Introduction

John Williamson
Senior Fellow, Peterson Institute for International Economics

A workshop was held at the Peterson Institute on February 8–9, 2007, to explore solutions to the current large global imbalances, which were the focus of the International Monetary Fund’s multilateral consultations process.¹ Now that the results of the consultation process are published, they can only be described as disappointing. They fulfilled the worst fears that motivated the decision to hold the workshop and produce a blueprint for what we believed the multilateral consultations should aim to achieve. Even the IMF governing body chairman’s description of the results of the exercise as representing “commitments” by the participants was promptly challenged by the US treasury secretary, who denied that the consultations had ever aimed to produce commitments. Certainly there was no recognition that exchange rates have to be in the right ballpark to support adjustment and no indication that any of the participants had the slightest intention of modifying their policies in light of the discussions. The results looked more like a G-7 communiqué than like a reform of the international monetary system: All will be well with the world if only we continue doing exactly what we plan to do.

The cosponsors of the workshop that took up the issue of global imbalances along with us were Brussels-based BRUEGEL and Seoul-based Korea Institute for International Economic Policy (KIEP). We jointly decided that we would post the papers submitted to the workshop on our Web sites at the same time as we published the joint statement,² which aimed to summarize what the six signatories had deduced from the workshop. We have now decided that in view of the urgency of making the material widely available and the likelihood that it will quickly become dated, we will dispense with a conference volume and make the papers available only on our Web sites. This introductory note gives some background to guide reading the papers and discussions that follow.

The project originated in the course of 2006 after the IMF created the multilateral consultations process that has just reported. At both BRUEGEL and the Peterson Institute it was feared that these multilateral consultations would avoid what we conceived to be a key part of a meaningful agreement capable of nurturing a progressive, orderly adjustment of the imbalances: namely, agreement on “ballpark” estimates of the exchange rates that would be consistent with achieving adjustment. We were well aware that most exchange rates now float and that accordingly it is quite unrealistic to treat them as policy variables that policymakers can choose in order to facilitate adjustment. Nevertheless, we regarded it as important to achieve a common recognition of what rates can be expected to promote adjustment and what rates would impede adjustment, so as to

attempt to alter market rates in the desired direction where the opportunity arises. Some of us believe that these rates could usefully be designated as reference rates, with the consequential obligation on issuers of those currencies not to impede market rates moving toward those levels (see Williamson, *Reference Rates and the International Monetary System*). But all of us believe that agreement on a desired set of rates could help ensure consistency between the objective of adjustment and official willingness to take action. It is, for example, no good expecting much adjustment in Asia without a lead coming from China and Japan, both of whose currencies are widely known to be greatly undervalued. In the case of China the exchange rate still is a policy weapon, while the Japanese authorities sit on over half a trillion dollars of excess reserves, which would surely enable them to lead the market if they so choose. The decision of the IMF staff to dismiss the case for intervention by saying they are against “heavy-handed intervention” has reduced the multilateral consultation process to futility even before its results were published.

Because of the apparently well-founded fear that the official exercise would shy away from naming even ballpark estimates of the exchange rates consistent with adjustment, our two institutes decided to try to fill the lacuna. We immediately realized the need for an Asian institute to partner with the two of us in convening any such workshop: East Asia is now far too important a part of the world economy, and source of adjustment problems, for it not to play a key role. But that presented a problem: an institute from China or Japan? We decided the solution was neither and instead quickly focused on Korea and thus KIEP, which had partnered with BRUEGEL in organizing a successful Asian-European conference on global imbalances in Beijing last year. To our great pleasure KIEP agreed to join us as a cosponsor.

