
Comment

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First, I address the issue of global imbalances. The number that comes up throughout part III of this book seems to be 25 percent. The US dollar should depreciate overall by 25 percent; China should appreciate 25 percent. This seems to be the magic number based on fundamental exchange rate calculations. In other words, instead of costing a buck to assemble a DVD player in China and package it for export, now it will cost \$1.25. And Wal-Mart will now sell it at \$39.75 instead of at \$39.50.

From the point of view of the United States, such a change is not going to do a lot. The result might be a shifting of assembly plants in Asia from China, perhaps to Vietnam. At least from the data that we can see, China does not have an overall trade surplus anymore, but it does have a huge bilateral surplus with the United States. This is simply a pass-through of the surplus of much of Asia's value added to the United States, which gets placed on China's bilateral books. If we just disintermediate China from the assembly process and disaggregate the surplus to the rest of Asia, the US deficit is still going to be quite similar. Of course, there may be a multi-country Asian game where, after a coordinated appreciation led by China, everyone else can appreciate their currencies as well; and that might have some impact in the United States. But the direct impact of a revaluation by China would not be consequential.

The telling image that I want to use as background is the one that Jim O'Neill presents on what the world economy will look like in 2050 (see figure II.1 in his comment on part II of this volume), when US GDP is projected

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to be three times larger than it is now in real terms. China's GDP will be larger than the US GDP and India's will be almost as large. These two countries are at the heart of the current and future imbalances because they have more than 2 billion, mostly underemployed people.

It is clear where the US growth will come from: a rise in the labor force from natural increase and immigration, productivity growth, and perhaps capital deepening. China already has four times the population of the United States, as does India. So for either country approximately to equal the United States in 2050 must mean that its productivity and capital intensity 40 years from now will have to be equivalent to the productivity and capital that the United States has right now. To construct these forecasts, we must multiply the projected labor force by the projected productivity to get the projected GDP. To get these numbers in the case of China, the 200 million people who are now unemployed, or underemployed, plus the natural population increase, will have to move into employment. Similarly, this must also be done in India, which is even more profoundly underemployed than is China.

The question is how do we get from here to there, and that is the crux of the issue of global imbalances. The analysis in part III on what should be the equilibrium exchange rates uses concepts from and is done in the context of relatively fully employed economies. But China has unemployment that in any industrial economy would be regarded as at depression levels. It has a profound internal imbalance that makes irrelevant all of the analyses that look exclusively at external balance.

One of the principles that seems to be in general use is that the capital account should finance the current account. That is, a country with a capital account surplus should be running a current account deficit; in that sense, there is balance. This is a first-best analysis, of the sort that generated recommendations that produced the Latin American development results. Of course, Asian countries have studied this history, which emanated from this prescription, and they have observed a financial and economic disaster. So they have opted for the Japanese and the South Korean method of growth. True, Japan's growth strategy led ultimately to 10 years of stagnation, but after 40 years of really rapid growth. Yet looking at Japan's performance from the perspective of a country at the early stages of development, even these past 10 years in Japan, with high real income and wealth, must look like paradise. So 40 years down the road, a country would be willing to pay with a 10-year stagnation and a major loss in its financial system in return for supergrowth in the meantime. It does not look like a real problem when discounted to the present over 40 years.

Two issues under discussion in this part of the book confuse me. One is the currency manipulation argument. In particular, it is well known—as Morris Goldstein mentions early in chapter 9—that a global monetary system is simply a reflection and a solution of the fundamental global economic problems that have to be resolved at any given time.

In particular, the Bretton Woods system itself was such a solution, although an imperfect one. It was the result of the deal between the United States and the United Kingdom during World War II, made after several bilateral meetings. The multilateral meeting in Bretton Woods itself was simply a ratification of what the United Kingdom and the United States presented. The only items at issue in New Hampshire were what fixed exchange rates and what quotas would be set—it was a tidying-up exercise.

The basic Bretton Woods system actually had been established months before in Washington. The US perspective was that of a postwar creditor with a trade surplus. The United States was worried about discrimination against its goods as experienced in the middle of the 1930s, through controls and multiple exchange rate regimes. It also wanted to avoid beggar-thy-neighbor devaluation policies, so it wanted a stable exchange rate system. Conversely, the United Kingdom, whose delegation was led by John Maynard Keynes, was a major debtor. Expecting a depression after the war in the usual Keynesian way, it was focused fundamentally on having a flexible enough exchange rate to establish internal balance. In other words, it wanted to manipulate its currency to insulate it against disturbances in external accounts. Ultimately, the compromise was to establish a system with fixed but changeable exchange rates. Later on, although the “currency manipulation” clause was added, the International Monetary Fund in its entire history hardly ever invoked it—and rightly so, because the concept was so ill defined.

