



THE IMPACT OF A MAJOR DOLLAR REALIGNMENT

Exchange Rate Adjustments Needed to Reduce Global Payments Imbalances

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The United States is now running a current account deficit that exceeds \$500 billion a year—by far the largest international payments imbalance ever recorded by any country. Plausible estimates suggest that—at present exchange rates and with US economic growth continuing to exceed that of most other industrial countries—the US external deficit could reach \$1 trillion by the end of this decade. The cumulative effect of these external deficits is reflected in the US net external liability position, which is now about 25 percent of annual GDP and which could rise to 50 percent within a decade and to more than 100 percent within the next 25 years.

On the other side of the US external payments position lies that of the rest of the world. Leaving aside the measurement problems associated with the global payments discrepancy, the combined current account surplus of the rest of the world amounts to about 1.5 percent of the GDP of the rest of the world (vs. about 5 percent of US GDP). This surplus tends not to be seen as a particular problem—at least until it is recognized that significant reduction in the US external payments deficit requires a corresponding reduction in the external surplus of the rest of the world and a corresponding negative impulse to output growth in the rest of the world.

Are the US external deficit, the associated buildup of US net foreign liabilities, and the corresponding developments in the rest of the world really important problems that require urgent attention? There are two extreme views on this question, each of which has (in its sophisticated and intellectually respectable form) a strong advocate among those asso-

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ciated with the Institute for International Economics. On one side, the Institute's chair, Peter G. Peterson (in his new best-seller, *Running on Empty*), takes Chicken Little's "The sky is falling!" view that the US current account deficit and the US fiscal deficit are clearly on unsustainable paths and that serious damage to the US economy is likely to occur unless something is urgently done to correct these problems. On the other side, the chair of the Institute's Academic Advisory Panel, Richard N. Cooper, is an advocate of Alfred E. Newman's "What me worry?" view that US net foreign liabilities are only a small fraction of total US wealth (measured as the present value of US national income) and that the growth of these liabilities is unlikely to pose a serious problem as long as strong growth of the US economy continues to imply rapid increases in total US wealth.

The Institute's director, C. Fred Bergsten, is an advocate of "responsible excess" as a strategy for presenting the work of the Institute. However, with the extremes on the present issue already taken up, within the limits of intellectual respectability, by Peterson and Cooper, I am left with the alternative of being extremely moderate.

To that end, I argue in this chapter that there probably is a practical upper limit for US net external liabilities at something less than 100 percent of US GDP and, accordingly, that current account deficits of 5 percent or more of US GDP are not indefinitely sustainable. Conversely, the US current account deficit does not need to be eliminated to achieve external payments sustainability. For the United States, which is particularly attractive to foreign investors, current account deficits of up to 2 percent of GDP or slightly more, and net foreign liability ratios as high as 40 or even 50 percent of GDP, are probably sustainable without undue economic strain or risk of crisis.

Bringing the US current account deficit down from about 5 to 2 percent of GDP (and achieving a reverse change in the current account balance of the rest of the world) requires some key macroeconomic adjustments. Consistent with the focus of this volume, adjustments of exchange rates are particularly important. Specifically, it is argued below that a real effective depreciation of the dollar of about 30 percent (from the baseline of the period from mid-2000 to mid-2002) will probably be needed in connection with an improvement of about 3 percent of GDP in the US current account balance. Concerning the magnitude and timing of adjustments of individual exchange rates against the dollar, there is no sound basis for precise conclusions, but it is possible to reach some broad judgments about key individual exchange rate changes that might be expected to contribute to a 30 percent average real depreciation of the dollar over a time horizon of four to five years.

Exchange rate adjustments, however, are only one of three important classes of macroeconomic adjustments that must occur to address the problem of global payments imbalances represented by the large US current

account deficit and rapidly growing net foreign liabilities. In addition, it is required that

- in the United States, domestic demand grow more slowly than domestic output to make room for an expansion of US net exports, and as logically necessary counterparts of this downward adjustment of US demand relative to output, there must be a corresponding improvement in the US national savings/investment balance and an equivalent reduction in the net use of foreign savings by the United States;
- in the rest of the world, domestic demand grow more rapidly than domestic output to allow for a reduction of net exports that corresponds to the improvement of US net exports.

And as logically necessary counterparts of this upward adjustment of demand relative to output, there must be a corresponding deterioration in the savings/investment balance and an equivalent reduction in the net outflow of capital to the United States from the rest of the world.

Indeed, from the perspective of challenges for economic policies around the world, the key issue is not primarily securing adequate adjustments of exchange rates. Those adjustments will eventually come, perhaps rapidly and disruptively, as the enthusiasm of foreign wealth holders (and central banks) for continued massive accumulation of United States-based assets begins to wane or even possibly reverses. The principal challenge for economic policy is to ensure that the exchange rate and other key macroeconomic adjustments essential to reducing global payments imbalances take place in a manner that allows economic output to remain near its potential in the United States and in the rest of the world.

As discussed below, for the United States, the most important policy adjustment necessary to contribute to a successful result is a gradual and cumulatively substantial reduction of the government deficit. This fiscal adjustment is needed fundamentally for its own sake—to put government finances in the United States on a more sustainable path. The main problem is political—agreeing upon and implementing the requisite changes in expenditure and revenue policies necessary to enforce meaningful fiscal consolidation.

In other industrial countries, the policy challenge is conceptually more difficult. The key problem is sustaining adequate growth of domestic demand to keep output and employment in line with its potential while offsetting the negative impulse associated with deteriorating current account balances. The relatively weak growth of domestic demand in most other industrial countries in recent years, the overextension of government budgets in most industrial countries, and the already easy stance of most monetary policies suggest important difficulties in designing measures to support more rapid growth of domestic demand.

In developing countries, the policy challenges are more mixed. For some countries, especially in emerging Asia, a change in exchange rate policies

that have resisted currency appreciation against the dollar is clearly needed. In other countries, notably several in Latin America, the main need is for sound monetary and fiscal policies that will support sustainable recovery and instill confidence among domestic and foreign investors. Over time, success in these areas should permit some real currency appreciation and some widening of current account deficits to levels consistent with sustainable capital inflows and with a meaningful contribution to the reduction of key global payments imbalances.

The Sustainable Scale of External Imbalances

For nearly a quarter of a century, the United States has persistently run significant current account deficits. The cumulative consequence of these deficits is that the United States has been transformed from the world's largest net creditor to its largest net debtor—with a total shift in the US net asset position relative to GDP of about 50 percentage points since 1970. So far, the United States does not appear to have suffered significant ill effects from these developments, despite widely expressed fears of a “hard landing” in the 1980s and other dire warnings of catastrophe.¹ Nevertheless, this massive shift in the US net asset position and the persistent deficits that underlie it naturally give rise to the question: Is there any limit?

Plausible Limits to US Net External Liabilities

The alarmists of the Chicken Little school insist that there is a limit and that the threat that we may soon test that limit raises substantial risk of a foreign exchange crisis, or even of a broader financial crisis, for the United States and the global economy. Conversely, the unbridled optimists of the Alfred E. Newman school take the view that if there is a limit it is quite far off, and that, provided that the United States continues to perform well, it can go on piling up net external liabilities at a prodigious pace for a considerable time.

