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Should there be a coordinated response to the problem of global imbalances? Can there be one?

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Abstract

This paper analyzes the options for international policy coordination in order to redress the global imbalances. The case for policy coordination rests on a number of assumptions such as the existence of important spillover effects of national policies and a common understanding of the nature of the problem. In reality, important obstacles exist to get to effective policy coordination, including resistance from domestic interest groups and disagreement of the effectiveness of policy instruments. These obstacles can be reduced by developing a multilateral consensus on common goals and by addressing commitment problems via issuing multi-year schedules for policy adjustments.

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Should There Be a Coordinated Response to the Problem of Global Imbalances? Can There Be One?¹

Barry Eichengreen

Introduction

The problem of global imbalances continues to loom over the world economy. Although global growth was robust again in 2006, the U.S. current account deficit widened from its already high levels, raising questions about its sustainability. If the U.S. deficit is not sustainable, then foreign financing for it will dry up sooner or later.² Since the country's deficit will then have to be compressed, its saving will have to rise, meaning that consumption falls, or else investment spending will have to decline. Higher interest rates, reflecting falling foreign demand for U.S. debt securities, will be the mechanism bringing about this adjustment. The slowdown in the growth of U.S. spending could then mean a demand and growth slowdown for the rest of the world. The one thing that could keep the U.S. out of recession would be if the fall in the dollar encouraged additional foreign demand for American exports. But even this would not be good news for the rest of the world, since it would imply real exchange rate appreciation, the intensification of import competition, and greater difficulty of exporting to the United States.

This scenario has motivated calls for action before the U.S. deficit widens further and the country's foreign debt/GNP and foreign debt/export ratios significantly exceed current levels. Better, in this view, would be steps to gradually narrow the deficit starting now, thereby averting the danger of an abrupt fall in the availability of foreign finance and a sharp, disruptive adjustment. The U.S. could raise taxes or cut government expenditure to boost public savings. It could raise interest rates more sharply or take other public policy measures to encourage higher private savings.

The difficulty with this set of recommendations is that measures to narrow the U.S. deficit by slowing the growth of consumption and investment demand will mean slower growth for the country and slower growth also for the world insofar as there is a fall in America's demand for imports. The corresponding solution is policy adjustments in other countries. Asian countries with current account surpluses can boost domestic spending by raising government outlays on health care, education and rural infrastructure.³ They can encourage household spending by spurring the development of markets for consumer and mortgage credit. European countries can redouble their efforts at structural reform; insofar as this resulted in faster growth and improved consumer confidence, demand in Europe would strengthen as well.⁴ Because the slowdown in demand growth in the U.S. would then be matched by an acceleration of demand growth in other countries, the level of demand worldwide will remain unchanged. In this scenario, growth in other countries no longer suffers as a result of more slowly growing demand in the United States. And, in turn, production in the United States is sustained, despite the slowdown in domestic demand, by increased demand from abroad.

1 This paper was prepared as a background study for United Nations, *World Economic Situation and Prospects 2007* (Sales No. E.07.II.C.2; <http://www.un.org/esa/policy/wess/wesp.html>).

2 The "if" in this sentence is significant, as we will see below.

3 Doing so has already been accepted as an objective of the authorities' most recent Five Year Plan.

4 It is sometimes argued that insofar as Europe is not the source of global imbalances—it has not seen policy adjustments giving rise to large surpluses—it need not play a role in their resolution. The counter-argument is that Europe has a stake in the orderly resolution of the current problem, and in particular in seeing that global demand growth is maintained at the same time U.S. demand growth slows (for discussion see Ahearne and von Hagen 2005).

With demand in the rest of the world rising relative to demand in the United States and each region spending disproportionately on its own goods, there will have to be some rise in the price of foreign goods relative to U.S. goods. In other words, there will have to be an adjustment of the real exchange rate between the dollar and other currencies (other currencies up, the dollar down). In this scenario, then, the exchange rate adjustments that are the most contentious aspect of the adjustment are simply the market's response to these complementary policy initiatives.