The principal focus of the exercise is indeed on identifying the set of exchange rates consistent with adjustment, but this is not because we suffer from the illusion that all else follows automatically if the exchange rate is “right.” In fact, we quite unambiguously believe that—as economics has taught for many years—successful adjustment requires both expenditure switching and expenditure changes. The correct real exchange rate is a key determinant of expenditure switching, and a change in the nominal exchange rate is generally the easiest way to change the real exchange rate, hence the need to consider exchange rates. But the level of demand is also key. We focused on it less since the main players already show every sign of being aware of its importance and because the failings in their policy actions are already so amply illuminated by IMF strictures (e.g., on the persistence of a US fiscal deficit in the midst of a boom) that we doubted whether regurgitation would add much value. Despite those doubts, we do in fact emphasize the issues in the policy brief.

Many models capable of illuminating adjustment require as inputs a set of current account targets. I endeavored to provide these in my background paper (“The Target Current Account Outcomes”) for the conference. The single most important figure here is the amount by which the US current account deficit should be reduced in the medium term (three or four years). I took as the objective a reduction to 3 percent of GDP, not because this figure has a particularly firm base but because it is a sensible order of magnitude and the figure that everyone else has used. The next issue is who should bear the counterpart (often described as a “burden,” though that is a misnomer since it calls for increasing spending) reduction in surplus or increase in deficit. In this age when almost
everyone except the United States seems to be so sensitive to the danger of inviting a crisis if international debts are large, it is natural to focus on surplus countries as the leading candidates. The paper suggests three ways in which the counterpart could be distributed: by an equal percentage reduction in surplus by all surplus countries (including the oil countries), to an equal percentage of GDP (except for the oil countries), and focused principally on developing East Asia. The latter is justified on the rationale that one would expect it to be welfare enhancing: These are still relatively poor countries, which can therefore make good use of real resources in raising consumption even where they do not need to raise investment, and there is no reason in any reputable economic theory for expecting a switch of demand from abroad to the home market to reduce growth.

The basic aim of the workshop was to explore what the macroeconometric models have to say about the set of exchange rates that would be needed to accomplish these payments objectives. By way of background, we had an already-published paper from the IMF that was presented by Gian Maria Milesi-Ferretti entitled “Methodology for CGER Exchange Rate Assessments.” (CGER stands for Consultative Group on Exchange Rates, which is an internal IMF committee that prepares the estimates of equilibrium exchange rates periodically presented to the IMF Executive Board.) The paper outlined the three methods currently used to prepare the IMF’s estimates of equilibrium exchange rates. These methods are classified in box 1 in Policy Brief 07-4: Two of them merely offer different ways of deriving the current account targets that are fed into what the IMF calls the macroeconomic balance approach, but the third is completely different. This paper was discussed by David Vines of Oxford University. Note that the policy brief also classifies the macroeconometric papers presented to the workshop in terms of which approach to estimating equilibrium exchange rates each employs.

The other general paper presented to the workshop was that of Brad Setser (Roubini Global Economics) on “Oil and Global Adjustment.” The paper aims to describe what lies behind the large 2006 surplus of the oil exporters and peer into the future prospects for their balance of payments position, as well as argues that it would be advantageous to them (as well as promote more rapid payments adjustment and in that way benefit the rest of the system) to adopt a more flexible exchange rate policy. He shows how under present arrangements of widespread pegging to the dollar, the oil exporters’ spending is dependent upon the reaction of the fiscal system, leading to an important lag between the oil price and their surplus. If it is indeed true that the oil price has already peaked, then adjustment is well under way, and one can expect future reductions in the size of their surplus. This vision is reinforced, and usefully summarized in his chart 3, by discussant Trevor Reeve (Federal Reserve Board).