I take the middle ground between the fears of Chicken Little and the complacency of Alfred E. Newman. In particular, I broadly share the conclusions of Catherine Mann in the analysis she prepared several years ago.² There must be some upper limit on the amount of net claims that foreigners will wish to hold against the United States (and its resident businesses and

1. In popular discussions, it is often suggested that large US current account deficits result in high unemployment. This view, however, is fundamentally nonsense from a medium- or longer-run perspective. For instance, the unemployment rate in the United States in the second half of the 1990s was generally the lowest it has been since the late 1960s, notwithstanding the fact that the US current account deficit widened greatly between 1995 and 2001.

2. Catherine Mann, *Is the US Trade Deficit Sustainable?* (Washington: Institute for International Economics, 1999).

households) on terms that will be attractive both to the foreigners who hold these assets and to the US residents that have the obligations to service them.

There is, however, no indication yet that we may be approaching that upper limit. Nor, in my view, is there any way to estimate with precision and confidence where that limit might be. Nevertheless, there is good reason to suppose that US current account deficits of 5 percent or more of GDP cannot continue for a decade or longer and that there should be some urgency to fostering adjustments that would give evidence that US external payments are moving toward a more clearly sustainable path.

As a starting point for the analysis of this issue, it needs to be emphasized that achieving a zero current account deficit is not necessary to stabilize the US ratio of net external liabilities to GDP. This ratio, call it $n = N/Y$, stabilizes when the current account deficit as a share of GDP, call it $c = C/Y$, is equal to the rate of growth of GDP, call it g , multiplied by the net foreign liability ratio; that is, n stabilizes when $c = g \times n$. In this formula, N , Y , and C are all measured in nominal dollars, and g is the growth rate of nominal GDP. Because the issues concerning sustainability of the US external position are fundamentally longer-run issues, the relevant growth rate for nominal GDP, g , is the long-run average annual growth rate of Y . It is plausible to assume that g is about 5 percent a year—with about 3 percent coming from annual real GDP growth and about 2 percent coming from annual increases in the GDP deflator.³

At present, the US current account deficit is about 5 percent of US GDP; that is, $c = C/Y$ equals about 0.05. The ratio of net foreign assets to GDP, $n = N/Y$, is presently about 25 percent. Thus, c is presently greater than $g \times n$; $c = 0.05 > 0.25 \times 0.05 = n \times g$. The excess of c over $n \times g$ generally implies that the ratio of net foreign assets must be rising. Indeed (ignoring some complications to be discussed), the current account deficit is equal to the annual increase in US net foreign liabilities—presently running at about 5 percent of GDP. In contrast, an increase of net foreign liabilities of only one-fourth that amount (corresponding to the present ratio of N to Y) would be consistent with keeping the present ratio of N to Y constant.

We may further calculate that if the current account deficit were to be somehow stabilized at its present ratio to GDP (i.e., at 5 percent), then the ratio of US net foreign liabilities would continue to rise until it reached 100 percent of GDP. Using the same logic, we may calculate that if the US current account deficit were reduced to and stabilized at 3 percent of GDP, the US net foreign liability position would eventually level out at 60 percent of GDP; $c = 0.03$ is equal to $n = 0.6 \times g = 0.05$. Similarly, if the current account

3. Formally, working in continuous time, let $D(X)$ be the operator that takes the derivative of X with respect to time. Then $D(n) = D(N/Y) = (D(N)/Y) - (N/Y)g = (D(N)/Y) - ng$. Ignoring the issue of capital gains and losses on foreign assets and liabilities (to be addressed below), use the fact that the change in net foreign liabilities is equal to the current account deficit; i.e., $D(N) = C$. It follows that $D(N)/Y = C/Y = c$ and hence that $D(n) = D(N/Y) = c - ng$. Thus, the ratio of net foreign liabilities (N) to GDP (Y) is rising when $c > ng$, is falling when $c < ng$, and is stable when $c = ng$.

deficit were reduced to and stabilized at 2 percent of GDP, then US net foreign liabilities would be contained at 40 percent of GDP; $c = 0.02$ is equal to $n = 0.4 \times g = 0.05$.

No one knows, or can estimate with great confidence, the outer limit of US net foreign liabilities that would be tolerable both to US residents as net debtors to the rest of the world and to residents of the rest of the world as holders of claims on assets located in the United States. However, no country of significant size has ever run up a net external liability position approaching 100 percent of its GDP. And for the world's largest economy (accounting for about one-quarter of global GDP), there would be the special challenge of persuading foreign investors to forgo diversification and vest an exceptionally large fraction of their total external investment in a single country.

Thus, while there is no absolute proof that there is an impenetrable upper bound on US net external liabilities at about 100 percent of GDP, it is prudent to conclude that this boundary should not be tested. This, in turn, implies that US current account deficits of 5 percent of GDP or larger are not sustainable in the longer term.

Conversely, neither US residents nor foreign investors in United States-based assets seem troubled at present by a net external liability ratio of 25 percent of GDP or by the likely prospect that this ratio will rise significantly in the next several years as a consequence of continuing, substantial US current account deficits.

The decline in the foreign exchange value of the dollar against most other industrial-country currencies since 2002, together with the shift of foreign investment in the United States away from private investment and toward official reserve accumulation, may suggest some slackening of foreign enthusiasm for US assets. However, the extent and pace of the dollar's downward correction do not indicate investor panic about either the present scale or the likely near-term growth of US net external liabilities. Thus, it would appear that net external liability ratios of perhaps 40 to 50 percent of GDP would not challenge long-term external payments sustainability. Correspondingly, continuing US current account deficits that would decline gradually to about 2 percent of GDP (or slightly higher) would appear to be sustainable in the longer term.

This conclusion recognizes that there are good reasons why the United States is a particularly attractive place for foreigners to invest significant fractions of their wealth. The United States has an exceptional record of economic and political stability—unrivaled by any other large country over the past two centuries.⁴ Property rights are respected and protected.

4. Among the Group of Seven countries, the United States suffered economic turbulence and substantial inflation in connection with the Civil War of 1861–65. But the United Kingdom lost its empire in the 20th century and had about three times as much price inflation as the United States. Canada became a self-governing commonwealth only in 1867. Germany and Italy did not exist as national entities until 1871, and they, along with France and Japan, suffered substantial economic turbulence in connection with the world wars of the 20th century.

There is a wide diversity of assets available to foreign investors, including vast quantities of equities, real estate and other real assets, and privately issued bonds and mortgages, as well as highly secure government debt. Investors are generally well treated, and there is no record of any significant discrimination against foreign as compared with domestic investors.

These attractions for foreign investment in the United States are probably an important part of the explanation of why, with a net debtor position of already about 25 percent of GDP, the United States still seems able to secure inward foreign investment on terms (e.g., interest rates on bonds) that are below the returns that US residents earn on their investments abroad. However, as the US net debtor position rises higher and higher, the United States will probably need to offer more attractive terms to continue to attract large additional inflows of foreign investment.

This, in turn, should make US residents less enthusiastic about increasing their net foreign liabilities. When the situation reaches the point at which US residents are unwilling to offer the improved returns necessary to attract further increases in net foreign investment, the game will end. No one knows where this point is, though it appears to be well beyond the present ratio of US net foreign liabilities to GDP. My guess is that for the United States, a net external liability ratio of 40 percent of GDP, and probably up to 50 percent of GDP, is not a problem, but sustainability becomes highly questionable for ratios rising toward 100 percent of GDP.

