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NEW INTERNATIONAL REPORT CALLS FOR MAJOR EXCHANGE RATE REALIGNMENTS

Washington—A new report from leading research institutions in Asia, Europe, and the United States concludes that correction of the large global current account imbalances while sustaining global growth will require major changes in policies and in currency values:

- a substantial increase in saving in the United States and the expansion of much more robust domestic consumption in East Asia;
- a decline in the trade-weighted average exchange rate of the dollar by 10 to 20 percent;
- a strengthening of the Chinese renminbi to about 6:1 against the dollar (30 percent)[1] from its current rate of about 7.7:1, with a step revaluation of 10 percent in the near term followed by further appreciation over three to four years leading to the complete cessation of official intervention to prevent a stronger renminbi;
- a strengthening of the Japanese yen to around 90:1 against the dollar (25 to 30 percent) from its present 118:1, including through direct official intervention in the currency markets if necessary;
- a rise in the euro to $1.45 to $1.50 per euro from $1.33 per euro now;
- a strengthening of the trade-weighted average exchange rates of several other economies running large external surpluses, including Hong Kong, Malaysia,

1. This estimate assumes that the objective is to reduce the Chinese surplus by at most 6.5 percent of GDP, whereas the complete elimination of the surplus suggested by some would require a substantially larger adjustment of at least 9 percent of China's GDP and hence a much greater strengthening of the renminbi.

Norway, Russia, Singapore, Sweden, Switzerland, and Taiwan; and

- rises in the bilateral rates against the dollar of many other currencies that do not require an effective appreciation on a trade-weighted average basis.

The report was prepared by leading economists from BRUEGEL, the new European think tank in Brussels; the Korea Institute for International Economic Policy in Seoul; and the Peterson Institute for International Economics in Washington. It was based on an intensive workshop held at the Peterson Institute on February 8 to 9, which brought together about 30 of the world's leading experts on the global imbalances. The report conveys the principal findings of the workshop though not all of its views would necessarily be endorsed by all participants. Descriptions of the authors and sponsoring institutions are attached. The full report is being released simultaneously in the three capitals.

The report concludes that "the current pattern of global imbalances is not sustainable" over time and that "a key question is whether...adjustment will be initiated by financial markets or policy actions." The authors judge that "a market-led adjustment might involve global recession, abrupt and excessive changes in key exchange rates and asset prices, and as a consequence aggravated trade frictions." They note that "the recent volatility in global financial markets is a reminder of the dangers of failing to act promptly" and urge "policymakers to initiate a policy-induced adjustment in the near future," suggesting that "the forthcoming spring meetings of the International Monetary Fund (IMF) will provide a crucial opportunity to move in earnest toward reaching agreement on an adjustment package."

The report emphasizes the unprecedented size of the current account imbalances:

- the US deficit reached $857 billion in 2006, about 6.5 percent of GDP;
- the Chinese surplus is estimated at $240 billion in 2006, about 9.1 percent of GDP, and its trade surplus has tripled during the first two months of 2007 from a year ago;
- the Japanese surplus reached $171 billion, about 3.9 percent of GDP; and
- the oil exporters of the Middle East recorded a surplus approaching $300 billion.

The group agreed that "persistent external deficits and surpluses of this scale imply an implausible accumulation of foreign liabilities on the US side (rising to more than 50 percent of its GDP by 2011) and an implausible accumulation of assets on the Chinese and Japanese sides" (whose foreign exchange reserves already exceed $1 trillion and $850 billion, respectively). They draw the inference that at some point global current account adjustment must take place. They argue that "the most elementary theory tells us that this will require movements in exchange rates, including a significant depreciation of the dollar and corresponding appreciation in the currencies of other economies, as well as a rebalancing of demand and savings across the globe."

A central premise of the calculations that underlie the report is that the US current account deficit needs to be narrowed to about 3 percent of GDP in the medium term. A second central premise is that this adjustment should and can be accomplished without depressing global economic growth. A third is that most of the adjustment from the surplus side should be borne by China, Japan, other Asian economies, a few high-surplus European economies outside the euro area, and the oil-exporting countries. The euro area, which is now close to current account balance, would not need to make a net contribution to the correction, nor would several other countries such as Korea and the United Kingdom, which have already experienced substantial currency appreciation, although they would need to accept further bilateral appreciations against the dollar in the context of global adjustment.

