November 5, 2007

Are Global Imbalances a Problem?[1]

John Williamson
Senior Fellow, Peterson Institute

Everyone agrees that the global imbalances are today very large. There is also quite a wide measure of agreement on what would need to be done to rein them in: rebalance world demand by a shift from the United Sates to East Asia; appreciate most of the currencies of East Asia in effective and bilateral terms; and accept bilateral appreciations against the dollar (but not significant—or maybe any—appreciations in effective exchange rates) in the rest of the world. Where there is strong disagreement is on whether it is desirable to take measures designed to secure reasonably prompt adjustment. There is a school of thought that maintains that any cure for the global imbalances would be worse than the disease, and that the best course of action is to do nothing.

I am not an adherent of this position, and since I suspect that most of my audience does not subscribe to it either it could be argued that I am giving myself an unduly easy assignment this morning. I nevertheless believe it to be important to understand the "do-nothing" view, and the dangers that come from allowing it to continue to dominate policy. I also believe that we can learn important lessons about what are and are not real problems by examining the arguments of those who hold this view. That is why it forms the subject of this lecture.

I start by laying out a version of the opposing view. I then examine several of its arguments in detail:

- The view that on present trends a gradual adjustment is likely, or else that the market will automatically induce a gradual adjustment in its own good time
- The view that a deliberate attempt to achieve adjustment would face irreconcilable problems of conflicting national interests
- The view that the organizational problems of concerting adjustment policies are so formidable as to preclude this solution.

The final section of the paper shows the basis for believing that a deliberate, concerted adjustment would be less dangerous than the current policy of relying on the market to bring about adjustment in due course.

---

[1] Keynote lecture to be delivered to the conference on "Currency and Competitiveness" organized by the Austrian National Bank in Vienna on 19-20 November 2007.

The Cooper View

I take as my text a recent presentation that I heard given by Richard Cooper (2007/8). He began with a lengthy description of why the US savings rate may well be under-measured by the conventional national accounts. I suspect that on this the truth lies somewhere between Cooper and convention, but in any event it is not very pertinent to international adjustment since (a) his proposed additions all add equally to savings and investment, and (b) one would need to make analogous additions to the figures for other countries in order to get a correct international comparison. The fact (as he agrees) is that his revised figures do not affect the discrepancy between saving and investment, so they do not address the pertinent question of whether a U.S. current account deficit of over 6% of GDP can be sustained.

The next point he makes is that the actual capital inflow in 2006 was smaller than it would have been if financial markets were fully globalized, in the sense that home bias was everywhere zero. This is because foreign savings (at least when they are measured in a non-Cooperesque way, as he does!) are a much higher proportion of GDP than are US savings, so that if they were invested in proportion to GDP (as he assumes to be implied by the no-home bias assumption) there would have been an even larger capital inflow than that recorded. One could argue that the correct test would have been to distribute savings in proportion to investment rather than in proportion to GDP, and that this would have reduced the "no home bias" inflow to the United States, but it would remain true that the potential capital inflow would have been larger than the actual inflow, which was of course sufficient to finance the current account deficit. [Check.] In any event, I would not challenge Cooper's contention that the United States does not need to fear an imminent end to sufficient availability of foreign savings to finance the deficit.

Cooper also examines demographic developments, noting that population aging tends to reduce saving but that it cuts investment even more. Since the U.S. is the only major advanced country that is not aging, it is to be expected that it will exhibit a relative excess of investment over saving, which can then be expected to result in a current account deficit. Prospective retirees benefit by being able to make secure, profitable investments. (I agree with this view.)

Cooper also argues that the United States is likely to be able to continue to provide assets on an adequate scale for many years in the future. He points out that the U.S. tendency to hold a much larger proportion of its assets in the form of equity than the proportion of its liabilities that takes the form of equity both leads to a higher yield on its foreign assets than it has to pay on its liabilities and results in substantial capital gains, especially when the dollar depreciates. But fundamentally he comes back to a "no home bias" calculation, to show that the proportion of financial assets held by foreigners is still well below what would be needed for foreigners to hold 30% of their assets in the U.S. Maybe they do hold assets equal to 89% of GDP, but since financial assets are nearly ten times GDP there is still ample scope for them to hold more. Of course, there is still a lot

of home bias in the world, but Cooper's comparisons do show that if we believe globalization is progressively decreasing this bias there is no basis here for assuming that the U.S. cannot go a lot further into debt.