Several Complexities and a Conclusion

The preceding discussion has bypassed a number of caveats and complexities that are of some practical importance in discussing external imbalances and exchange rate adjustments likely to be required to reduce these imbalances. A few of these are worthy of at least brief mention.

First, significant measurement error (and some important conceptual difficulties) infect reported figures for the current account balances of the United States and other countries. In particular, at the global level, whereas the sum of all countries' current account balances should be zero, the actual sum in recent years—the global current account discrepancy—has shown a significant global deficit. It is plausible that some of this global current account discrepancy is reflected in the measured US current account deficit, with the effect of raising the measured US deficit by one-quarter to one-half of 1 percent of US GDP. If there is such overstatement in the measured US current account deficit, then the adjustments necessary to reduce the true deficit to any particular level (e.g., 2 percent of US GDP) are correspondingly reduced.

Second, the effects of exchange rates and other variables on current account balances occur with varying lags and are estimated with considerable potential for error. For the United States, it appears that exchange rate changes take about two years to have the bulk of their effect on the cur-

rent account. Thus, the current account result for 2004 still reflects, to a considerable extent, the very strong dollar of 2000–02, rather than the weaker dollar since 2002. It is unclear, however, how much downward adjustment of the current account deficit from its 2004 level should be assumed on the basis of the dollar's depreciation from 2002 to 2004. This uncertainty, in turn, adds to the uncertainty about how much further dollar depreciation will be needed to help reduce the US current account deficit to some specific level, such as 2 percent of GDP.

Third, the current account positions consistent with given patterns of exchange rates and growth rates of national economies are surely evolving over time, but in ways that are not perfectly predictable. In particular, for the United States, the Houthakker-Magee results (which have held up for more than three decades) suggest that because the US income elasticity of imports multiplied by the growth rate of US GDP is greater than the income elasticity of foreign demand for US exports multiplied by the growth rate of foreign income, the dollar must depreciate continually in real terms to sustain any given ratio of the current account deficit to GDP.

Recent estimates by Catherine Mann indicate that, taking account of this effect (and of the present large difference between the value of US imports and the value of US exports), the US current account deficit at present exchange rates would widen by about 1 percent of GDP per year to reach \$1 trillion by 2010. If this is correct, then the adjustments required to reduce the US current account deficit to sustainable proportions will be correspondingly greater than suggested in the discussion below.

Fourth, the net foreign investment positions of the United States and other countries are measured with considerable uncertainty; and because of both conceptual issues and measurement problems, changes in these positions do not correspond to current account imbalances. For the United States, there is no comprehensive register of foreign investment (particularly by private individuals) and at least some foreign investors undoubtedly have strong incentives not to report their external investments to their own authorities. (For example, it is estimated that about half of the total US currency outstanding is held by foreigners, but who they are and where they are cannot be pinned down with confidence.) This uncertainty may lead, on balance, to undermeasurement of US assets held by foreigners.

Conversely, the concept of the current account balance excludes capital gains and losses as part of both US earnings on foreign assets and US payments to foreigners on their holdings of US assets. Standard estimates of the net foreign asset position of the United States are based on historical cost and also exclude such capital gains and losses; but other estimates that seek to reflect current market values take account of cumulative capital gains and losses. In general, US owners of foreign assets have enjoyed greater capital gains on their foreign assets (especially direct investments and portfolio equity) than foreigners have earned on their US assets (which are more heavily concentrated in debt instruments that return interest rather than

capital gains). This factor has tended to keep the US net foreign liability position growing less rapidly than would be implied by the accumulation of US current account deficits.

Fifth, real capital losses from the effect of inflation eroding the value of nominal investments in bonds and similar instruments are not recorded in current accounts, either as losses for the holders of such instruments or as gains for their issuers. As a large net issuer of nominal instruments to the rest of the world, the United States undoubtedly enjoys a net unrecorded benefit from this source. Also, US debt instruments held by foreigners are predominantly denominated in US dollars, whereas US investments abroad are either real assets, equity, or debt instruments denominated to a significant extent in foreign currencies.

As William Cline emphasizes, this means that when the US dollar depreciates against foreign currencies, the US net foreign liability position tends to improve.⁵ The dollar value of US gross investments in most foreign assets goes up, while the dollar value of a large volume of foreign gross investments in United States-based assets remains unchanged. The effect can be significant. Assuming (conservatively) that each 1 percent depreciation of the dollar generates a 1 percent capital gain on each dollar of US net foreign liabilities, then a 20 percent dollar depreciation operating on net foreign liabilities of 25 percent of GDP generates a gain of 5 percent of US GDP.

Finally, the sustainable level of the US current account deficit and of US net external liabilities is surely not invariant to key economic developments in the United States and elsewhere in the world economy. For example, the growth of the US current account deficit during the 1990s appears to have had benign—even beneficial—consequences in light of what was going on that helped to induce this deficit. Surely the acceleration of productivity growth in the United States was a good thing, even if it did not spread in equal measure to the rest of the world. The difficulties in other industrial countries and the catastrophic crises that afflicted emerging-market economies were not good things. However, given that these bad things happened, the widening of the US current account deficit and the appreciation of the dollar were favorable developments from the perspective of the performance of the world economy. Moreover, the widening of the US external deficit in the 1990s was clearly not the result of an irresponsible and unsustainable US fiscal policy; the US government budget moved into significant surplus for the first time in three decades.

Looking forward, if the next decade looks like a repeat of the 1990s—with the US economy driven by rapid productivity growth and the US budget moving to surplus while much of the rest of the world economy is mired in difficulty—then continuing large US current account deficits,

5. See William Cline, *The United States as a Debtor Nation: Problems, Policies, and Prospects* (Washington: Institute for International Economics, forthcoming).

financed by large voluntary foreign capital inflows, would probably also be a good thing. In contrast, if US economic performance is modest while the rest of the world booms, and if large US current account deficits persist because of a failure to address US fiscal problems, then this will not be a good thing. Moreover, in this latter situation, foreign wealth holders may well cease to be such enthusiastic investors in the US economy, with the result that the United States may experience significant difficulties in financing continued large external deficits.

Taking account of these complexities, I would still conclude that persistent US current account deficits of 5 percent of GDP or more (and net foreign liability ratios threatening to rise to 100 percent of GDP or higher) are not sustainable in the longer term. Conversely, US current account deficits of 2 percent of GDP or a little higher (with net foreign liability ratios rising to no more than about 50 percent of GDP) probably are sustainable—especially if it is perceived that timely adjustment in the next few years will put US external payments clearly on a path that will respect these limits.

The General Need for Dollar Depreciation

As was emphasized above, several important things will need to happen to reduce the US current account deficit to a sustainable level of about 2 percent of GDP. One of these things is that there must be a substantial depreciation of the dollar in real effective terms against the currencies of US trading partners. Such a depreciation is needed to shift the pattern of global demand toward goods and services produced by the United States and, correspondingly, away from goods and services produced by other countries—with the effect of raising US exports relative to US imports and thereby improving the US trade and current account balances.

