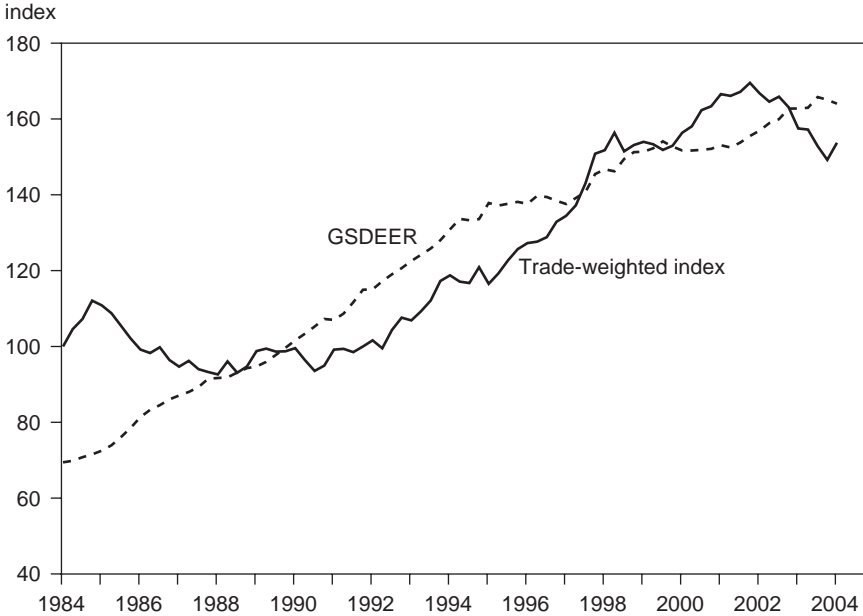
Source: US Department of Labor.

Another, more general point, noted by Wren-Lewis but also evident in chapters 2 and 4, is the lack of discussion of *internal* equilibrium in the US consistent with the desirability of a decline in the current account deficit. In its original presentation and most derivatives since, Williamson's model of the fundamental equilibrium exchange rate requires internal *and* external equilibrium. All three chapters in part II seem to focus mostly on the external balance. At the time of the Institute for International Economics conference in May 2004 (and becoming increasingly topical immediately afterward), there was some evidence that US inflation was starting to rise (figure II.5). If this indicates that the US output gap will be closed earlier than anticipated, it may follow that the United States is able to cope with a more delayed period of adjustment of its current account deficit. Certainly, a repeat of the dollar's decline since 2002 might have undesirable consequences if it coincides with, or contributes to, rising inflation in the United States.

Currencies and Productivity

The later sections of Wren-Lewis's chapter are its most interesting; there, he discusses simulations of the sustainable current account deficit based on both fiscal policy and technology shocks in the United States. He argues

Figure II.6 Dollar trade-weighted index versus GSDEER, 1984–2004



GSDEER = Goldman Sachs dynamic equilibrium exchange rate

Rise = dollar appreciation

Source: Goldman Sachs.

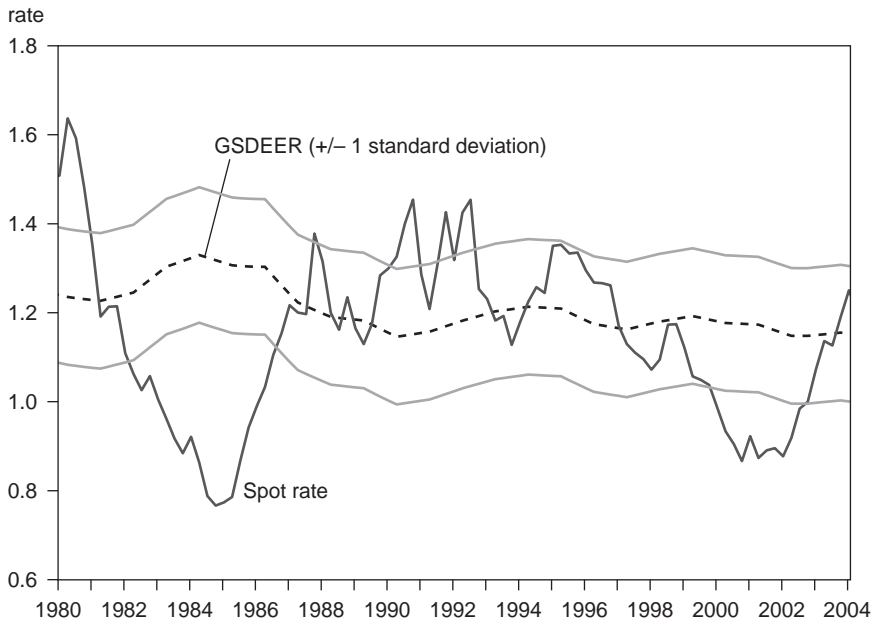
that both raise the current account deficit, which may be financed more readily. This research is consistent with aspects of the O'Neill and Hatzius paper. It can be argued that though the US current account deficit is too big, a larger deficit may perhaps be financeable because longer-term capital flows to the United States are sustainable on a larger basis than in the past, due to evidence of stronger US productivity.