The last section of Cooper's paper dwells on the difficulties that foreign countries would supposedly face if they had to reduce their surpluses on the requisite scale. They would have to simulate domestic demand, which he argues would be difficult for export-oriented economies like Japan, Germany, and China, since investment would be discouraged by appreciation. There is a widespread desire for fiscal consolidation, which would be an obstacle to raising demand. Use of monetary ease to stimulate consumption would require lower interest rates, which would run counter to the need for currency appreciation. The Lisbon Agenda is focused on greater international competitiveness, not on expanding domestic demand. A Chinese appreciation large enough to eliminate China's current account surplus would still not solve the US problem, while it would threaten Chinese growth since exports have been the driving sector.

On the other hand, if the US deficit is allowed to continue at its current level, or even increase, one would avoid the grave economic consequences of a precipitate dollar devaluation, such as depressing investment outside the United States. Eventually corrective forces will set in, as financial globalization slows and ageing societies cease acquiring new foreign assets and seek to liquidate some existing claims. Then foreign expenditure will rise relative to output and surpluses will decline, perhaps without any need for a dollar depreciation.

Gradual and Automatic Adjustment versus a Crisis

The do-nothing view comes in two versions. One is that a gradual adjustment has already started, for which the prime evidence is the reduction in the US current account deficit as a proportion of GDP. The non-oil deficit has fallen from its peak of 5.1 % in 2006Q3 to its most recent published value of 4.0% in 2007Q2. The other version appeals to the fact that a floating exchange rate can depreciate when this is needed to facilitate adjustment, and combines this with an assurance that depreciation will happen in a crisis-free way when foreigners cease to wish to finance the US deficit.

Let us discuss the first version first. The facts are indeed correct: the US current account deficit is now decreasing and foreign demand for US goods is now increasing at a faster rate than domestic demand, including that for foreign goods. This is highly gratifying, but it is hardly a surprise to anyone who believes that the received theory of what determines the current account is basically right. Growth in the rest of the world has averaged 3.9 % since 2006Q3, against growth of 2.2 % in the United States in the same period. Moreover, the dollar has depreciated by 24 % (according to the Fed's broad index) since its peak in 2002Q1 until early November 2007. Of course, that depreciation has been very lopsided, with the euro and most other non-Asian currencies having appreciated strongly (the euro 's appreciation against the dollar is now over 41 %), and most Asian currencies having appreciated rather little in bilateral terms and a number

having depreciated in real effective terms. The result has been what we adherents of the derided “elasticities approach” would have expected, namely a substantially larger decline in the US non-oil current account deficit with the world excluding Asia of $28 billion per quarter and a decrease in the deficit with Asian countries of $11 billion. (I leave it to Ron McKinnon and other critics of what they always call the “elasticities approach” to explain away these facts.)

The critical question is whether this decline in the US deficit marks the start of a trend decline or an interruption of a trend increase. Assuming that US policy continues to react to any sign of increasing unemployment by expansionary macroeconomic policy measures, it seems to me overwhelmingly likely that we are merely witnessing an interruption of the trend increase. I say this because there are three powerful trend factors tending to increase the current account deficit at given pressures of demand and exchange rates:

1. The “gap factor”. The fact that imports are now over 50% larger than exports means that the trade deficit will increase even with a similar percentage growth rate of exports and imports.
2. The “Houthakker-Magee” asymmetry in the trade elasticities. If it is true, as Houthakker and Magee (1969) found, that the US income elasticity of demand for imports exceeds the foreign demand elasticity for US exports, then similar growth rates imply trend deterioration in the US current account in the absence of secular real depreciation. Even if, as has been suggested, the finding can be explained away by faster supply-side growth in the economies providing US imports, the fact is that that faster supply-side growth is likely to persist. It is only if the US growth rate is in the future going to be sufficiently below the foreign growth rate that this factor will not come into play.
3. The increase in debt service consequent on an increasing foreign debt. It is of course true that so far net debt service has been rather modest, mainly because the US has far more of its assets than of its liabilities in the form of equity and therefore gaining the higher returns that equity typically earns. It is also true that part of the return to portfolio equity (and perhaps in practice, though not in theory, of FDI as well) typically takes the form of capital appreciation that is not recorded in the balance of payments but only in the periodic revaluation of the stock of foreign assets. And it is true that dollar depreciation brings a one-off increase in the net international investment position, because non-equity assets are often denominated in foreign currency while non-equity liabilities are overwhelmingly denominated in dollars. All these factors have helped the United States to delay the ill-consequences of a large foreign debt far longer than many of us realized would be possible, but increasing debts will eventually have the qualitative impact that was expected. And this cannot be evaded in the long run: real devaluation is not a feature of steady state.

