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A better sense of balance
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The IMF's latest World Economic Outlook has triggered another round of concern about large international payments imbalances, with a special focus on the sustainability of the US current account deficit, now at 6 per cent of national income and growing inexorably. What, if anything, should be done?

"Something which is unsustainable will stop" is the oft-quoted mantra of former US president Richard Nixon's economic adviser Herb Stein. Ben Bernanke, Stein's successor as chairman of the President's Council of Economic Advisers, has provided more specific and timely comfort. He argues that the imbalances are not principally a result of America's huge budget deficit or its credit-supported consumer binge, but reflect a world saving surplus. Not only does this shift the responsibility away from the US, but "too much saving" sounds rather virtuous, as if it might beneficially go on indefinitely.

The present conjuncture, however, is a result of a delicate alignment of the planets, of patterns of behaviour which are, individually, rather unusual. If one of these were to change, it would require offsetting adjustments in other elements of the jigsaw to maintain the overall balance. Unsustainable things do stop, but adjustment is often painful. These risks deserve to be set out, not as predictions, but as a set of scenarios whose implications should be thought through.

The analytical key is the recognition that, in each country, the savings-investment balance is always identical to the country's current account balance (if a nation spends more than it produces, it must be importing more than it is exporting), so that a change in savings or investment has to have a counterpart adjustment in the external balance. The question is: at what level of national income will the new equilibrium be achieved?

What are the sensitivities in the present alignment? There are various possible triggers for adjustment, but two examples will suffice: a change in US saving; and a change in the funding of the US external deficit.

Paradoxically, the sustainability of the current conjuncture could be disturbed by an apparently virtuous change: if the US reformed its prodigal ways and saved more. It has certainly been fortunate for the world that, with Japanese and Germans wanting to save and East Asian investment still dampened by the Asian crisis of 1997, the US has fortuitously reduced its savings and allowed its external deficit to rise. If it had not done so, there would have been a worldwide demand deficiency, and a recession. So US profligacy is one of the supporting pillars of the present conjuncture. One component of this seems likely to continue: with a low-taxing president and civic reconstruction now added to the demands of the Iraq war, large budget deficits are likely to remain, for better or worse. But what about the other unusual element of the US savings performance, the households which have in recent years decided to save nothing, and to fund their consumption from "equity extraction" (borrowing against the newly inflated prices of their homes)? Even US Federal Reserve chairman Alan Greenspan, who is usually ready to let the market sort things out, is now worrying about the extent of this borrowing. When households come to share his concern, they will tighten consumption expenditure, upsetting the present balance.

The funding of the US external deficit could become more difficult. Germany and Japan's high saving rates reflect their demographics, so their behaviour is unlikely to change much. But these ageing savers are not putting their funds directly into US assets. The US external deficit is financed, instead, by the lenders of last resort, the central banks of China and Japan — which are now funding 60 per cent of the US deficit by buying low-interest US government securities. In doing this, they are in a real bind. Neither country wants to see its exchange rate appreciate much. But investing in low-return securities denominated in a currency which is likely to go down (perhaps sharply) doesn't seem all that rational. The penalty may be high — a 20 per cent change in the yuan-dollar parity would give China a loss on its reserves of close to 10 per cent of GDP. This would be a huge blow to the balance sheet of the central bank, as holder of the reserves. Restructuring reserves to reduce the weight of the dollar is tricky: the Chinese have only the yen and the euro to choose from. For Japan the choice of reserve currency is more limited still. In short, while China and Japan will be reluctant to run down their US reserves, it may not be sustainable for them to go on building ever-larger reserves, and their search among the unpalatable alternatives would remove one of the supports of the present situation.

If we acknowledge the possibility that the present situation may not be sustainable, and that that it may indeed come to an end, how painful might the adjustment be?

Let's continue with the two examples already explored. Suppose that US households decide the house-price bubble has run its course and they want to spend less and save more. This is not enough in itself to reach a new equilibrium with a smaller US external deficit: for that to happen, there would need to be a simultaneous increase in world demand for US exports (or a cut in US imports). For the economy to maintain its current output, the fall in domestic demand from increased savings has to be matched by a rise in foreign demand for US exports. This adjustment could occur in a good way — through stronger US international competitiveness (a lower dollar or higher productivity); or in a bad way (protectionism, driven by industry pressures, might narrow the deficit). Protectionism is never far below the surface: with the ending of decades of protection via the Multi-Fibre Arrangements, the US Congress is ready to replace this with unilateral limits on textile imports.

Taking the second scenario, what happens if foreign central banks decide they have enough US dollar assets, and either let their currencies appreciate or buy euro-denominated assets for their reserve holdings? The upward pressure on non-dollar currencies would be unpopular and painful outside America, and would add to price pressures in the US as imports become dearer. This would be softened if foreign investors decided to buy more US assets. Among these foreigners might be, say, Chinese investors who, if their capital market were freed up, would diversify their portfolios into foreign assets, including a good amount of US dollar investments. Could China follow the example of Singapore, and invest its external surplus in productive assets in the US (the long-term nature of the investment would buffer any currency loss)? None of this looks easy or automatic. CNOOC's attempt to buy Unocal, a second-tier oil producer representing only 1 per cent of American oil assets, foundered because of US strategic protection. It might also be noted in passing that encouraging greater private capital inflows into America would have been easier five years ago, when US productivity performance and the technology boom were offering the promise of high investment returns.

It would be tedious to rehearse the full range of possible initiating changes and the permutations of adjustment. Instead, two general points could be made. First, that the adjustments are unlikely to be quick or automatic — the invisible hand of the market works in a slow, jerky and sometime convoluted way. When the US adjusted to the similar (but smaller) imbalances in the mid-1980s, the current account continued to deteriorate for two years after the exchange rate adjustment. International trade is slow to respond to price signals, and there is the famous "J-curve" — things get worse before they get better. In the course of a drawn-out adjustment, exchange rates can overshoot, often dramatically. Secondly, some of

the adjustments are less painful and less unattractive than others: encouraging more private capital flow into the US, a revival of investment in non-Chinese Asia or a revival of productive investment in Germany and Japan all seem good adjustments. So there are differentiated paths of adaptation, and policy has some capacity to choose between them.

The overarching conclusion is that if we convince ourselves that the current position is sustainable, we don't feel the need to explore these adjustment scenarios, or to explore what policy (and policy co-ordination between countries) might be able to achieve. The US can go on pointing the finger of blame at the Chinese — who may be part of the "problem", but only a small part, as their current account surplus is one tenth the size of the US deficit. A more productive approach would be to work through these (and other) scenarios in the course of international meetings (the G20, meeting in China this weekend, provides a good forum), to prepare the ground for helpful adjustments (more private capital flow into the US; more exchange rate movements but with some safeguards against overshooting) rather than to allow momentum to build behind the bad solution — more protection. One last point: an early start on adjustment would spread the shock and give more time for adaptation.

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