What may reasonably be concluded about the extent of dollar depreciation that will be needed to contribute to the reduction of the US external deficit to sustainable proportions? A precise answer is not available, for at least two key reasons: The extent of the reduction in the US current account deficit needed to achieve external payments sustainability is not known with precision; and the (reduced-form) relationship between the real effective exchange rate of the dollar and the US current account deficit is neither precise nor invariant to other key developments that will affect global payments imbalances.

Real Effective Depreciation of the Dollar by About 30 Percent

Nevertheless, there is a reasonably stable empirical relationship between the real exchange rate of the dollar and the US current account deficit (with a lag of about two years). This relationship appears to be sufficiently reliable to

give at least a broad idea of the extent of dollar depreciation that would be needed to reduce the US current account deficit by about 3 percent of GDP.

Indeed, though a variety of estimates of the sensitivity of the US current account to the dollar exchange rate are available, I like to use a simple relationship that says that a 10 percent real effective depreciation of the dollar (measured as a change in the natural logarithm of the Federal Reserve's broad exchange rate index for the dollar) will be associated with an improvement of about 1 percent in the ratio of the current account to GDP. This is a somewhat larger response than suggested by many estimates, but it is not out of the ballpark and is consistent with both the precision of our knowledge and the spirit of this exercise. Using this estimate, it follows that a 30 percent real depreciation of the dollar would be needed in connection with an improvement in the US current account of about 3 percent of GDP.

The average real effective exchange rate of the dollar between the middle of 2000 and the middle of 2002 is taken as the base from which the required depreciation needs to occur. This base (which corresponds closely to the peak value of the dollar since the mid-1980s) is selected because the normal two-year lag in the relationship between the exchange rate and the US current account balance indicates that the deficit of about 5 percent of GDP in 2003–04 is reflective of this base exchange rate.

Since its recent peak, the dollar has depreciated by a little more than 10 percent in real effective terms—with most of this downward correction occurring during 2003 and against the currencies of other industrial countries. This suggests that about one-third of the necessary downward correction in the value of the dollar has already taken place (as of mid-2004). It also suggests that about another 20 percent real dollar depreciation is still needed to help restore a sustainable US external payments position.

To achieve a substantial downward adjustment in the real effective foreign exchange value of the dollar, the value of the dollar obviously must decline against the currencies of most US trading partners. Given a requirement for a real effective depreciation of 30 percent (from the average level of mid-2000 to mid-2002), by how much should the dollar adjust against individual foreign currencies?

There is no reasonable and succinct way to answer this question. Indeed, little can be said with high confidence on this issue beyond three general principles. First, to achieve a real effective depreciation of 30 percent, the dollar must depreciate by 30 percent on average against the currencies of each of the other countries.

Second, though the magnitude and timing of exchange rate adjustments may vary considerably across different countries, significant depreciation of the dollar against the currencies of all significant US trading partners is likely to be needed and appropriate in the medium to longer term.

Third, the extent of downward correction of the foreign exchange value of the dollar against individual currencies should respect market forces and should appropriately reflect the strength of these countries' external

payments positions. In particular, this means that countries facing upward market pressures on their exchange rates or giving other evidence of the undervaluation of their exchange rates should be expected to allow significant appreciations of their currencies against the dollar and, probably to a lesser extent, allow appreciation on a real effective basis. In contrast, countries with downward market pressures on their exchange rates or other indications of possible currency overvaluation should expect less appreciation (or, in some cases, possibly even depreciation) against the dollar.

Taking account of these three general principles, and without intending to be precise about the magnitude or timing of individual exchange rate adjustments, it is nevertheless useful for the purposes of this discussion to give some quantitative indication of the scale of exchange rate adjustments likely to be needed and appropriate in connection with the restoration of external payments sustainability for the United States. Let us do this first for industrial and then for developing countries.

Exchange Rate Adjustments Against Industrial Countries

The euro area (to which I attach Denmark, Sweden, and Switzerland for the purposes of this discussion) is the world's largest trading entity and approaches the United States in the size of its aggregate economy. Clearly, substantial depreciation of the dollar against the euro (from the average level of €1 equaling about \$0.90 for the period mid-2000 to mid-2002) is an essential part of achieving a 30 percent real depreciation of the dollar. A significant appreciation of the euro has already occurred since mid-2002, taking the euro's exchange value to just above \$1.20 in mid-2004.

Most of this appreciation was a reversal of the euro's somewhat surprising and ultimately excessive depreciation during the period 1999–2000. Although partly reflecting the relatively weak recovery from the world recession of 2001, the euro area has a relatively strong external payments position. Thus, it is reasonable to expect that further appreciation of the euro against the US dollar—to the range of \$1.35 to \$1.45 per €1—would be an appropriate counterpart of necessary further downward correction of the foreign exchange value of the dollar.

A total move of the euro from about \$0.90 to about \$1.40 implies a real appreciation against the dollar (measured as a logarithmic change) of 44 percent. This means that appreciation of the euro would contribute significantly more than the average amount required to achieve a 30 percent real effective depreciation of the dollar. This is reasonable in view of the excessive depreciation of the euro at a value of \$0.90 and the continuing relatively strong external payments position of the euro area.

The timing of further euro appreciation is a more subtle matter. The significant appreciation of the euro in the past two years already makes an important contribution to the needed downward correction of the dollar, while contribution from other (particularly developing-country) exchange

rate adjustments has been more modest or nonexistent. Meanwhile, the recovery of the euro area economies since 2001 has been quite sluggish, probably partly as a consequence of the euro's appreciation against virtually all other currencies. Thus, it would not seem untoward if market forces allowed further euro appreciation to take a bit of a breather while other needed exchange rate adjustments catch up.

The exchange rate of the pound sterling has been very strong in recent years, with the pound tending to follow the dollar up against the euro in fiscal 1999–2000 and tending to follow the euro up against the dollar in fiscal 2002–04. In mid-2004 (at the time of this writing), the pound appears somewhat overvalued in real effective terms. (The UK economy has prospered because of strong household consumption and residential investment, but the tradable goods sector has suffered.) This suggests that modest further appreciation of the pound against the dollar (of about 5 percent, to about £1 to \$1.90, from just above \$1.80) should be more than offset in real effective terms by further moderate depreciation (of about 10 percent) against the euro.

In total, taking the pound-dollar exchange rate from about \$1.50 in the base period to about \$1.90 amounts to a 24 percent appreciation of the pound against the dollar (measured logarithmically). Thus, with an exchange rate that was already strongly valued in the base period, the pound would reasonably contribute somewhat less than the average to a 30 percent downward correction of the dollar.

The Japanese economy was exceptionally weak from 1997 through 2001. With two recessions, cumulative real GDP growth was negative during this five-year period; and the general price level was falling in the only episode of sustained deflation in an industrial country since the 1930s. Traditional macroeconomic policies were pressed to their expansionary limits, with the government budget in large deficit and monetary authorities pursuing a zero interest rate policy for most of the period.

In this situation, a weak foreign exchange value of the yen was desirable, in comparison with the exchange rate that would have been appropriate for a more normally performing Japanese economy. And it was appropriate for the authorities to encourage a suitably weak yen through foreign exchange market intervention when that was not the outcome of market forces.

