

The Trans-Pacific Imbalance: A Disaster in the Making?

C. Fred Bergsten
Director, Institute for International Economics

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The Problem

The title of this session is “The Trans-Pacific Imbalance: A Disaster in the Making?” I would submit that *the disaster is already occurring and is likely to become much worse unless substantial remedial action is taken promptly.*

The facts of the situation are well known. On the eastern shore of the Pacific, the United States is running a global current account deficit that has now reached an annual rate of almost \$800 billion—7 percent of GDP, the same ratio that ensued in Mexico before its crisis in 1994 and in Thailand before it triggered the Asian crisis in 1997. The US deficit is rising by about \$100 billion per year so its trajectory is even more unsustainable than its level.

To finance these deficits, as well as its own outward foreign investment, the United States must borrow about \$6 billion every working day from the rest of the world. The net foreign debt of the United States reached \$2.5 trillion at the end of 2004 and is climbing by more than 20 percent per year. The annual deficit must be cut at least in half to stabilize the ratio of US foreign debt to GDP and thus restore a modicum of sustainability to the situation.

On the western shore of the Pacific, the Asian countries are running half or more of the counterpart global surpluses (table 1¹). They are piling up massive foreign exchange reserves, accounting for 90 percent of the increase in world reserves over the past three years (table 2) and financing most of the US deficit. Japan has been running the largest surplus in absolute terms (about \$150 billion), but China’s surplus may be even larger this year, has been rising the most rapidly, and is far greater as a share of its economy (probably 7½ percent in 2005). Taiwan and Korea, respectively, hold the world’s third and fourth largest reserves—both over \$200 billion. Hong Kong, Malaysia, and Singapore all run sizable surpluses and have accumulated large reserves as well.

The US deficits and the Asian surpluses are thus opposite sides of the same coin. Neither can decline significantly unless the other does so as well. The central issues are

- whether adjustment is really necessary or whether the status quo can continue to prevail?
- if adjustment is necessary, what will be its nature and its distribution among the key countries?
- which countries need to initiate adjustment measures to achieve an orderly correction?

¹ The IMF estimates for 2005 (and almost certainly 2006) in table 1 are already outdated. The US deficit ran at an annual rate of \$780 billion in the first quarter and China’s surplus is likely to hit about \$145 billion for the full year.

The Need for Immediate Action

Most observers focus on the *international financial* unsustainability of the present situation. The United States cannot indefinitely finance annual external deficits rising rapidly toward \$1 trillion per year. Foreign private and even official investors will at some point become unwilling to invest the needed amounts at current exchange rates and interest rates. The dollar will then fall substantially and US interest rates will rise, perhaps sharply in a disorderly “free fall.” This would be highly disruptive for the United States itself due to higher inflation and interest rates, which in turn would tank the equity and housing markets and thus the overall economy. It would be costly for the Asians as well due to the parallel reduction in their external surpluses, on which many of them continue to rely for much of their economic growth. Such a scenario could begin to occur at literally any moment.

There is also a second, *domestic US political*, unsustainability in the situation that has already begun to hit and leads me to conclude that “the disaster” is already well underway. We know from the history of trade policy that dollar overvaluation and the large external deficits it produces are by far the best predictors of protectionism in the United States (and Europe) that can threaten the entire global trading system. It was the first surge of postwar protectionism in the United States, not any collapse of foreign financing for the US deficits of the day, that led President Nixon and Secretary Connally to force dollar devaluation in 1971 by imposing their import surcharge and taking the dollar off gold. The soaring dollar and record trade deficits of the 1980s led Congress to be ready “to reinstate the Smoot-Hawley tariff itself,” as congressional leaders said at the time, and prompted President Reagan and Secretary Baker to initiate the Plaza Agreement in 1985 to drive the dollar down by 50 percent and to adopt much tougher trade measures against Japan.

We are seeing a repeat of that situation today. Despite the strength of the US economy, which is currently approaching full employment, widespread import controls have been applied to six Chinese industries over the past year. The House of Representatives passed anti-China economic legislation in July and essentially vetoed the proposed CNOOC takeover of Unocal. A spate of trade disputes have erupted with the European Union and other trading partners as well.