Unfortunately, each of these policy changes is likely to be unattractive to the countries concerned if taken in isolation. Narrowing the U.S. deficit by slowing the growth of consumption and investment demand will mean slower growth, something that Americans would not see as congenial. Similarly, narrowing current account surpluses in China and other surplus countries by stimulating public and private saving will aggravate the risk of overheating and fan inflation if undertaken in isolation. Only if U.S. policies to slow the growth of spending are accompanied by policies in other countries to stimulate the growth of spending will these adjustments appeal to the countries concerned.

These observations have prompted calls for the international coordination of economic policies to facilitate the orderly adjustment of global imbalances while at the same time maintaining global growth. Examples include the idea of a "grand bargain" (Buirra and Abeles 2006), proposals for a "new Plaza Agreement" (Cline 2005), and calls for a "coordinated response" on the part of systemically important countries (Group of 24, 2006). Cline's version is representative. He argues that there is the need for an initiative comparable to the 1985 Plaza Agreement to be undertaken by the G-20 group of industrial and emerging-market economies.⁵ The United States would set forth credible plans for eliminating its fiscal deficit over five years. U.S. trading partners would agree to allow their currencies to rise against the dollar. Countries that have been intervening in foreign exchange markets to prevent their currencies from appreciating would pledge to stop doing so. The Bank of Japan and the European Central Bank, which have not been intervening, could pledge to sell dollar reserves. The International Monetary Fund would provide advice on how much fiscal adjustment and currency realignment is required.⁶

The analogy with the 1985 Plaza Agreement is direct.⁷ (See also Box 1.) Then, too, the U.S. was running budget and current account deficits, and commentators warned that the dollar's level against foreign currencies was unsustainable (Krugman 1985). Current account imbalances fueling protectionist sentiment in the United States jeopardized the maintenance of an open trading system. In September 1985 the finance ministers of the five largest industrial countries (France, Germany, Japan, the United Kingdom and the United States) therefore met at the Plaza Hotel in New York and agreed on a package of coordinated policy adjustments designed to encourage currency and current account adjustment.⁸ The United States pledged to tighten its fiscal policy, while Germany committed to cut taxes and Japan agreed to stimulate domestic

5 The G-20 is made up of finance ministers and central bank governors from 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United King and the United States, plus two European Union representatives (the president of the Council and the president of the European Central Bank).

6 A problem with Cline's variant, which will be evident in light of the preceding, is that it does not include measures, fiscal or other, to directly stimulate spending outside the United States.

7 A comprehensive analysis of the Plaza Agreement is Funabashi (1989).

8 In March 1973, in an effort to foster cooperation in managing the problems created by the breakdown of the Bretton Woods System, U.S. Treasury Secretary George Shultz invited the German, French and British finance ministers to an informal meeting at the White House. Japan's finance minister was invited to join subsequent meetings, giving rise to the Group of Five. Summits followed once Schmidt and Giscard became heads of their respective governments; Italy was invited to attend in 1975 and Canada was invited in 1976, giving birth to the Group of Seven.

BOX 1

The Plaza Agreement

The Plaza Agreement of 1985 is a widely-cited precedent for current efforts to arrange a coordinated response to the problem of global imbalances. In 1985, as today, observers pointed to the twin budget- and current-account deficits of the United States as a source of global imbalances, and there were worries that the dollar would have to fall significantly in order to return the international accounts to sustainable levels. (By early 1985 the greenback had risen by some 80 per cent from the beginning of the 1980s.) Surging U.S. imports and the competitive difficulties of U.S. manufacturing industries, the automotive industry in particular, also raised the specter of a protectionist backlash, fanning fears for the maintenance of an open trading system.

But exchange rate adjustment without the adjustment of underlying policies was unattractive. Pushing the dollar down without at the same time taking steps to adjust the level of American spending threatened to fan inflation without bringing about current account adjustment. At the same time, implementing measures to reduce U.S. spending without simultaneously stimulating spending abroad only promised to depress global demand. But for other countries, adopting policies of domestic demand stimulus without the accompanying consolidation of demand in the United States was unattractive.