This strength in productivity can be linked to a technology shock. The so-called Goldman Sachs dynamic equilibrium exchange rate (GSDEER) model for estimating the equilibrium value of currencies is based on analyzing movements in the real exchange rate against movements in relative productivity. In recent years, the estimated GSDEER fair value for the dollar has risen both on a trade-weighted basis and against important bilateral currencies, such as the euro (figures II.6 and II.7).

This rise is due to the higher productivity performance of the United States against many other nations. Indeed, at the time of this writing, the specific Goldman Sachs trade-weighted estimate suggests that the dollar may be slightly *undervalued*.

This estimate appears to be at odds with comments above suggesting that the current account needs to decline to around 3 percent of GDP. For

Figure II.7 Dollar-euro GSDEER, 1980–2004



GSDEER = Goldman Sachs dynamic equilibrium exchange rate

Note: Fall = dollar appreciation

Source: Goldman Sachs.

the two approaches to be consistent, either long-term capital flows into the United States will have to rise considerably more, offsetting a persistently large current account deficit, or—and perhaps this is more likely—*future* productivity-driven estimates of fair value for the dollar will be lower.

Indeed, it is difficult to understand why and how a technology shock such as that in the late 1990s can permanently help the United States relative to other countries. Either the US productivity improvement will turn out to be temporary and/or there will be a productivity “catch-up” in other regions.

Of course, there is a strong case to be argued that the dollar *needs* to be undervalued against most conventional estimates of fair value. After all, the dollar was overvalued for much of the late 1990s and early 2000s. The case for an undervalued dollar is rather compelling, especially in view of the need to reduce the current account deficit to more sustainable levels. Indeed, some credible research that focuses on the long-term stability of the net foreign investment or net liability position would argue that the US current account needs to move into balance for a while (O’Neill, Ades, and Fuentes 2004; Lane and Milesi-Ferretti 2002). Such requirements would imply that the dollar needs to fall even more sharply.

Table II.2 Important weights in the trade-weighted dollar, 2004 (percent)

Currency	Weight
Euro	18.53
Canadian dollar	16.50
Japanese yen	11.13
Mexican peso	11.03
Chinese renminbi	9.78
British pound	5.23
Swedish krona	1.09

Source: US Federal Reserve data.