The workshop considered a number of papers that dealt with the principal nations or regions in the world economy. Martin Baily (Peterson Institute) wrote about the United States (“How Large a Dollar Adjustment to Reduce the US Imbalance?”), with his discussant being Barry Eichengreen (University of California, Berkeley). Alan Ahearne, Jürgen von Hagen, and Birgit Schmitz (BRUEGEL) wrote about Europe (“Internal and External Current Account Balances in the Euro Area”), discussed by Desmond Lachman (American Enterprise Institute). Koichi Hamada (Yale University) wrote about Japan (“Will Japan Turn into a Deficit Country in the Near Future?”), with his paper discussed by Marvin Barth (US Treasury). Yu Yongding (Chinese Academy of Social Sciences)
wrote about the adjustment issue in China (“Global Imbalances: China’s Perspective”), and his paper was discussed by Nicholas Lardy (Peterson Institute). Doo Yong Yang (KIEP) examined the situation in Korea (“The Exchange Rate Adjustment in the Course of Global Rebalancing: The Case of the Korean Won”), and his paper was discussed by Carmen Reinhart (University of Maryland). In each case the intention was to ask an author well acquainted with the country to identify what he saw as the main issues and offer him the opportunity of reflecting on the adjustment issues that were likely to arise, such as the likely nature of the adjustment, its size, and its timing.

The core of the conference involved a series of papers intended to offer estimates of what the principal macroeconometric models imply about the set of real effective exchange rates that would be consistent with adjustment. The first of these, entitled “Sustainable Adjustment of Global Imbalances,” was by Ray Barrell, Dawn Holland, and Ian Hurst (National Institute of Economic and Social Research, London). It presented a number of simulations of the National Institute’s global model, NiGEM, about the impact of changes that tend to achieve the postulated adjustment target. However, since NiGEM is a model that assumes that all agents were optimizing in the initial situation, any deviation from the baseline path can arise only from some exogenous change in the conditions postulated. They show how an exogenous revaluation of the renminbi would in their model be neutralized over time by induced disinflation. In the end they seek to approximate the conditions laid out in the background paper by postulating that the risk premium on the dollar increases. In the end they seek to approximate the conditions laid out in the background paper by postulating that the risk premium on the dollar increases. The second of these papers was by William R. Cline (Peterson Institute), entitled “Estimating Reference Exchange Rates.” It is based on the model developed for his Peterson Institute/Center for Global Development study The United States as a Debtor Nation (2005), modified to answer the questions posed in the background paper. These two papers were discussed by Douglas Laxton of the IMF.

Agnès Bénassy-Quéré, Amina Lahrèche-Révil, and Valérie Mignon (CEPII, Paris) presented a paper entitled “World-Consistent Equilibrium Exchange Rates.” This paper is primarily concerned with examining and contributing to the resolution of the problem of world consistency in a closed system of exchange rates. Like the National Institute model, it assumes that actual market outcomes reflect equilibrium solutions and are therefore not well adapted to examining the question posed at the conference, which is how one could change a situation that by hypothesis is not a sustainable equilibrium. Thomas Stolper and Monica Fuentes (Goldman Sachs) called their paper “GSDEER and Trade Elasticities.” It acknowledged that the Goldman Sachs dynamic equilibrium exchange rate (GSDEER) fair value model of exchange rates is unable to analyze the adjustment of the global imbalances specified in the background note, since any adjustment postulated in that model must operate on a far longer time scale. They therefore constructed and estimated a traditional elasticities model in order to offer answers to the specific questions posed. The final paper is that of Ronald MacDonald (University of Glasgow) and Preethike Dias (Peterson Institute), entitled “BEER Estimates and Target Current Account Imbalances.” Their paper starts by recounting the distinctive features of the behavioral equilibrium exchange rate (BEER) approach, notably the assumption that on average the exchange rate is in equilibrium over the period of estimation. It ends with the presentation of their results.
The conference concluded with a panel discussion of the policy implications. The participants were Michael Mussa (Peterson Institute), Jean Pisani-Ferry (BRUEGEL), Yu Yongding (Chinese Academy of Social Sciences), and Yung Chul Park (KIEP).

We hope that in due course all the papers and comments noted above will appear on our Web site. For the moment we have the joint statement issued in light of the workshop, which was signed by two individuals from each of the three institutes (published by the Peterson Institute as Policy Briefs in International Economics 07-4); all of the papers submitted to the workshop or revised versions of them where they have been submitted; and some of the discussants’ comments. We shall post other contributions as they are received.