The current improvement in the US current account deficit will ameliorate two of these three factors: it will reduce the exports/imports ratio, and it will curb the debt service increase. But no one expects that these changes will push the US into current account

surplus. The expectation has to be that both factors will remain negative for the US current account, merely less negative. Together with the second factor, they will eventually overwhelm the depreciation-caused improvement in the deficit, so an increased deficit will resume without further policy changes.

Adherents of the do-nothing view argue that even if an adequate adjustment has not already started it can be relied upon to do so when foreigners decide that they wish to start saving less in order to consume or invest more. Maybe this will involve a dollar depreciation, in which case there is nothing to prevent the dollar responding to market forces, or maybe adjustment will occur with a largely unchanged value of the dollar. In neither case is there a need to worry about the current balance of payments deficit.

Since there is no policy that would obstruct a timely dollar depreciation, at least against some currencies, no sensible person can assert that this benign outcome is not conceivable. The danger is that it will be short-circuited by a crisis. By this one is thinking of a rapid depreciation of the dollar against those currencies that float, accompanied by a loss of confidence that causes falls in consumption and investment and thereby induces a recession. The fact that this sequence of events has not as yet been triggered by the 2007 financial turmoil is mildly reassuring, but does not justify entirely dismissing the danger. If it materialized, it would be quite likely to trigger a world recession. In the United States, at least the expenditure reduction consequent on the loss of confidence would in due course be offset by the positive expenditure-switching effect of the dollar depreciation. In the rest of the world, the two effects would reinforce one another to magnify recession.

It is important, however, to stress that recession is a danger and not a certainty. Too often the debate is conducted on the assumption that anyone who worries about the US deficit is forecasting that the deficit is definitely unsustainable. That is something we do not, and cannot, know. If the consequences of a continued deficit *may* be a sufficiently grave crisis, that should be motive enough to act.

Are There Conflicting National Interests?

The second prong of the do-nothing view is the assertion that governments are unlikely to reach agreements to act because of inherent conflicts of national interest. The most powerful version of this view at the moment appears to be that China has a fundamental national interest in maintaining its policy of export-led growth, which implies a large balance-of-trade surplus. China, and a number of other East Asian countries, refuse demands to revalue significantly, since these would threaten to pre-empt their rapid growth and the associated employment creation (see, for example, Dooley, Folkerts-Landau, and Garber, 2003).

I see three basic errors in this argument. The first is the association of large current account surpluses with export-led growth. The fact is that the idea of export-led growth was first propagated enthusiastically by Bela Balassa. His example par excellence

was the East Asian NICs, and then the Southeast Asian countries of Indonesia, Malaysia, and Thailand, long *before* the East Asian crisis of 1997. Yet those countries on average had current account deficits, not surpluses, in their years of rapid growth, as Table 1 shows. What made their growth export-led was that they aimed to resolve their balance-of-payments problems through exporting and not through import substitution. Their success in exporting made them attractive clients for Wall Street to lend to, and this gave them the wherewithal to run import surpluses, which added to their investible funds and thus their growth rates. The consequence was high exports, even higher imports, high investment, and high growth. There was no current account surplus.

[Table 1 about here]

The popularity of current account surpluses arose only after the Asian crisis of 1997, initially inspired by a resolve that never again would the countries be thrown on the mercies of the West, which they had found singularly lacking. Growth in due course resumed in those countries, though at the much reduced rate that anyone who thinks growth is in part driven by investment would expect, since the countries had diverted up to 10 percent of their GDP from investment into net exports.