As a consequence of these forces, the yen-dollar exchange rate in the base period (mid-2000 to mid-2002) was only about ¥125/\$1. Subsequently, the yen has appreciated against the dollar, briefly reaching ¥105/\$1, but more recently stabilizing at about ¥110/\$1. Thus, the appreciation of the yen against the dollar since the base period has been about 13 percent (measured logarithmically), in comparison with an appreciation of the euro of about 30 percent. (Because inflation in Japan has been slightly negative and meaningfully below inflation in the United States, the real appreciation of the yen against the dollar since the base period has been only about 8 percent.)

During the past two years, aided by a weak yen, the Japanese economy has begun to recover more vigorously and has achieved significantly stronger real GDP growth than the euro area. Through March 2004, the Japanese authorities maintained their policy of resisting rapid appreciation of the yen through official intervention—which reached a massive scale during the first quarter of 2004 (see chapter 8 of the present volume). However, now that the Japanese economy appears to have regained significant forward momentum, a policy of trying to keep the yen exceptionally weak no longer makes sense—especially from a global perspective that recognizes both the longer-term need to reduce key external imbalances and the shorter-term requirements for keeping output close to potential in a number of countries with significant economic slack.

In the short term of the next year or so, continued Japanese recovery might be threatened if the yen were to appreciate suddenly much beyond ¥100/\$1; and the authorities might reasonably offer some resistance to market pressures tending to produce such rapid appreciation. However, over the next three to five years, assuming that the Japanese economy continues to recover toward its potential growth path, it is reasonable to expect that the yen will appreciate significantly further against the dollar to a level of ¥85 or ¥90/\$1. This implies a total appreciation of the yen-dollar exchange rate of about 35 percent (measured logarithmically) from the base period. Taking account of inflation differentials, the total real appreciation is slightly less than 30 percent.

Moreover, if the currencies of other countries (notably Asian emerging-market countries as well as other industrial countries) also appreciate significantly against the dollar, then the total real effective appreciation of the yen will be substantially less than 30 percent—probably only 15 percent. This is a quite modest adjustment considering that the Japanese yen was (for good but temporary reasons) exceptionally weak in the base period.

Although their economies performed relatively well, the exchange rates of the Australian, Canadian, and New Zealand dollars were very weak in the base period. Subsequently, all these currencies have appreciated against the US dollar and (somewhat less so) in real effective terms—aided by rising world commodity prices.

Focusing on Canada, given its much greater importance as a US trading partner than Australia or New Zealand, the appreciation of the Canadian dollar has been about 14 percent—from about US\$0.65 in the base period to about US\$0.75 around mid-2004. Further appreciation during the next few years might reasonably take the Canadian dollar above US\$0.80, to perhaps as high as US\$0.85. This would amount to a total appreciation of the Canadian dollar against the US dollar from the base period of about 25 percent. The real effective appreciation of the Canadian dollar would be only moderately less (about 20 percent), reflecting the dominant position of the United States as Canada's principal trading partner. This fairly large change

in Canada's real effective exchange rate makes reasonable sense in view of the large swing from deficit to surplus in the Canadian current account since the mid-1990s—evidence that the Canadian dollar was meaningfully undervalued in much of this period.

Exchange Rate Adjustments Against Developing Countries

Nearly 40 percent of US trade now takes place with developing countries, and a significant fraction of the deterioration of the US external payments position since the mid-1990s corresponds with the improvement in the aggregate current account position of developing countries. From these facts, it is apparent that developing countries as a group must play an important role as counterparts to both the improvement in the US current account and the depreciation of the real effective exchange rate of the dollar.

This does not mean that on a bilateral, country-by-country basis the US trade balance should necessarily be expected to improve against all individual developing countries. Nor, in particular, does it mean that exchange rate and other adjustments by individual developing countries should be targeted on some basis, such as the size of bilateral trade imbalances with the United States.

Nevertheless, developing countries as a group are far too large a fraction of “the rest of the world” for anyone reasonably to believe that a substantial reduction in the US external deficit could occur without a significant movement in the other direction in the aggregate external payments position of developing countries. Similarly, a substantial (30 percent real effective) depreciation of the dollar—which is essential to restoring a sustainable US current account position—must include significant real depreciation of the dollar against the broad range of developing countries.

For developing countries, however, this required exchange rate adjustment poses policy issues that do not arise for most industrial countries. With the notable exception of Japan, industrial countries generally allow the exchange rates of their currencies against the US dollar to fluctuate freely in response to market forces—without resorting to massive official intervention or other policies to influence the exchange rate against the dollar. During the past two years, these floating exchange rate policies have allowed substantial real appreciations against the dollar—real appreciations that will go a considerable distance toward those required to achieve a more sustainable pattern of international payments positions.

In contrast, for most developing countries there has been very little real currency appreciation against the dollar during the past two years. Indeed, on a real effective basis, many developing countries have experienced real depreciations. This is not generally the result of market forces operating on market-determined exchange rates (although it may be so in some cases, e.g., Mexico). Instead, it is primarily the result of the exchange rate policies of many developing countries that either peg the rate against the dollar

(de jure or de facto) or that aggressively limit fluctuations in the rate against the dollar through official intervention and other policies.

One important manifestation of these exchange rate policies is the massive buildup since 2001 of official foreign exchange reserves by several key Asian emerging-market economies (and the similar buildup of official reserves by Japan). In this regard, China is the country whose exchange rate policy and reserve accumulation are most often cited as issues of concern; and my colleagues Morris Goldstein and Nicholas Lardy have rightly focused on the need for adjustment in China's exchange rate and related policies (see Goldstein's chapter in the present volume).

However, important as the Chinese case may be, the issues about exchange rate policies and reserve accumulation apply much more broadly than just to China. Indeed, combined official reserve accumulation since 2001 by the main Asian surplus economies other than China has been more than double the reserve accumulation of China, and the combined current account surpluses of these countries are much larger than China's surplus, both in absolute terms (measured in dollars) and relative to GDP.

Because exchange rates are—by definition—exchange values between different national currencies, no country can logically claim exclusive property rights in "its" exchange rate. And especially because present concerns about external imbalances are fundamentally global concerns, the exchange rate adjustments needed to reduce these imbalances should be made from a multilateral and global perspective.

The importance of this multilateral and global perspective on exchange rate issues is well illustrated by the case of China. As convincingly advocated by Goldstein and Lardy, an appreciation of the renminbi by 15 to 25 percent against the dollar—together with repegging to a basket of the dollar, the euro, and the yen and with allowance for a wider band of market-determined exchange rate fluctuation—is a reasonable response to the clear need for a significant modification of the Chinese exchange rate policy.

Yet the Goldstein-Lardy proposal makes much more sense if (as they intend) it is part of a broader modification of exchange rate policies of most Asian emerging-market economies (and Japan). Appreciation of the renminbi against the dollar means much less in terms of effective appreciation against all Chinese trading partners if it is accompanied by significant appreciations of other Asian emerging-market currencies (and the yen). Similarly, for other Asian emerging-market economies, upward adjustments in the foreign exchange values of their currencies will appear much more digestible if they are not pursued in isolation but rather as part of a general upward adjustment in the value of Asian currencies against the dollar.