These realizations led finance ministers and central bank governors from the G5 countries, the United States, Japan, West Germany, France and the UK, to assemble at the Plaza Hotel in New York in September 1985. (On the origins of the G5, see footnote 8 in the text.) The U.S. committed to cut its budget deficit, while Japan promised to loosen monetary policy and accelerate financial-sector reforms, and Germany agreed to implement tax cuts. France, the UK, Germany and Japan agreed to raise interest rates while the United States cut its, in order to place downward pressure on the dollar. Concerted intervention in the foreign exchange market was agreed in order to propel the dollar downward.

The results were mixed. The aftermath of the meeting was marked by a sharp fall in the dollar, which by the end of 1987 amounted to 50 per cent against both the Japanese yen and the German deutschmark, relative to the currency's early 1985 peak. Although the United States did not follow through on its commitment to strengthen the budget balance, the fall in the currency, combined with foreign stimulus, was still sufficient to enhance U.S. export competitiveness and crowd in additional foreign sales, slowing the growth of the U.S. current account deficit. But that the decision to intervene in foreign exchange markets was the source of dollar adjustment is uncertain; the dollar had already begun falling some six months before G5 officials assembled in New York.^a And as that fall accelerated, worries mounted about its adverse effects on inflation in the U.S. and loss of competitiveness in other industrial countries. Ultimately officials were led to assemble again, this time in Paris in late 1987, to negotiate another accord, this time to stabilize the dollar.

The 1933 World Economic Conference

The 1933 World Economic Conference (see Eichengreen and Uzan 1993) is another episode revealing of the obstacles to international policy coordination. Officials assembled in London at the trough of the Great Depression to address problems of deflation, exchange rate instability, tariffs, and external debts. By early 1933, the value of world trade had fallen to less than 60 per cent of 1929 levels, reflecting the collapse of demand, falling prices, tariff increases, and the depressing effects of exchange rate instability. In most countries, prices had fallen sharply for three years, and competitive depreciations had transmitted deflation internationally. In a number of countries, above all Germany, external debts that had been rendered unsustainable by the collapse of production and trade, and in many cases they had negotiated or unilaterally imposed moratoria on payments with adverse effects on their financial systems and those of the creditor countries.

^a Frankel (1994) suggests that this earlier fall might be attributed to the Plaza regime more generally, insofar as it reflected concerted intervention by the U.S. and German monetary authorities in March-April 1985 and the accession to the U.S. Treasury of the more intervention-minded James Baker and Richard Darman.

BOX 1 (cont'd)

The 1933 World Economic Conference was an effort to acknowledge the interdependent nature of these problems and negotiate a coordinated response. The “grand bargain” that lay behind the decision to assemble governments in London would have entailed stabilizing exchange rates to reduce uncertainty, reducing tariffs to rebuild trade, and negotiating an orderly resolution of debt problems to eliminate the debt overhang that destabilized financial markets and depressed investment.

The United States was a key player in these negotiations: without willingness on its part to stabilize the dollar, reduce tariffs, and forgive foreign debts, negotiations could go nowhere. But neither was it attractive to the United States to offer concessions in the absence of a commitment on the part of other countries to do likewise. Dollar stabilization would only aggravate U.S. deflation if other countries continued to devalue competitively. Reducing tariffs would only weaken the country’s bargaining leverage in the absence of a more general tariff truce. And forgiving foreign debts – where the U.S. was the principal international creditor – looked unattractive if the country got nothing in return. Hence the key at London was to attempt to arrange an agreement between the United States and other countries.

In the event, no agreement was reached. Two obstacles, not unlike the obstacles to reaching a coordinated solution to global imbalances today, proved insurmountable. First, different countries adhered to different conceptual models of the causes of the depression. France saw it as reflecting the unwillingness of countries to play by the rules of the gold standard game, whereas the United States saw it as the result of the perverse operation of the gold standard itself. Thus, where the French saw exchange rate stabilization as essential for economic stabilization, the U.S. saw abandoning fixed exchange rates as a precondition for restoring stability and growth. These different interpretations reflected the two countries’ respective historical experiences. Efforts by opinion leaders to bridge this interpretative gap fell short under the circumstances.