The second fallacy is the belief that bigger undervaluation is better (for growth). There is good reason for believing that *overvaluation* is damaging for growth, particularly for emerging markets; not only is it easy to think of anecdotal examples of countries in which growth ground to a standstill as they fought to maintain overvalued exchange rates, or to concoct a theory, but there is now solid empirical evidence (Razin and Collins 1999; Aguirre and Calderon 2006; Raghuram, Subramanian, and ___). It is true that there are also two attempts to establish empirically that the bigger is undervaluation, the faster is growth (Bhalla 2007; Rodrik 2007), but not all of us find these provide convincing evidence that it is rational policy to run large current account surpluses. And they confront the theoretical obstacle of having to explain why a diversion of resources from investment into the accumulation of low-yielding foreign exchange should lead to a growth acceleration. It is fair to say, however, that this subject remains in contention.

The final fallacy, and the one that is most clearly wrong, is the belief that rapid growth in GDP is inevitably associated with fast employment creation. The statistics on China are telling. GDP has certainly grown rapidly, at an average of close to 10 % per year for the past 10 years, but employment has grown at little over 1 % a year. Since this is essentially the rate of growth in the labor force, China's current policy is not succeeding in providing jobs for any significant part of the estimated 250 million surplus workers in the countryside. The reasons are easy to understand. The industry that has grown in recent years is less the labor-intensive part of manufacturing that grew in the early years but rather capital-intensive heavy industry. Moreover, the low price and ready availability of capital have encouraged any given industry to adopt more capital-intensive techniques than it would have done with factor prices that reflected relative scarcities.

Obviously it is of central importance that any curtailment of the incentive to produce exports be accompanied by an increase in demand from other sources. This is the famous rebalancing of global demand; while payments adjustment requires that the U.S. curtail demand, other countries like China need to expand it, or else we shall have world demand deficiency (recession). In particular, increased Chinese demand will lead to an increase in demand for Chinese non-tradable products. It is a fact that the production of services (which are largely non-tradable) is more labor-intensive than is manufacturing. Thus the supporters of rapid Chinese growth through a highly undervalued exchange rate have it exactly backwards: their strategy is inimical to the rapid absorption of surplus labor into productive modern-sector employment. Payments adjustment pursued with a properly balanced strategy embracing both revaluation and demand rebalancing (i.e. expansion in the Chinese case) would increase rather than decrease the absorption of surplus labor.

I would not claim that the case for thinking that payments adjustment to a less unbalanced level would be in the interest of the present surplus countries is as clear for all other countries as it is for China. The most difficult case among the major countries is without doubt Japan. Certainly when Japan was mired in hopeless recession, in the late 1990s and early 2000s, adjustment would have risked imposing a waste of real resources that would have benefited no one. The case is now less clearcut, given that Japan's real GDP has grown quite rapidly for the last several years, but there is still no scope for a major fiscal expansion in Japan. It seems wrong to absolve Japan of all responsibility for adjustment, but right to allow it a rather less demanding pace of adjustment than other major surplus countries.

Almost all, perhaps all, the oil-exporting countries are currently with large current account surpluses, in the case of the Gulf countries in massive surplus. But unless one takes the view that the oil price is near or below its trend path, this seems quite reasonable. If the oil price is abnormally high, they need to save now as part of a strategy to even out their expenditure over the cycle, and in cases of limited domestic investment possibilities they need also to save abroad as part of an optimal accumulation strategy. One may legitimately complain about the lethargic pace of adjustment in most oil-exporting countries, which results from the fact that the pace of spending increases only when government spending can be ramped up, but at this stage that leaves little additional scope for deliberately engineering adjustment.

Since Germany is also a major surplus country at the moment, the question is sometimes posed as to whether it too should be expected to implement decisive expansionary actions. My answer to that is in the negative, because payments adjustment generally requires an appropriate combination of exchange rate change and demand change, not just one or the other. (I once quipped that those who believed that adjustment requires just fiscal policy are believers in immaculate adjustment.) And Germany now lacks a separate exchange rate, since it is a part of the euro area. The question that should be asked is whether the euro area as a whole needs payments adjustment, and the answer is no. The German surplus is essentially offset by the Spanish deficit. Imbalances within a monetary area are not phenomena for policy to eliminate.