In view of the general need for downward adjustment in the real effective exchange rate of the dollar, of the strength of the external payments positions of Asian emerging-market economies, and of the evident market pressures for appreciations of these currencies, appreciations of 20 to 25 percent of

Asian currencies (including the yen) appear broadly appropriate over the next few years.

Of course, the situation does differ somewhat across different Asian economies. For example, the difficulties of Hong Kong's economy in recent years suggest that the case for the appreciation of the Hong Kong dollar is weaker than for most Asian currencies, including the Chinese renminbi. Accordingly, the appreciation of the Hong Kong dollar against the US dollar should plausibly be somewhat less than the appreciations of other Asian currencies, implying relatively little real effective appreciation of the Hong Kong dollar. On somewhat different grounds, a case can be made that the appreciations of the Indonesian rupiah, the Thai baht, and the Philippine peso should be somewhat less than the average for Asian currencies. But the details of individual country cases are too complex to get into in detail.

The situation in Latin America is quite different from that in emerging Asia. Argentina, Brazil, and Venezuela, as well as several smaller countries, have experienced significant economic difficulties since 2000; and the exchange rates of their currencies have all come under significant downward pressure. Mexico, which is by far the most important US trading partner in Latin America, has not experienced an economic crisis, but the peso has been under downward pressure and, in response to market forces, has depreciated against the dollar from about 9.5 pesos to \$1 in the base period to more than 11 pesos to \$1 in mid-2004, implying a real depreciation against the dollar of about 15 percent.

Looking ahead, it seems plausible that as the Mexican economy regains stronger forward momentum and as the currencies of countries that produce competing products for export to the United States appreciate, the peso should recover the ground that it has recently lost against the dollar. But real appreciation of the Mexican peso to 20 or 30 percent above its level in the base period does not seem plausible. Unlike virtually all other currencies, the Mexican peso was probably too strong against the dollar from mid-2000 to mid-2002; and the implication now is that there is not great potential for appreciation above that base-period level.

For other key Latin American countries, the potential for real appreciation against the dollar from the exchange rates prevailing in mid-2004 should be substantial—at least over a time horizon of three to five years. In the context of a series of economic crises since the collapse of the Argentine exchange rate peg in December 2001, the currencies of Argentina, Brazil, the Dominican Republic, Uruguay, and Venezuela have all depreciated substantially (in real terms) against the dollar. Some recovery of these real exchange rates from their crisis lows has already occurred; and following the pattern of many previous crises, more real appreciation should be expected if economic recovery continues.

Moreover, in contrast to Mexico, most of Latin America's trade is not heavily focused on the United States. Accordingly, in a situation where other industrial-country currencies and Asian emerging-market currencies

are appreciating against the dollar, the appreciation of most Latin American currencies against the dollar translates into significantly less appreciation in real effective terms. Over a five-year horizon, real appreciation of Latin American currencies (excluding the Mexican peso) of 20 percent or so is not an unreasonable prospect.

The third group of developing countries meriting specific attention (because of their importance for US external payments) is the oil-exporting countries in the Middle East, Africa, Asia, and Latin America (including Russia and, perhaps somewhat bizarrely, Norway). For most of these countries, what matters for an impact on the US balance of payments is not primarily the currency exchange rate but rather the world price of oil. The increase in the world oil price from an average of about \$20 per barrel in the 1990s to \$30 per barrel in 2003 directly implies an increase in the cost of US energy imports of about 0.4 percent of US GDP. Further increases in the world oil price to about \$40 per barrel by mid-2004 (and even higher thereafter) indicate further deterioration of the US current account by a similar magnitude.

Looking ahead, oil futures markets continue to predict that world oil prices will decline during the next few years, but to a level now estimated to be closer to \$30 per barrel rather than \$20 per barrel. If world oil prices decline as predicted by oil futures markets, this should tend to improve the US external balance, plausibly by about half of a percentage point of US GDP. If world oil prices remain high, the effects on the US external position are more difficult to project. Experience suggests that in the short run, oil exporters will save a significant part of the windfall from higher oil prices, thereby adding to their current account surpluses and to the current account deficits of oil importers such as the United States.

In the longer run, however, oil exporters are likely to spend much of the gain from higher oil prices on increased imports, including imports from the United States. This should mitigate (but probably not eliminate) the long-run negative effect of higher world oil prices on the US external balance. For the exchange rate of the dollar, the implications are murky because other oil-importing countries make up the vast bulk of US trade and are in much the same situation as the United States vis-à-vis world oil prices.

Beyond the other industrial countries, Asian emerging-market economies, Latin America, and the oil exporters, there is not much left that matters in the world economy for the US external payments position. The region of Central and Eastern Europe is closely linked economically to Western Europe and is likely to become even more so with the recent enlargement of the European Union. Even before formal expansion of the euro area, the currencies of most of these countries are likely to move in sympathy (if not lockstep) with the euro against the dollar.

Thus, further appreciation of the euro against the dollar should apply to a wider range of countries than those now inside the euro area. In Africa, South Africa is by far the most important economy (and other economically

important countries, including Nigeria, have been covered as oil exporters). South Africa's market-determined floating exchange rate has already appreciated more than 30 percent from its (much depressed) level in the base period. Many other African countries (especially the African franc zone) have exchange rates closely linked to the euro. And for many African countries, linkages to US external payments are both of very minor importance and more influenced by commodity prices than by currency exchange rates.

In sum, adding up the suggested adjustments of real exchange rates of the dollar against other currencies, how do we come out vis-à-vis the notion of a 30 percent real effective depreciation of the dollar from its value in the base period from mid-2000 to mid-2002? The answer is somewhat ambiguous because the suggested adjustments of individual exchange rates have (for good reason) been a little vague, and not all exchange rates have been covered.

Nevertheless, broadly speaking, the suggested individual exchange rate adjustments (from the base of mid-2000 to mid-2002) add up to a real effective depreciation of the dollar of more than 25 percent but a little short of 30 percent. The presumed real appreciation of more than 40 percent by the euro is more than enough to offset the allowance for limited real appreciation of the Mexican peso (and some other developing-country currencies) and push the average above 25 percent. But projected appreciations for the Canadian dollar, the pound sterling, and the average of Asian emerging-market currencies below 30 percent keep the average a little below 30 percent.

So what? The spirit of the exercise has been to suggest plausible orders of magnitude for the adjustments of particular exchange rates and the economic reasoning behind these judgments. Precision concerning the magnitude and (especially) the timing of exchange rate adjustments is neither achievable nor desirable. A complex of macroeconomic forces operating over the next few years will determine the course that exchange rates will actually follow. If the result after four or five years is anywhere close to what has been suggested here, then the exercise will have been a great success.

Policies to Contribute to the Orderly Reduction of External Imbalances

Exchange rate adjustments are not the only important class of macroeconomic adjustments necessary for a more sustainable pattern of international payments. Indeed, as was noted at the outset, the key policy challenges associated with securing an orderly reduction in international payments imbalances, consistent with sustainable economic growth around the world, are related primarily to the other two classes of macroeconomic adjustments:

- Domestic demand growth in the United States must be kept moderately below potential output growth to allow room for improvements

in net exports and for corresponding improvements in the US national savings/investment balance and reductions in the needed inflow of foreign capital.