Second, domestic interest groups opposed policy adjustments that might have rendered the country as a whole, and the world, better off. In France, tariff reductions were opposed by powerful agricultural interests suffering from the effects of low farm-gate prices. In the U.S., well-organized financial interests opposed debt writedowns that might have helped to jump-start investment. And the general economic situation, which was one of depressed macroeconomic conditions and severe fiscal problems, prevented use of the budget to make the requisite side payments.

spending by reforming its tax system. All five countries committed to intervening in the foreign exchange market to reduce the value of the dollar. The dollar fell by 4.3 per cent against the other major currencies on the day following announcement of the agreement. From there the greenback continued falling and the U.S. current account deficit began to narrow, until officials sought to stabilize exchange rates at their new levels by negotiating, in early 1987, another such agreement, the Louvre Accord.

While this episode is widely invoked in support of efforts to cooperate in correcting global imbalances, this history also raises troubling questions. For one thing, there was no mechanism to bind governments to their commitments, and not all the policy adjustments agreed to at the Plaza were ultimately carried out. The dollar had actually begun falling several months before the agreement was negotiated; thus, it is not clear that the subsequent policy adjustments were necessary or, for that matter, responsible for contemporaneous currency adjustments.⁹ No sooner did governments begin pushing the dollar down than the process showed signs of getting out of hand. Indeed, it was fears that excessive dollar depreciation was fan-

⁹ Here, inevitably, there is a problem of imagining the appropriate counterfactual. One can imagine, for example, that the dollar might have begun rising again in the autumn of 1985 had there not been an agreement at the Plaza on coordinated policy adjustments; this would lead the proponents of currency adjustment to a more positive assessment of the agreement.

ning inflation in the U.S. and creating problems for its trading partners that led to the Louvre Accord two years later. Finally, it has been argued that the Plaza, together with subsequent efforts at policy coordination, had unfortunate side effects; in particular, excessive stimulus to the Japanese economy led to the financial bubble that burst subsequently, consigning the economy to a decade of depression.¹⁰

Moreover, the world has changed since 1985 in ways that complicate efforts to coordinate policies. Financial markets have grown, making it still more difficult to manage exchange rates. There are more systemically-significant countries—from China to India to Russia to Saudi Arabia—increasing the number and heterogeneity of countries that would have to be party to an effective agreement. Existing groupings, from the G3 to the G5 to the G7, G10 and G20, are less than ideally constituted to address current problems.¹¹ In addition, there is even less agreement about the nature of the problem and the design of an appropriate response than in 1985. All this suggests that coordinating an appropriate macroeconomic response will be, at the least, challenging.

These are the topics taken up in the remainder of this paper. Section 1 first analyzes the validity of the case for policy coordination. Section 2 next considers the obstacles to a coordinated response. Section 3 asks what can be done to surmount those obstacles. Section 4 then is a brief conclusion.

How Compelling is the Case for Coordination?

The current account imbalance between a country and the rest of the world—say, between the United States and its global partners—reflects policies and actions both at home and abroad. The easiest way of seeing this is by observing that a country's current account is the difference between its savings and investment and that the global current account discrepancy should equal zero.¹² The U.S. current account deficit is the excess of U.S. investment (I) over U.S. saving (S), while the surplus of the rest of the world is the excess of its saving (S*) over its investment (I*). From the balance-of-payments identity it follows that $S - I = S^* - I^*$. Immediately we see that a current account imbalance like that between the United States and the rest of the world is unlikely to reflect exclusively the actions of public- and private-sector agents on either side of the equation. Rather, domestic and foreign factors both contribute to the observed current account outcome. It follows that both domestic and foreign policy initiatives can contribute to its orderly resolution.