I outlined in my remarks yesterday² *the enormous consequences for the world trading system, the Asia Pacific region in particular and especially US-China relations of this domestic US political unsustainability of the present imbalances*. The Senate is ready to pass the Schumer Amendment, which would levy an across-the-board tariff of 27.5 percent on all imports from China until they revalue substantially. The administration will almost certainly have to label China a “currency manipulator” in its October report to Congress, and launch an aggressive campaign of its own to persuade China to act, or risk triggering even stronger congressional reactions. The international financial unsustainability of the situation, described above, could erupt at any moment. Hence urgent remedial action is required.

The Steps Required

Responsibility for the huge imbalances of course rests to a large extent with the United States as the deficit country. The underlying cause of the problem is America’s abysmally low national saving rate, particularly the huge budget deficit of the federal government and the virtual absence of private household savings. Hence the United States relies on foreign capital to finance much of its economic growth and must run the counterpart large current account deficits that cause so many problems.

The US budget deficit will decline by a welcome \$100 billion or so in the current year. However, it is likely to rise substantially in the future unless major new policy actions are taken—as opposed to the above-budget increases in several areas of spending just voted by the Congress and signed by the president, the prospect of sizable further tax cuts over the coming year or so, and the absence of any plan to check the sharp increases in entitlement spending (especially for health care)

² C. Fred Bergsten, “A New Strategy for APEC,” remarks presented at the 16th General Meeting of the Pacific Economic Cooperation Council in Seoul, Korea on September 6, 2005 and attached to this paper.

that are inevitable as the population ages rapidly. The US government needs to restore the budget surpluses that the present administration inherited when it took office five years ago. We do not know how to increase private saving, but the continuing steady rise in interest rates will presumably dampen spending on housing and other interest-sensitive sectors so could well move in that essential direction. *Now is the time for the United States to address these issues since the economy is growing so strongly.*

The result of such adjustments in the United States will be a reduction in the growth of domestic demand, offset partially over several years by a reduction in the external imbalance. This will of course weaken the US growth impetus for the rest of the world. The corollary in East Asia will therefore have to be an increase in domestic demand to counter the decline in external positions.³ China is fortunately running a very large budget surplus, as well as enjoying very high rates of private saving, so should be able to couple the sizable appreciation of the renminbi that is so badly needed with a substantial fiscal stimulus and increased private consumption, to maintain rapid expansion in the short run by boosting domestic demand and to promote the country's essential long-term shift from export-led to consumption-led growth. *Mishandling of either the deficit or surplus sides of the equation will lead to a decline in global growth and even a world recession.*

An essential instrument for achieving these changes in the two regions is a substantial realignment of exchange rates. Our studies at the Institute for International Economics⁴ suggest that *the dollar remains overvalued by at least 20 percent against a trade-weighted average of the currencies of its main economic partners.* The dollar's trade-weighted decline of about 10 percent in 2002–04 took place almost wholly against the floating currencies of Europe, Canada, and the Southwest Pacific, and the *remaining adjustment should come primarily against the currencies of East Asia.*

Asian exchange rate policies have severely exacerbated the problem. The Chinese renminbi has *depreciated* by about 10 percent over the past three years by riding the dollar down against most other currencies, further *strengthening* China's international competitive position. Most other Asians, fearing losses of their own competitiveness against China, have intervened heavily to keep their supposedly floating exchange rates from rising nearly as much as market forces wanted. Hence *a number of Asian countries, most obviously China and Malaysia but also Japan prior to March 2004, have been guilty of violating their IMF obligations to avoid "competitive undervaluation" and "manipulation" of their currencies—as reflected in their "large, prolonged and one-way" intervention in the markets.*⁵ Calculations at our Institute for International Economics suggest that *the renminbi is undervalued by at least 25 percent and that such a rise in its value, along with a parallel rise in the other currencies in the region, would cut \$100 billion per year off the US current account deficit* while avoiding any significant change in competitiveness among the East Asian countries themselves.⁶

China took a welcome first step toward correcting this situation by revaluing the renminbi in late July. However, the 2 percent amount of the step was far too small to have any appreciable impact nor is there yet any discernible effect from the announced adoption of the basket peg.⁷ *China will have to revalue by at least 10 to 15 percent, preferably 20 to 25 percent, to offer a prospect for meaningful*

³ Europe has been running modest external surpluses and will also need to expand its growth of domestic demand, through both structural reforms and easier monetary policy from the European Central Bank.