- Domestic demand growth in the rest of the world must be boosted somewhat above potential output growth to support output and employment in the face of deteriorations in net exports and, correspondingly, to provide the global offset to the improvement in the US savings/investment balance and the decline in capital flows to the United States.

What key policies in the United States, in other industrial countries, and in developing countries would contribute constructively to these necessary macroeconomic adjustments?

Fiscal Consolidation in the United States

For the United States, a gradual and cumulatively substantial tightening of fiscal policy is clearly necessary to achieve medium- and longer-term fiscal sustainability, especially in view of the fiscal strains arising from an aging population. This would be so even if the United States had no external deficit. But the need to reduce a large external deficit means that fiscal consolidation (which is desirable for more basic reasons) can also play a useful role in constraining the growth of domestic demand relative to domestic output in the United States, and, correspondingly, in reducing the current account deficit, improving the national savings/investment balance, and diminishing the need for net foreign capital inflows—all of which are part and parcel of reducing the US external imbalance.

This prescription that US fiscal consolidation should make an important contribution to the orderly reduction of external imbalances does not rely on the simplistic notion that the US fiscal deficit and US current account deficit are closely related “twins” and that a reduction in the fiscal deficit will automatically result in a similar reduction in the current account deficit. Rather, the fiscal deficit and current account deficit are related through a complex of macroeconomic interactions that must be taken into account in assessing the likely effect of fiscal consolidation on the US external deficit.

From this macroeconomic perspective, it is relevant to take account of the following facts: Margins of slack in the US economy are now relatively low. Business investment appears to be taking over from consumer demand as the mainstay of domestic demand growth. Although not yet sufficient for the longer term, there has already been a substantial downward adjustment of the real foreign exchange value of the dollar that should tend to shift world demand toward US goods and services. The strengthening of demand growth now apparently under way in much of the rest of the world should further aid the improvement in US net exports. In this situa-

tion, it is reasonable to expect that gradual fiscal consolidation will exert modest restraint on domestic demand growth and will tend to improve the national savings/investment balance and the US current account without posing a critical threat to the sustainable growth of US output.

Of course, it is possible that if financial markets react exuberantly to evidence of gradual fiscal consolidation, pushing up asset values and private investment, the effect may be to keep the dollar unduly strong and to worsen rather than improve the current account. But there is no a priori reason to anticipate such perversity; and should it occur, the perversity will tend to be naturally self-limiting as foreign investors come to recognize the longer-run implications of rapidly rising US net external liabilities.

For US monetary policy, the fundamental objective is to keep inflation low while supporting the sustainable growth of output and employment. Fiscal consolidation implies that monetary policy should be able to achieve these fundamental objectives by pursuing a course for policy interest rates that is lower than it would be in the absence of such fiscal action. Other things being equal, an easier course for monetary policy should normally mean a lower path for the foreign exchange value of the dollar. A cheaper dollar, in turn, should help to bring both an improvement in the US external balance and a positive (or less negative) contribution from net exports to output and employment growth in the United States. The latter effect will help to offset the short-run negative impact of fiscal consolidation on output and employment.

Enhancing Demand Growth in Japan and Europe

In the rest of the world, the main macroeconomic adjustments necessary to achieve a smaller external surplus are essentially the reverse of the adjustments needed in the United States; that is, an increase in domestic demand growth relative to output growth (and a corresponding deterioration in the savings/investment balance and a reduction in net capital outflows) and real currency appreciation to help shift demand away from domestic output and toward US output. Unfortunately, the macroeconomic situation in much of the rest of the world is not the reverse of that in the United States; and the policies that would contribute to reducing the rest of the world's external surplus, while maintaining sustainable noninflationary growth, are difficult to prescribe.

In particular, in Japan and most of Western Europe, margins of slack are generally wider than in the United States, while the medium- and longer-term need for fiscal consolidation is generally no less pressing. This means that fiscal expansion cannot generally be prescribed in these countries as a means for stimulating domestic demand growth to offset the loss of effective demand that is inevitably associated with declining external surpluses. As a consequence, monetary policy faces an increased responsibility for

sustaining adequate growth of domestic demand—especially so if fiscal policies are oriented toward consolidation rather than mere neutrality.

Japan's situation in this regard is a vivid case in point. After more than a decade of disappointing growth and five years of outright deflation, facing a large fiscal deficit and a massive buildup of government debt, and with policy interest rates effectively at zero, Japan confronts particularly difficult challenges in designing policies to achieve sustainable growth while contributing appropriately to the reduction of global payments imbalances.

Indeed, as noted above, the challenging experience of Japan in recent years provides a rationale for its highly aggressive policy of resisting rapid appreciation of the yen through massive foreign exchange market intervention. However, now that the Japanese economy appears to have regained substantial forward momentum, massive intervention to resist further orderly appreciation of the yen is not a desirable or defensible policy.

With substantial margins of slack remaining in the Japanese economy and with no signs of a resurgence of inflation, Japanese monetary policy should continue to pursue a course of unusual ease for a considerable period. This, in turn, will tend to imply a somewhat weaker course for the foreign exchange value of the yen than would likely prevail with a more robust Japanese economy, but it is clearly not inconsistent with a significant appreciation of the yen from its recently depressed level. In the longer term, as the Japanese economy recovers its traditional strength, substantial further real appreciation of the yen against the dollar should reasonably be expected as part of the process of gradually reducing global payments imbalances.

For industrial countries other than Japan, exchange rate adjustments since the peak of the dollar in 2000–02 are already quite substantial. In general, these adjustments should be enough to achieve a significant fraction (although not the entire amount) of what is needed to restore a sustainable pattern of international payments. In three key US trading partners—Australia, Canada, and the United Kingdom—demand growth in recent years has also been sufficient to achieve reasonable output growth.

For these three countries, further fiscal expansion cannot generally be recommended as a responsible means to augment demand growth (especially not in the United Kingdom). But longer-term fiscal prospects appear to be sound without the need for substantial consolidation—implying that fiscal contraction will not add to problems of sustaining output growth in the face of some deterioration of net exports. In addition, monetary policies in Australia, Canada, and the United Kingdom have all been tightened somewhat since the end of the global recession of 2001, and this leaves significant room for monetary easing should that seem needed to ward off excessive weakness in output growth.

In the euro area, economic performance since the mid-1990s has been better than in Japan but somewhat worse (especially in domestic demand growth) than in Australia, Canada, and the United Kingdom (as well as in

the United States). Fiscal deficits and government debt burdens are generally not as large as in Japan but are more of a concern than in Canada and the United Kingdom. Monetary easing by the European Central Bank (ECB) to combat recent sluggishness has cut policy interest rates down to only 2 percent, compared with zero in Japan (and 1 percent in the United States). But, for good reason, there has not yet been any move by the ECB to begin the cycle of monetary tightening already under way in Australia, Canada, and the United Kingdom (and more recently in the United States).

Thus, it is fair to say that economic policy in the euro area retains greater room for maneuver to address issues arising from the correction of external imbalances than in Japan, but less so than in Australia, Canada, and the United Kingdom. Moreover, it is relevant that, unlike Japan, authorities in the euro area have not intervened at all to resist the substantial appreciation of the euro against the dollar that has occurred since mid-2002.