There is no general proposition according to which surplus countries should be required to adjust simply because they have a surplus. The aim should be to have countries aim for a payments balance that can expected to enhance their welfare. It is conceivable that welfare-maximization would lead to a general desire to avoid deficits, or at least to a net desire for surpluses in the world as a whole. One would normally expect this to be remedied by a lower interest rate, which would stimulate spending and curb saving in many countries. There would only be a problem of global inconsistency if a net desire for surpluses persisted at any positive interest rate. The most likely origin of this problem would be if the oil price were very high and expected to remain high for a long but not indefinite period. Most of the oil exporters would then see a national advantage in saving much of their oil revenue, while most of the oil importers might then wish to shift the deficit on to other countries. (This was in fact the scenario envisaged by the Committee of Twenty after the oil price increase of 1973, though things turned out not to be so drastic.) But at present it is quite unpersuasive to argue that there are not surplus countries that could benefit their citizens by expanding their demand enough to eliminate any question of demand deficiency. It is not in fact difficult to envisage a pattern of global current account imbalances that would be both globally consistent and compatible with a major and sustained cut in the US current account deficit (Williamson 2007).

Concerting Adjustment Policies

Suppose one agrees that it is a gamble to rely on a continuing US deficit indefinitely, since there is a danger of a collapse of confidence rather than an orderly adjustment at the end of the day. Suppose one agrees also that there are countries that could advantageously—to themselves—move toward a deficit in the current account, and that there is no problem of inconsistency in payments objectives. But there is a third bow to the string of the do-nothing school: a belief that it will be impractical to organize a simultaneous policy change on the part of a large number of countries, so that it is preferable to live with what we have at the moment rather than to attempt a concerted adjustment that is doomed to fail.

Let me start by agreeing that it would be possible for half the adjustment to be worse than no change. The matter is no longer quite as clear since there is a chance that the pressure of demand is spontaneously declining, but a few months ago I would certainly have held that a dollar devaluation unaccompanied by contractionary US fiscal policies to make room for an improvement in the balance of payments would simply have led to some combination of higher interest rates and faster inflation. Similarly, a substantial renminbi appreciation without demand expansion would have led to a waste of resources and a tendency toward world recession. It is indeed important that countries implement the whole of the policy package that is being prescribed, not just a half of it.

I also agree that the major institutional form that cooperation has taken in the past, the Group of Seven countries, is outmoded. It excludes one of the major essential partners in any future adjustment effort, namely China. All the G7 can do about China is lecture it,

which it regularly does but which has proved as ineffective as might have been expected. No proud country like China is going to adjust its policies in response to the calls of a group from which it is excluded.

Nevertheless, we need to recognize that the last Managing Director of the IMF created exactly the right type of group for negotiating these matters. The "multilateral consultations" that he organized under an IMF umbrella contained the right countries (the United States, Euroland, China, Japan, and Saudi Arabia) in the right context and were given the right agenda. They were expected to report back to the IMF Board, which gave any other interested party the opportunity of participating in a joint policy adjustment. It also gave other countries the opportunity of reacting to the proposals of the inner group, and it offered the opportunity of seeking to organize a wider policy adjustment if that were judged to be necessary. The error was for the MD to declare himself satisfied with the communiqué they produced, which sounded like a typical G7 communiqué in essentially declaring that everything would turn out just fine if only they kept on doing exactly what the participants had been doing all along. The opportunity to negotiate a joint and simultaneous policy change was lost.

An Organized Adjustment versus Laissez-Faire

What is necessary is to create the next multilateral consultation with essentially the same group of countries, but with two crucial differences. The first is that the new Managing Director of the Fund must not be so easily satisfied with the outcome. The second difference concerns the US attitude. Rather than taking the position that its role is solely that of demandeur, asking policy adjustments of other countries but taking the view that a fiscal deficit of 1.2% of GDP at the peak of the boom and a "strong dollar" with a floating exchange rate entitles it do nothing, it needs to show a willingness to make some policy adjustments itself. Between one and four of the other participants in the multilateral consultation in fact regarded a tighter U.S. cyclically-adjusted fiscal policy as the key policy change required to initiate comprehensive adjustment, and to exclude that policy change from consideration was to doom the negotiations from the start.