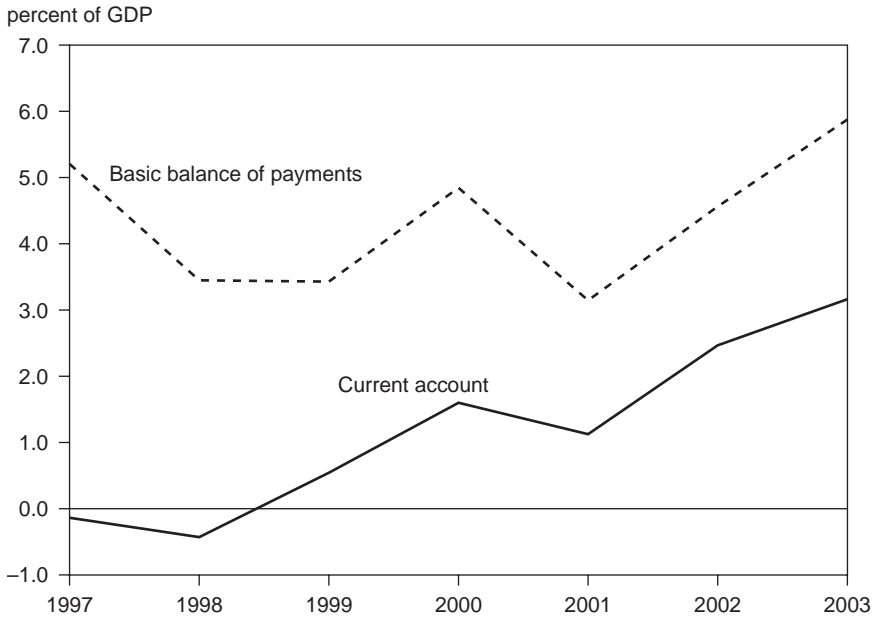
Chapter 4 by Bénassy-Quéré and Colleagues

Chapter 4, by Agnès Bénassy-Quéré and her colleagues, is especially interesting, given its sophisticated technical approach and its modern conceptual framework. In particular, its focus on the growth of bilateral US deficits with many emerging-market countries, especially China, warrants the method that Bénassy-Quéré and her colleagues employed. Only about 50 percent of the modern trade-weighted dollar carries weights with G-7 countries and much of the rest is with developing countries. The weight of the Chinese renminbi and the Mexican peso, combined around 22 percent, is bigger than the weight of the euro (table II.2). Therefore, the approach of Bénassy-Quéré and her colleagues is quite an advance over much of the previous research insofar as it recognizes that the US imbalances are no longer with the G-7 alone.

It is a shame that world policymakers cannot find a better club than the G-7/G-8 to help achieve some improvements in the US imbalances, and a correspondingly more optimal set of policies for the world economy. This is clearly acknowledged by Bénassy-Quéré and her colleagues. It is perhaps the key aspect of part II of this book, and it is something Goldman Sachs has been writing about recently (O'Neill 2001, Wilson and Purushothaman 2003, O'Neill and Hormats 2004). As was shown above, the future world economy may look very different than today (see figure II.1). Of course, projections for world GDP and its makeup in 2050 may turn out somewhat differently, but the growing roles of India, Russia, and especially China suggest that an improved structure for current world policymaking is necessary.

Linked to this theme, the chapter by Bénassy-Quéré and her colleagues very clearly shows how the consequences for the Group of Three currencies may vary, depending on whether some important emerging currencies share in any future dollar weakness. The results demonstrating the sensitivity of the euro to the consequences of a Chinese renminbi move

Figure II.8 Basic balance of payments versus current account for BRIC nations, 1997–2003



BRIC = Brazil, Russia, India, and China

Sources: Goldman Sachs; national accounts.

against the dollar are especially useful, not least because this is a topical issue. A significant appreciation of the renminbi would almost definitely allow further euro strength against the dollar to be less damaging than otherwise.

Some observers may believe that the importance of China, India, and other countries to stimulate the reduction in the US current account deficit is overstated and/or that some of these countries should be allowed to run current account surpluses to help them reach their long-term potential. However, if the United States is to have any chance of reducing its growing broad basic balance of payments deficit, the major developing countries will need to reduce their growing broad balance of payments surpluses.

The overall broad basic balance—the aggregation of the current account, net FDI, and net portfolio flows—is a good guide to the net commercial supply and demand for a currency. Presumably, over repeated cycles, countries should be hoping to achieve a position close to zero. A current account deficit should ideally be offset by a similar-sized surplus in the other components of the broad balance, and a current account surplus should be offset by a similar-sized deficit. Currently, all four of the so-called

BRIC nations (Brazil, Russia, India, and China) are running surpluses on all three components of the broad basic balance (figure II.8).

This growing basic balance surplus of the BRIC countries suggests that their currencies may be too cheap, and certainly that they deserve to be part of any dollar depreciation in the future. This is clearly recognized more by Bénassy-Quéré and her colleagues than by many others, and they deserve congratulations for this research.

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