Looking forward, however, economic policy in the euro area faces critical challenges that will not be made easier to meet by the need to contribute to the reduction in global payments imbalances. Substantial fiscal deficits and government debt burdens and the fiscal demands of aging populations do not allow room for expansionary fiscal policies to prop up domestic demand growth in order to offset declining net exports.

Moreover, monetary policy for the euro area does not provide an easy way out of this conundrum (even if the ECB were willing to recognize this possibility). Facing prospective weakness in domestic demand growth (especially if fiscal consolidation is pursued), as well as weakness in output growth from the deterioration of net exports, monetary policy would normally be expected to follow a somewhat easier course to properly serve its basic objectives. But an easier course for monetary policy should normally be expected to work against the exchange rate adjustments (i.e., further appreciation of the euro against the dollar) that are needed to facilitate the reduction of external imbalances.

Policy Challenges for Developing Countries

For developing countries, the nature and timing of the macroeconomic and policy adjustments necessary to contribute to a successful and orderly reduction of external imbalances differs considerably across regions and specific economies. Indeed, as already discussed in connection with exchange rate adjustments, the contrast between most of emerging Asia and much of Latin America is particularly striking. Aside from the brief setbacks associated with the global recession of 2001 and the SARS scare of the spring of 2003, economic growth in virtually all of emerging Asia has been very strong since recovery from the Asian crisis began in late 1998. Also, Asian emerging-market economies typically have very strong external payments positions. In contrast, several key Latin American countries have experienced considerable economic weakness in recent years, and the external

payments position of most Latin American countries is generally less secure than that of Asian emerging-market economies.

Taking account of these differences, it appears that emerging Asia should have relatively little difficulty in absorbing some deterioration in external payments positions as a partial counterpart to the needed improvement in the US external payments position. Real appreciations of Asian currencies against the dollar are essential contributions to this shift in external payments positions. Provided that Asian currencies appreciate together against the dollar, the negative impact on demand and output growth should be moderate and within the capacity of macroeconomic policies to offset. A danger to be avoided is prolonged resistance to nominal exchange rate appreciation, which would lead to excessive domestic credit expansion and an unsustainable economic boom. This is an important part of the story of the buildup to the Asian crisis of 1997–98. These mistakes should not be repeated.

For many developing countries that do not enjoy the same strengths as Asian emerging-market economies, the key policy requirement is to establish and maintain sound macroeconomic policies that will support sustainable economic growth and instill confidence in domestic and foreign investors. Even if this does not imply any short-term contribution to reducing key global payments imbalances, in the longer run it will mean stronger real exchange rates and a capacity to attract reasonable inflows of foreign capital that will finance moderate and sustainable current account deficits.

An important potential threat to this favorable long-term scenario is the risk of another round of emerging-market financial crises. At present, this risk seems relatively low. Global economic recovery is under way, policy interest rates in industrial countries are still quite low, and global financial markets are still taking a relatively benign view of the risks in emerging markets.

During the next several years, however—as interest rates in industrial countries probably rise and as the global expansion probably loses some of its recent robustness—it is not unlikely that one or more of the emerging-market countries will have to face a potential external financing crisis. As occurred in the 1990s (and in earlier episodes of emerging-market financial crises), it is also not unlikely that a financial crisis afflicting one emerging-market economy will spread through a variety of mechanisms to affect others. In contrast to the 1990s, however, a rapidly expanding US current account deficit (supported by particularly rapid growth of domestic demand in the United States) is unlikely to provide the necessary counterpart for emerging-market countries seeking rapid improvements in their current account positions under the pressure of external financing crises.

This concern also applies in reverse. Emerging-market financial crises that generate the need for rapid improvements in the external payments positions of these countries will tend to interfere with the orderly reduction of the US external payments deficit. And the effects of this problem will

not be limited to emerging-market countries and the United States. If the expansion of the US external deficit is to be less of a counterpart to crisis-induced improvements in the external payments positions of emerging-market countries, then adjustments in the external positions of other industrial countries will need to shoulder more of the load—and this will be in addition to, not as a substitute for, adjustments that are needed as the counterpart to improvements in the US external position.

Thus, virtually all countries have a self-interest in avoiding or minimizing possible future emerging-market financial crises—as one element of the broader strategy to secure orderly reductions in international payments imbalances. Of course, the primary responsibility for reducing vulnerabilities to a crisis inevitably rests with each emerging-market country itself—and there is much that countries can do in this regard. But the international community also has an important role to play in reducing the risk of crises and in ameliorating the consequences when crises occur.

Conclusion: The Virtues of Some International Policy Cooperation

Dealing with potential emerging-market financial crises is one area where some international policy cooperation is clearly helpful. Important progress has been made in recent years in the decisions of a number of developing countries to adopt more flexible exchange rate policies, in the increased flow of relevant and reliable information to financial markets, and (one hopes) in the awareness of both governments and investors of the factors that contribute to risks of emerging-market financial crises and of the need to contain these risks. However, critical issues still remain to be fully addressed: how the international financial community will react to actual or potential crises (especially concerning the appropriate level and conditionality for support from the International Monetary Fund), and how sovereign defaults will be resolved.

Beyond the particular issues of emerging-market financial crises, international policy coordination can probably play a constructive but limited role with regard to the general problem of reducing global payments imbalances. It is unrealistic to believe that there is or could be a reasonable consensus among industrial countries on the magnitude and time of exchange rate adjustments needed to contribute to a reduction of the US external deficit to sustainable proportions. For this reason and several others, I believe that it is fruitless (and perhaps dangerous) to seek to coordinate on fostering specific adjustments of industrial-country exchange rates or on establishing some form of “target zones” for these rates. Nevertheless, it probably is feasible to agree that some further downward correction of the dollar is likely to be needed and that market developments tending in this direction should not be resisted—unless they threaten to become disruptive.

Concerning other key macroeconomic policies, I see no harm in other countries pressing the United States on the need for a more responsible fiscal policy. Similarly, there is nothing wrong with pressing other industrial countries with the need to do all that is feasible and reasonable to stimulate more rapid and sustainable growth of domestic demand. However, one should not harbor much optimism that such exhortations will dramatically affect either the concerns that govern central bank decisions about monetary policies or the political forces that largely determine key fiscal policy decisions.

Finally, concerning the exchange rates of the Asian emerging-market economies, there clearly is some role for international cooperation among these economies and with the broader international community. As was emphasized above, the general appreciation of Asian currencies (including the yen) needs to be part of the process of reducing unsustainable payments imbalances. For Asian countries, it clearly makes an important difference that they see adjustments of their individual exchange rates as part of a general appreciation against the dollar and not as isolated appreciations by individual Asian countries. The industrial countries also have an interest in fostering the upward adjustment of Asian currencies against the dollar, and they should make this interest clear. However, the key argument is not that the appreciation of Asian currencies is needed by the industrial countries or by the world in general, but rather that it is in the longer-term interest of Asia as a participant in the global economy.

In this regard, industrial countries should insist that they are not asking Asia to do what they themselves are not prepared to do—namely, to allow exchange rates to adjust to take appropriate account of the need to reduce global payments imbalances. If most Asian countries do not want their exchange rates to fluctuate in response to market forces to the same extent as most industrial countries now permit, then they must be prepared to adjust their exchange rate policies with due regard to what market forces suggest is required for the medium and longer terms.