⁴ C. Fred Bergsten and John Williamson, eds., *Dollar Adjustment: How Far? Against What?* Special Report 17, Institute for International Economics, 2004; and *Dollar Overvaluation and the World Economy*, Special Report 16, Institute for International Economics, 2003.

⁵ The International Monetary Fund identifies such intervention as a key factor in assessing the existence of "currency manipulation." Taiwan has been guilty of the same behavior but is not a member of the IMF.

⁶ See Morris Goldstein and Nicholas Lardy, "China's Role in the Revived Bretton Woods System: A Case of Mistaken Identity," Working Paper WP 05–2, Institute for International Economics, March 2005; and Morris Goldstein "The International Financial Architecture," in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Institute for International Economics, Washington, January 2005.

⁷ See John Williamson, *A Currency Basket for East Asia, Not Just China*, International Economics Policy Brief No. 05-1, Institute for International Economics, Washington, August 2005.

adjustment and therefore to avoid sharp US (and probably European) protectionist reactions and a likely crisis in economic relations between the world's two leading growth locomotives.

A Role for APEC and the PECC?

The APEC Finance Ministers are meeting here in Korea over the next two days. In light of the centrality of the US deficits and Asian surpluses to the global imbalances, they are in a better position than the G-7 Finance Ministers or any other existing group to initiate the policy measures needed to start correcting the situation.

We at PECC XVI should urge them to do so. If they do not, we should recommend that the APEC Leaders meeting in Busan in November instruct them to do so or begin the process themselves. Both the world trading system and the world economy are at grave risk if they do not.

Table 1**Global Current Account Balances of East Asian Economies and the United States** (in billions of US dollars)

Country	2002	2003	2004	2005est	2006est
Brunei	3.1	3.8	4.2	4.6	4.2
Cambodia	0.0	-0.1	-0.1	-0.2	-0.2
China	35.4	45.9	70.0	76.5	81.3
Hong Kong	12.6	16.2	15.9	16.3	17.0
Indonesia	7.8	7.3	7.3	6.3	2.7
Japan	112.6	136.2	171.8	157.2	173.1
Korea	5.4	12.1	26.8	26.1	23.1
Laos	-0.1	-0.1	-0.2	-0.2	-0.3
Malaysia	8.0	13.4	15.7	17.4	16.9
Myanmar	0.1	0.0	0.0	-0.1	-0.1
Philippines	4.4	3.3	3.9	2.4	2.0
Singapore	15.7	27.0	27.9	27.2	28.7
Thailand	7.0	8.0	7.3	3.5	2.8
Taiwan	25.6	29.3	19.0	22.6	21.9
Vietnam	-0.4	-1.8	-2.0	-2.3	-1.9
Total	237.3	300.3	367.4	357.4	371.1
Share of US CA Deficit	50%	57%	55%	49%	49%
United States	-473.9	-530.7	-665.9	-724.5	-749.8

Source: International Monetary Fund, *World Economic Outlook*, April 2005.

Table 2

Foreign exchange reserves (in billions of US dollars)

Country/region	End of year		Dollar change		Percent change
	2001	2004	2001–04	Share of total	
Total	1685	3105	1417	100	84
Industrial, non-Asia	330	358	27	2	1
Euro area	208	179	-29	-2	-14
Canada	30	30	0	0	0
United Kingdom	32	39	8	1	22
Australia	16	34	17	1	113
Sweden	13	21	8	1	62
Switzerland	30	54	23	2	80
Asia	1158	2396	1238	90	107
Japan	388	824	437	31	112
China	212	610	398	28	188
Taiwan	122	242	120	8	98
Korea	102	198	96	7	94
Singapore	75	112	37	3	49
Hong Kong	111	124	12	1	12
India	45	125	80	6	178
Malaysia	30	65	36	3	117
Thailand	32	49	16	1	53
Philippines	13	13	-1	0	0
Indonesia	27	35	8	1	30
Latin America	128	180	51	4	41
Mexico	44	63	18	1	43
Brazil	36	53	17	1	47
Argentina	15	18	3	0	20
Venezuela	9	18	9	1	100
Chile	14	16	1	0	14
Colombia	10	13	3	0	30
All others	70	171	101	7	144
Israel	23	27	3	0	17
Saudi Arabia	15	23	8	1	53
Russia	33	121	88	6	267

Source: International Monetary Fund, *International Financial Statistics*.