If and when the United States shows a willingness to engage in genuine negotiations, the MD should convene a second multilateral consultation. The essential nature of the bargain that should be negotiated is clear enough (it was outlined in a workshop held at the Peterson Institute last February). First, it needs to embrace both levels of demand and exchange rates, rather than relying on either one or the other to carry the whole burden of adjustment. Second, unless the repercussions of the financial turbulence are already plunging the world into recession (which is not at this stage clear), global demand needs to be broadly unchanged. Demand contractions in some areas (specifically, the United States) need to be offset by demand expansions in other areas (specifically, in East Asia). Third, the exchange rates of some areas—most of the currencies of East Asia, though perhaps not those of Korea and Thailand since their currencies have already appreciated like many non-dollar currencies in other parts of the world—need to appreciate both overall (in effective terms) and bilaterally against the

dollar. Fourth, insofar as other non-dollar currencies are managed (and one would expect the merits of using intervention policy more actively to be a subject for negotiation), they should aim at keeping their effective rates broadly unchanged even though this may entail further bilateral appreciation against the dollar.[2] The time horizon over which these changes are to take place would be a subject for negotiation: if I were a non-East Asian participant I would start off by seeking rather rapid adjustment, but would settle for something that China and Japan felt they could live with, as long as that did not entail waiting for godot.

Once the outlines of such an agreement had been reached in the multilateral consultation exercise, it would be necessary for the participants to negotiate supporting agreements with their peers who are not in the negotiating group. This is really an issue for East Asia, since although it might potentially arise elsewhere (like Europe, the Middle East, or Australia) these areas are not expected to adjust their demand policies and (except for the Middle East) their exchange rates float fairly freely. Presumably one would look to China and Japan to convene a group which would essentially place the East Asian countries in three groups: those that would appreciate along with China and Japan (my candidates would be Hong Kong[3], Malaysia, Taiwan, and Singapore); those that would hold their effective rates broadly constant (Korea, Thailand); and an intermediate group that would depreciate against China but accept an effective appreciation (Indonesia, Philippines). It is of course important to realize that for all countries, especially those in the first group, the effective appreciations would be much less than the bilateral appreciations against the dollar precisely because of the simultaneous adjustment of competitor currencies. Changes in demand policies might also be discussed, with countries appreciating in effective terms being expected to offset the deflationary impact of this on the rest of the world by demand expansion, except insofar as they were already suffering from excess demand.

The multilateral consultations exercise might also cover some complimentary issues. For example, there would be much to be said for establishing some international discipline on what used to be referred to as “jawboning” and has now been dubbed “verbal intervention”. These are official expressions of hope about where exchange rates ought to be heading that are presumably intended to influence markets, in the same way that currency intervention is undertaken with the intent of influencing where the exchange rate goes. There is no question that this is not always an effective weapon: to convince oneself of that it is not necessary to think beyond the recent declarations of Secretary Paulson’s faith in a strong dollar, after which the dollar proceeded to hit record lows against most non-Asian currencies. At the same time, econometric evidence (Fratscher 2004) suggests that verbal intervention sometimes has an effect. It may not be

---

[2] At the time of the Peterson Institute workshop in February 2007, the euro stood at about $1.30. Our formula at that time was for non-dollar currencies outside of East Asia to seek to hold effective rates broadly constant but to accept bilateral appreciations against the dollar. Since then these currencies have already experienced substantial dollar appreciations but have not as yet had depreciations against the East Asian currencies, so they can now be expected to accept smaller appreciations against the dollar and seek somewhat more competitive effective exchange rates.

[3] Yes, that would mean scrapping the currency board. Good riddance: it long ago outlived its usefulness.

a reliable instrument, but it is a policy instrument, and it needs to be used consciously and with an agreed international objective in mind.

The first principle of rational use of verbal intervention is that governments favor equilibrium exchange rates, rather than always expressing themselves as being in favor of strong or weak rates. Where they wish to see a rate heading depends on where it is relevant to a plausible estimate of equilibrium. It would yield an even greater gain for popular understanding if the press could be persuaded to adopt this position too.

Obviously such a formula is of limited use without an agreed view on equilibrium rates. No one expects governments or the IMF or anyone else to agree exact rates with high margins of precision, but positions of complete agnosticism are equally absurd. Exchange rates that get seriously out of line with fundamentals are recognizable, and they are damaging. No one should be forced to push rates exactly to estimates that will always be rough and uncertain, but there would be advantages in agreeing a pattern of what the official sector believes to be approximate equilibrium rates.