The case for international policy coordination rests on the assumption that each country or region's policy adjustments have cross-border effects accruing as non-pecuniary externalities to its foreign counterpart. For example, a decision by the United States to raise taxes or reduce government spending may have the direct effect of moving the U.S. current account deficit in desirable directions and U.S. growth in undesirable directions, but also the external effect of moving foreign current accounts in desirable directions and foreign growth rates in undesirable directions.¹³ Analogously, decisions in Asia to cut taxes or raise govern-

¹⁰ See Kuroda (2004) on these links between the Plaza and the bubble economy. The hypothesis that loose Japanese monetary policy was responsible for the bubble and, in turn, that the Plaza Agreement was responsible for loose Japanese monetary policy has been disputed; see Posen (2003). Similarly, it can be argued that the depressed decade that followed reflected less the legacy of earlier monetary policies than the difficulty of adjusting to the end of catch-up growth, population ageing, and delayed adaptation to the imperatives of the information-technology revolution.

¹¹ The problem with the G20, as we will see below, is not the omission of systemically significant countries but, to the contrary, its excessive inclusiveness and size.

¹² That it does not reflect statistical misreporting unless there is trade with other planets.

¹³ This assumes that the direct expenditure effects of the fiscal initiative (U.S. residents spend less, including on imported goods) dominate its financial effects (fiscal consolidation by the U.S. puts downward pressure on interest rates and leaves more savings to finance investment abroad). I return to this assumption below.

ment spending may have the direct effect of moving Asia's current account in desirable directions and Asian growth in undesirable directions, but also the external effect of moving both the U.S. current account and U.S. growth in desirable directions.¹⁴ One can well imagine that neither region will wish to adjust so long as these decisions are taken in isolation. In the U.S., policies that move the current account toward smaller deficit also move growth in undesirable directions, namely downward. In Asia, policies that move the current account toward smaller surplus again move growth in undesirable directions, namely upward, creating a risk of overheating. Assume that policy makers have chosen the level of fiscal effort that just balances the benefits of further fiscal improvement against the costs of further changes in growth, taking foreign policies as given. Then there will be no policy adjustments by either region in the absence of further shocks.¹⁵

Policy coordination has the potential to achieve superior outcomes by internalizing these externalities. Assume as before that the initial situation is one where the U.S. current account deficit (foreign current account surplus) is unusually large, but growth in both regions is at its optimal level. Then the mythical social planner would recommend a combination of less expansionary U.S. fiscal policy and more expansionary foreign fiscal policy. Negotiations between governments to coordinate these adjustments are a way of achieving this same welfare improvement in a world of sovereign nations.

Note, however, that this case for policy coordination rests on a number of strong assumptions.

First, there are significant nonpecuniary spillovers of national policies. That first-order spillovers exist is not universally agreed. Some authors (viz. Feldstein 1988) have expressed skepticism that domestic policies constituting the national optimum are not also the global optimum.¹⁶ The skeptics appeal to macroeconomic models in which spillovers are small.¹⁷ To some extent the small magnitude of estimated spillovers reflects the fact that international integration is still limited; thus, U.S. imports are only 14 per cent of U.S. GNP, where full integration would imply that U.S. imports as a share of U.S. GDP would instead equal one minus the U.S. share of global GNP, which would imply an import share more on the order of 80 per cent. Since the U.S. accounts for 25 per cent of global economic activity, a 14 per cent import share means that U.S. imports account for less than 4 per cent of the GNP of the rest of the world.¹⁸ To some extent it reflects the fact

14 The assumption that the adjustment of Asia's current account in the direction of balance would be desirable could be grounded in the observation that the region's large surpluses fan protectionist pressure abroad (as in the Plaza precedent) or that foreign inflows are increasingly difficult to sterilize and therefore inflationary. The assumption that fiscal stimulus by itself would have undesirable effects on growth could reflect fears of overheating, as noted above.

15 The "absence of further shocks" proviso is a way of suggesting that the situation described in the text is one of Nash equilibrium. That is, each government (or set of governments) takes the policies of its counterpart as given. Each player is assumed to be on its reaction function. And the system is assumed to have settled down at the intersection of the respective reaction functions.

16 This was also the conclusion of early Chicago-School models of flexible exchange rates, where it was assumed that optimal policy chosen in the presence of a flexible rate would allow a country to attain the first-best optimum. Typically, it was assumed that wages and prices were fully flexible, that foreign policy impulses were felt only through the trade balance, and that the current account could be treated with benign neglect. Clearly, these are not appropriate assumptions for the case at hand. Feldstein also argues that policy coordination initiatives may create an attention-deficit problem—that it may distract policy makers from the need for appropriate domestic policy responses.