There is also a comment that “currency manipulation” is an academically narrow concept. I would agree with that. It is so narrow that it is zero-dimensional. There is no academic discussion of this concept at all because it has no scientific content. If it wants, a country can manipulate its currency to advantage its goods without intervening in the exchange markets at all. At its core, the currency manipulation concept is simply a contrivance of political rhetoric in the protectionist tool kit. It is invoked when it is convenient, just like child labor or prison labor or environmental degradation or whatever it is that suits the purpose in implementing a protectionist regime.

The second confusing issue is the metric that quantifies the size and nature of the fundamental imbalance: Add the current account surplus to the surplus of foreign direct investment (FDI). This looks suspiciously like double counting to me. The key impact on the rest of the world is encapsulated in the current account surplus alone. That is what policy is aimed at implementing, and that is what affects the rest of the world’s labor markets, especially if policy has a mercantilist intent. If a country uses exchange market intervention, and it happens to be associated also with an FDI inflow into the country, well, that is simply a balance sheet manipulation. It determines that foreigners will intermeditate between domestic savers and investors. If a country intervenes by buying foreign exchange and the funds

return as FDI, it is just indirectly financing the foreign direct investor. It could just as well have intermediated domestic savings through its domestic financial system, which might then have lent to the foreign investor. By going through foreign balance sheets, the FDI entrepreneur has to get funds at his own cost of capital, not at some arbitrary one established in the inefficient domestic financial system.

Aside from China, there have been similar complaints about the Bank of Japan's recent huge interventions that far exceeded not only Japan's own current account surplus but also the US current account deficit at annual rates. But, as Takatoshi Ito points out in chapter 8, most of this again is financing equity investment from the United States into Japan. Imagine that a US resident or a global investor wants to buy Japanese equity. She sells a Treasury bill in the United States. The US resident then sells dollars for yen and buys equity in Japan. To keep this inflow from appreciating the exchange rate, the Japanese Ministry of Finance buys the Treasury bill and thereby accumulates foreign exchange. To finance its part of this circle of transactions, the ministry sells financing bills on the market; so the ministry is indirectly financing the foreign purchase of Japanese equity. Finally, to close the circle, the seller of equity in Japan buys the ministry's issue of financing bills.

In this circle, the intervention of the Japanese Ministry of Finance is good for the sellers of equity because indirectly it supports yen equity prices. Although it may be a subsidy for equity sellers, at the end of the day this effect of the intervention does not change the flow of goods and services across countries. It is the current account surplus that you have to watch; adding capital account components to the current account tells us little. I am not sure what politics are behind proposing that sort of metric. If you are worried about the subsidization of local industries implicit in a current account surplus, just look at the current account surplus.

Let us get to the fundamental forces underlying this ascendant monetary system: In a nutshell, there are 200 million underemployed people in China who have to be employed at a gross rate of 20-plus million a year, a net rate of 10 million a year. There is a huge, exhaustible supply of labor that is socially and politically problematic. If it is not employed, it may cause real political trouble. It is desirable to employ it as fast as possible. The development strategy that the Chinese have selected, having seen what happened to Latin America, is export driven. The friction, though, is that the faster they employ the labor, the more pressure they get from their trading partners, whose labor markets they are disrupting.

So they have to think of a way to offset this. Straight beggar-thy-neighbor policies launched in the fundamentally depressed economies of the 1930s were shown not to work. Depreciating the exchange rate so that goods could be exported at fire sale prices might have increased employment, but trading partners soon intervened with counterdepreciations or commercial policy to undo the result. The political clout of consumers in the partner

country could never overcome that of the combination of labor and capital in the affected industries.

The solution is to align the interest of foreign capital with the strategy by allowing it access to the labor pool via FDI. More than 50 percent of China's exporting is done via FDI firms. The excess profit to foreign capital is the present value of the real wage differential between the United States, or the rest of the world, and Chinese wages, discounted from the time when this system finally ends and Chinese wages converge.

