ONE of the principal dangers currently facing the world economy arises from the large and unsustainable imbalances in current account positions. Some observers argue that these imbalances will unwind gradually and non-disruptively, while others emphasise the risks of a sudden change of sentiment in financial markets that could result in an abrupt and damaging adjustment. No one knows which scenario will materialise, but a priority for policymakers should be to reduce the risks of a crisis that could produce a world recession and disruptions to the global trading system. For that, the global economy requires official sponsorship of a credible and comprehensive adjustment programme. This policy brief outlines what such a programme could look like.

Bruegel, the Korea Institute for International Economic Policy, and the Peterson Institute for International Economics held a joint workshop including about 30 of the world's leading experts on how to achieve such an orderly reduction in global imbalances in Washington DC on 8 and 9 February 2007. The purpose of the workshop was to compare analyses and evaluations of the requirements for an adjustment of this type. The discussions centred on two sets of contributions: (1) country papers that provided a perspective on the underlying factors behind surpluses and deficits and the scope for adjustment in the current account, and (2) multi-country simulation papers that produced estimates of the changes in policy variables and the corresponding exchange rate adjustments that are consistent with scenarios for a reduction in current account imbalances.

This policy brief reports the results of the simulation papers and summarises the main policy conclusions that we draw from the analyses presented at the workshop. On the basis of the discussions, we outline in Section 1 reasons why the current situation is unsustainable. Adjustment must take place and will require significant movements in exchange rates. Section 2 argues that adjustment induced by policy actions is more likely to be orderly than one initiated by financial markets. We view the current stalemate regarding policy actions as dangerous, as financial market participants are likely to change their minds at some stage about the sustainability of imbalances unless they see that the main players are able to agree on the direction of desirable policy changes. Section 3 presents estimates of the exchange rate implications of global current account adjustment from a variety of models. Section 4 describes the policy implications that the authors of this policy decline in the foreign exchange value of the dollar over recent years has boosted the dollar equivalent of foreign assets, thereby reducing US net foreign liabilities as measured in dollars. As a result, the increase in US net foreign liabilities over the past few years has been considerably smaller than the cumulative current account deficits[4].

Nevertheless, the current pattern of global imbalances is not sustainable. Medium-term projections by the IMF indicate that at unchanged real effective exchange rates, large current account imbalances will

[4] For comprehensive data on the valuation effects, see Philip Lane and Gian Maria Milesi-Ferretti *The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970-2004,* IMF Working Papers 06/69, (Washington: International Monetary Fund, 2006).

[5] See, for example, Maurice Obstfeld and Kenneth Rogoff, Global Current Account Imbalances and Exchange Rate Adjustments, *Brookings Papers on Economic Activity*, 1, pp. 67–146 (Washington: Brookings Institution, 2005).

been getting vocal about the yen. Yet the issue of adjustment has a multilateral character. Thus, a multilateral institution or forum, such as the one convened by the IMF or possibly an informal Group of Four (US, euro area or the European Union, Japan, and China), would seem to be the appropriate venue to deal with it.

There is a large degree of convergence in the economic interest of the key players:

- The US needs to bring its current account deficit down to an acceptable level and this will require a significant effective depreciation of the dollar and higher US national saving.
- China needs to curb its accumulation of foreign exchange reserves, rebalance growth towards domestic demand, and continue removing distortions that favour exporting industries.
- Although Japan's weak exchange rate and ultra-low interest rates have been instrumental in countering deflation, economic recovery now permits the return of monetary policy and the exchange rate to a more neutral stance.
- Europe's currencies have already appreciated substantially both against the dollar and in effective terms. For Europeans, the priority is to

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[6] See, *Economic Forecasting for 2007*, (Korea Development Institute, December 2006), and *2007 Economic Forecasting* , (Samsung Economic Research Institute, November, 2006).

[7] Paul Krugman, 'Will There Be A Dollar Crisis?' Paper presented at the Economic Policy Panel at the Federal Reserve Bank of New York, 12 February 2007, available at www.cepr.org.

Table 2

Bilateral real exchange rate change against the U.S. dollar consistent with the REER movements in Table 1 (percent change; + implies appreciation)

	Japanese yen	Chinese RMB	Euro
Martin Baily	n.e.	n.e.	n.e.
Ray Barrell, Dawn Holland and Ian Hurst	+24	+18	+16
Bill Cline (a)	+28 to +39	+31 to +44	+20
Thomas Stolper and Monica Fuentes (b)	+25	+10	+15
Ronald MacDonald and Preèthike Dias	n.e.	n.e.	n.e.
Chris Erceg	[redacted]		

the dollar of between 10 and 20 percent from the current level is needed to shrink the U.S. current account deficit to 3 percent of GDP over the next few years.