An advantage in the present context is that it would provide a basis for disciplining verbal intervention. Specifically, statements of where a currency ought to be heading would be allowed if they were tending to push a currency toward its equilibrium (measured in effective, not bilateral, terms), but they would be prohibited if they were trying to push a currency away from what had been internationally accepted as a rough estimate of equilibrium. No country would be *forced* to take any exchange rate actions at all, but they could at least be prevented from making situations worse.

A second area where there is scope for the exercise of multilateral consultation to yield an outcome that might benefit the world economy concerns the pegging policy of the Gulf oil producers. At present all except Kuwait peg firmly to the dollar, while Kuwait pegs to a basket with a large dollar weight. Intellectually this makes no sense. The United States imports oil, so any systematic variation in its currency or its monetary policy is unlikely to favor oil exporters. In order to avoid delays while governments change spending in reaction to oil price increases (or decreases, though we have nowadays forgotten that oil prices may sometimes fall) and thus accelerate adjustment, it would make sense for these countries to peg their currencies to a basket that varies along with the price of oil. The most certain and straightforward way of doing this is to peg to a basket that is one-half or two-thirds composed of the major currencies with the balance comprising the price of oil (Setser 2007).

If the Saudis were persuaded of the virtues of such a change in the multilateral consultation, it would then be necessary for them to consult the smaller Gulf countries, in the same way that was earlier outlined for China and its smaller East Asian neighbors.

Concluding Remarks

But both verbal intervention and the pegging policy of the Gulf are essentially sideshows. The essence is negotiation of multilateral adjustment as described earlier. Such a negotiation does not seem infeasible, at least with a US willingness to contribute. It presents no obvious dangers: if it runs into the sands, we are no worse off than under the present drift. It is fallacious to argue that we face a problem of irreconcilable national interests. That it would be preferable to present arrangements, which seem to me well-described by the term “drift”, is clear to anyone who accepts that there is a significant probability of the world running into disaster. To repeat, I do not believe that there is a *certainty* of disaster under present trends, but the *likelihood* seems quite high. This is by no means the first time that we have been regaled by assurances that the world has changed and this time it is different, and even if it turns out that these assurances are as misplaced as they have always proved in the past they will doubtless be repeated many times in the future. Maybe one day they will prove true. Let us hope that this is the time, for I confess that I am not optimistic about a negotiated adjustment.

References

Aguirre, Alvaro, and César Calderón. 2006. The Effects of Real Exchange Rate Misalignments on Economic Growth. Santiago: Central Bank of Chile. Mimeo.

Bhalla, Surjit. 2007. There Are No Growth Miracles. Mimeo.

Cooper, Richard N. 2007/8. Understanding Global Imbalances. *Brookings Papers on Economic Activity*, forthcoming.

Dooley, Michael, David Folkerts-Landau, and Peter Garber. 2003. *An Essay on the Revived Bretton Woods System*. NBER Working Paper 9971.

Fratscher, Marcel. 2004. Exchange Rate Policy Strategies and Foreign Exchange Interventions in the Group of Three Economies. In C.F. Bergsten and J. Williamson, edds., *Dollar Adjustment: How Far? Against What?* (Washington: Peterson Institute.)

Houthakker, Hendrik, and Stephen P. Magee. 1969. Income and Price Elasticities in World Trade. *Review of Economics and Statistics*, 51, pp. 111-25.

Rajan, Raghurajan, Arvind Subramanian, and

Razin, Ofair, and Susan M. Collins. 1999. Real Exchange-Rate Misalignments and Growth. In A. Razin and E. Sadka, eds., *The Economics of Globalization: Policy Perspectives from Public Economics*. Cambridge: Cambridge University Press.

Rodrik, Dani. 2007. Is Undervaluation Good for Growth: Theory and Evidence. Mimeo (on http://ksghome.harvard.edu/~drodrik/papers.html).

Setser, Brad. 2007. *The Case for Exchange Rate Flexibility in Oil-Exporting Countries.* Policy Brief no. __. (Washington: Peterson Institute.)

Williamson, John. 2007. The Target Current Account Outcomes. Paper presented to the Bruegel/KIEP/Peterson Institute workshop on the Global Imbalances in Washington, Feb.