The recommended policy package is as follows:

- a slowing in the growth of domestic demand to a rate below that of output over coming years in the United States, to offset the increasing contribution to growth from rising US net exports without provoking inflationary excess demand, which is likely to require a sizable fiscal contraction in order to avoid an undesirable increase in US interest rates;
- an expansion of demand in East Asia, with both China and Japan expanding consumption to offset the required fall in their external surpluses, as well as the currency appreciations indicated above and, for China, the elimination of distortions that favor exporting sectors;

- Euroland acceptance of a stronger euro against the dollar as the Asian currencies rise against the dollar, since the effective exchange rate of the euro would otherwise depreciate and generate new current account surpluses; and
- continued growth of domestic absorption by the oil exporting countries, a process that is already under way.

The report concludes that "policymakers should not wait until financial markets force global adjustment." The authors also find, however, that "it is unlikely that the policymakers of each country will resolve independently to take actions that add up to a coherent package." Hence they call for an "international effort to persuade each country to contribute its fair share" to the needed program, emphasizing that the multilateral surveillance exercise initiated by the IMF in 2006 "provides an ideal context for organizing such an international effort." They recommend that the upcoming spring meetings of the IMF in Washington move decisively in this direction.

About the Authors

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Kyung Tae Lee is president of the Korea Institute for International Economic Policy, chair of the APEC Economic Committee, and member of the Presidential Economic Advisory Council in Korea. Before assuming his present position, he served as Korean Ambassador to the OECD. He also served as vice president and research fellow at the Korea Institute for International Economic Policy.

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Jean Pisani-Ferry was appointed director of BRUEGEL upon its creation in early 2005, after having been involved in the development of BRUEGEL since the project's earliest days. A French professor of economics with Université Paris-Dauphine, he was director of Cepii, the main French research institute in international economics (1992–97), and executive president of the French Prime Minister's Council of Economic Analysis (2001–02). His policy experience includes positions with the European Commission (1989–92) and as economic adviser to the French Minister of Finance (1997–2000).

John Williamson, senior fellow, has been associated with the Peterson Institute since 1981. He was also project director for the UN High-Level Panel on Financing for Development (the Zedillo Report) in 2001; on leave as chief economist for South Asia at the World Bank during 1996–99; economics professor at Pontificia Universidade Católica do Rio de Janeiro (1978–81), University of Warwick (1970–77), Massachusetts Institute of Technology (1967, 1980), University of York (1963–68), and Princeton

University (1962–63); adviser to the International Monetary Fund (1972–74); and economic consultant to the UK Treasury (1968–70).

About the Sponsoring Institutions

BRUEGEL is a European think tank devoted to international economics, which was created in Brussels in early 2005 with the support of European governments and leading corporations. Based on an innovative model that balances public and private inputs in its governance and funding, it intends to bring a new voice into Europe's economic policy discussion. BRUEGEL aims to contribute to the quality of economic policymaking in Europe through open, fact-based and policy-relevant research, analysis, and discussion. It draws its unique nature from a balanced partnership between private and public stakeholders. Its member base, initially composed of EU member states and corporations, will be extended in the future to research institutions, foundations, nongovernmental organizations, international organizations, and individuals.

The Korea Institute for International Economic Policy (KIEP) was founded in 1990 as a government-funded economic research institute. KIEP advises the government on all major international economic policy issues and serves as a resource on Korea's international economic policies. KIEP also carries out research for foreign institutes and governments on all areas of the Korean and international economies. Now numbering 100, KIEP's staff includes 40 research fellows supported by 40 research assistants. Its efforts are augmented by its affiliates the Korea Economic Institute of America in Washington and the KIEP Beijing office. KIEP also maintains a wide network of prominent local and international economists and businesspeople who contribute their expertise on individual projects.

The Peterson Institute for International Economics, whose director is C. Fred Bergsten, is the only major research center in the United States that is primarily devoted to global economic policy issues. Its staff of about 50 focus on macroeconomic topics, international money and finance, trade and related social issues, and international investment, and cover all key regions—especially Asia, Europe, and Latin America. The Institute averages one or more publications per month; holds one or more meetings, seminars, or conferences almost every week; and is widely tapped over its popular Web site, www.petersoninstitute.org.