- To reduce the Japanese current account surplus to levels specified in the scenarios (that is, to between $36 billion and $54 billion, depending on the scenario, from $167 billion in 2006), the models typically find that a real effective appreciation in the yen of between 10 percent and 15 percent is needed. This movement requires a 25 percent to 30 percent real appreciation of the yen vis-à-vis the dollar, moving the exchange rate to around 90 yen/dollar compared with roughly 118 yen/dollar today[13].

- The workshop produced a fairly wide range of estimates for the required movement in the Chinese renminbi. This uncertainty in part reflects the difficulty of estimating precisely the sensitivity of Chinese exports and imports to exchange rate movements[14]. Effective appreciation of between 5 and 25 percent was calculated to be required to reduce China's surplus by between roughly 3.5 and 6.5 percentage points of GDP (with the low end of the range being accompanied by an expansion of domestic demand in China that more than compensated for the loss of foreign demand). As in the case of the Japanese currency, this strengthening of the renminbi in effective terms implies a substantially larger bilateral appreciation against the dollar.

- Since the scenarios assume a roughly unchanged current account deficit in the euro area, little or no change in the effective value of the euro is needed. As the models find that the euro depreciates against the Asian currencies, a stable effective euro implies a marked bilateral appreciation of the euro vis-à-vis the dollar to between $1.45 and $1.50 per euro compared with about $1.32 today.

To summarise, the model estimates presented at the workshop placed the order of magnitude of effective depreciation of the dollar needed to bring about the targeted adjustment at around 15 percent. Effective appreciations of around 10 percent for the yen and 15 percent for the renminbi would provide part of the counterpart. To bring about these effective exchange rate movements, much larger bilateral appreciations against the dollar would be required, of maybe 25 to 30 percent for the yen and 30 percent for the renminbi. But there will also be a need for substantial bilateral appreciations against the dollar by currencies whose effective exchange rates do not need to change. In particular, the euro would need to strengthen to at least $1.45 per euro, while sterling would rise to well over $2 per pound.

Finally, although the primary focus of the workshop was on the currencies of countries taking part in the IMF multilateral talks, currencies of other economies running large external surpluses would also need to appreciate on an effective basis in order to meet the targets for correcting global imba-

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[12] We exclude from the comparisons estimates that do not meet the specifications of the scenario. Estimates from Bénassy-Quéré, Lahrèche-Révil and Mignon, as well as those of the GSDEER approach of Stolper and Fuentes, did not examine what exchange rate changes would be required to meet the 3 percent of GDP target for the US current account deficit specified in the workshop terms of reference. Both found surprisingly that the dollar was undervalued, implying that those models find financial markets to be comfortable with a persistent US current account deficit much higher than this target, at least for an extremely long period. Both models are subject to the possible problems noted in box 1 (third approach). Moreover, the alternative elasticities model estimated by Stolper and Fuentes produced results more in line with those of the other papers.

[13] The implied yen/dollar figure assumes that most of the required movement in the real bilateral exchange rate comes about through a change in the nominal exchange rate.

lances specified in the workshop scenarios. Otherwise US external adjustment would fall below target. The combined role of the smaller surplus economies in Asia and Europe (outside of the euro area) in the adjustment process will be more important than either China or Japan[15]. This consideration illustrates once again the multilateral nature of the adjustment problem, which to date has arguably been addressed with an excessive emphasis on just one facet: the US-China relationship.

4. POLICY CHOICES

The authors of this brief draw the following policy implications:

- With the US economy currently operating close to full employment, adjustment requires a rate of growth in US domestic demand below that of output over coming years to prevent

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[14] The time series of data on Chinese exports and imports is relatively short. In addition, the enormous structural changes that the Chinese economy has undergone over the past decade complicate econometric estimates of China's trade elasticities. Generally, the more sensitive to exchange rate movements that China's trade is estimated to be, the less appreciation of the renminbi is needed.

[15] For four East Asian economies (Hong Kong, Malaysia, Singapore, and Taiwan) and four European economies (Norway, Sweden, Switzerland, and Russia) with large current account surpluses, the combined weight in the Federal Reserve's broad real exchange rate index for the dollar amounts to 13.2 percent, higher than that of either China (11.3 percent) or Japan (10.5 percent).

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[16] Pre-1999 calculation uses the value of a synthetic euro based on the value of its legacy currencies.