This export system is financed with Chinese savings, although intermediated through the US financial system by the purchase of official foreign exchange reserves. China employs a repressed financial system to force large savings, to employ its unemployed labor at a maximum rate. China provides the savings that normally would go directly to capital in China through a domestic financial system. I am surprised that Michael Mussa states in chapter 5 that it might be four years before this policy ends; I thought it was a principle of the Institute for International Economics that it should have happened two years ago. But I would say that this can go on for twice that long.

What is the effect of all this on Europe? Because the euro floats against the dollar with no intervention from the official sector, Europe's current account is determined by the decisions of its investors, by private capital flows. If there is cheap, subsidized capital flowing into the United States via the Asian official sector, that will push private European capital out because it expects a better return for the increasing risks than the subsidized capital is getting. The other side of the coin is that the European current account has to shrink, via an exchange rate appreciation. This will cause European goods to be pushed out of both the United States and Asia, with rising European imports from these areas. This is problematic for Europe; it finds it difficult to expand its own domestic demand so this will lead to more unemployment and stagnant growth. One way around this problem is to use monetary policy to keep the exchange rate from appreciating, that is, to join the party.

I feel compelled to say a bit about outsourcing, or offshoring, given Martin Baily and Robert Lawrence's discussion of it in chapter 6, because I have just returned from India after an outsourcing mission. The organization with which I am affiliated has been exploring whether it can outsource various parts of research—not call center or back office operations, but some of the research itself. Some equity research has already been outsourced by some firms, in part to India.

The answer to this question is problematic, even though the economics of the decision is superficially straightforward. Just to put some hypothetical numbers on it, the outsourcing firm that one might contract to manage this activity can buy a unit of labor at 15 and sell it to us at 30; we would have to pay 90 for it here, a two-thirds cost saving for us, just on the face of it. In addition, this staff can be terminated quickly in a downturn in accord

with contractual arrangements. Now you might think investment banks are pretty ruthless in that situation anyway, but it is not that easy. In general, it is painful.

The idea is that these are not necessarily substitutes but complements to existing research staff because it would free up our personnel in the United States and in the other main financial centers for higher-value activities. The kinds of activities to outsource might start with simple things like the publication of economic calendars or dailies, and perhaps the construction of reports and charts. All of this would, by virtue of regulation, have to be approved by supervisory analysts back in the United States. Moving up to a higher-level activity, which would be regarded as serious research—like derivatives research or relative value calculations—presents a much more serious management problem.

One problem that might materialize is that the supply curve of such staff might be upward sloping, so that current pricing is deceptive, but we have become convinced that the supply curve is flat for recruits, even from the very top institutes of engineering and management. Also, a large stock of previous graduates have been forced over time to sit around in government planning agencies.

On the downside, a lack of recruitment here at entry levels means that we are eating our seed corn. It is from the new staff that people develop into more senior managers of research, and quickly in our industry. So we have to worry that we may be trading a short-term gain for a larger medium-term loss. As another issue, some of the information technology activities of our index group are already being done in India, but we have found that it takes two people in India to match one in the United States. This is not because of intelligence or training differentials, but just because of management difficulties and lack of access. The time zone differences are a problem, although staff in India are willing to work New York hours. But that leads to social problems anyway, and it is one of the factors that produces a 40 percent turnover in much of business process outsourcing. Constantly having to train new staff thus has to be factored in.

One major drawback is whether you can keep control of intellectual property. In particular, after training people to a level where their research output is similar to what is being done in New York but paying them a third as much, they can be poached. In the United States, poaching is made difficult because people are already being paid more or less the going market wage, and they are building up unvested equity claims, so it gets more and more costly to pry them away. In India, you spend the effort to train someone up to a level where they can actually do front-line research, then competitive firms immediately jump in to buy, not at one-third the New York cost but at something much higher, so it is very difficult to hold on to the apparent rent.

One question we ask is why not outsource instead to a US Midwestern university town where the wage would be in proportion to the cost-of-living

differential with New York. The training is good; people speak English; so why go to India? That brings us to ask just what it is that the outsourcing firms provide and what value added they have developed in India. Over the course of time, they have developed intense expertise in breaking down business processes into mechanical units that actually can be outsourced and intellectually protected. Their expertise might be such that we could just as well recruit one of these firms from Bangalore to outsource a center somewhere in the United States. So it is not clear whether outsourcing is actually going to move jobs to India, rather than move Indian management expertise to the United States.