17 There is some debate over whether the latest generation of policy coordination models (Obstfeld and Rogoff 2000, Corsetti and Pesenti 2001) strengthen or weaken the case. Cazoneri, Cumby and Diba (2001) suggest, not entirely surprisingly, that the answer depends on the size and correlation of shocks.

18 Of course, U.S. imports are a larger share of rest-of-world trade than they are of rest-of-world GDP. Cutting the U.S. current account deficit by half (i.e. by \$400 billion) would imply a drop in world trade by 5 per cent. How this would affect foreign economies depends on their trade exposure in general, their trade exposure to the United States in particular, and the magnitude of the associated multiplier effects.

that policy instruments can have offsetting effects neutralizing one another in the aggregate. For example, fiscal expansion will have the direct effect of stimulating the exports of neighboring countries but also the indirect effect of driving up global interest rates and thus limiting foreign absorption.¹⁹

Second, negotiators share a common understanding of the structure of the model (that is, of the structure of the world economy). Otherwise agreement on mutually beneficial policy adjustments may be difficult to achieve. Worse yet, adjustments in the name of policy coordination may result in macroeconomic changes in welfare-reducing directions.²⁰

Third, there do not exist additional distortions rendering otherwise be welfare-enhancing policy adjustments counterproductive. Rogoff (1985) has offered a famous example of counterproductive cooperation when monetary policy makers have a commitment problem—when they are tempted to inflate to drive up employment—and knowing this the private sector forms higher inflationary expectations, leading actual inflation to be excessive. In such a setting, the danger that the currency will depreciate in response to a monetary expansion helps to restrain the central bank. Correspondingly, an international agreement to stabilize exchange rates may only aggravate the situation.

Fourth, governments have the freedom and flexibility to adjust domestic policies as part of international negotiations. In practice, this is not always the case. Monetary policy is in the purview of the central bank, not the government that is typically party to international negotiations. This distinction matters importantly in an era of central bank independence. In democracies, fiscal policy is made not by executive fiat but requires the consent and sometimes the initiative of the congress. Adjustments may have to be negotiated not just internationally but domestically. Officials may be wedded to an ideology that prevents them from embracing the case for coordinated adjustments. In the 1980s, Ronald Reagan's economic advisors Donald Regan and Beryl Sprinkel were ideologically wedded to monetarism and laissez faire; the more activist approach required for international policy coordination had to wait on their replacement by the more pragmatic James Baker and Richard Darman. Similarly, in the current environment the ideology of tax cuts and the strategy of "starve the beast" make it more difficult for the U.S. to offer revenue enhancement as part of an international bargain. Politics and ideology thus may prevent a successful conclusion from being reached.

Fifth, there exists a mechanism to bind governments to their agreement. In the static Nash set-up that is the framework for textbook discussions of policy coordination, a government that is party to a cooperative policy agreement has an incentive to renege. Assuming no changes in foreign policies (the Nash assumption), it has an incentive to move back onto its reaction function. Equivalently, it has an incentive to announce its willingness to engage in coordinated policy adjustments, in the hope that other governments will do their part, without actually following through itself. As in other settings, sustaining the cooperative outcome will require repeated interaction, an outside mechanism for punishment in the event of renegeing, or something else to make commitments credible.²¹

Thus, significant preconditions must be satisfied before one can be confident that policy coordination is welfare improving and before there is reason to hope that effective coordination can be achieved.

¹⁹ The case analyzed in the introduction and earlier in the present section assumes, in line with most empirical macro-models, that the first channel dominates. But the fact that there may also exist a second countervailing channel leaves open the question of the magnitude of the net effect.

²⁰ Frankel and Rockett (1988) show that the danger of welfare-reducing policy adjustments is quite real when policy makers do not agree on the true model.

²¹ This commitment problem and mechanisms for solving it are discussed at length by Meyer, Doyle, Gagnon and Henderson (2002).

Obstacles to Policy Coordination

The literature stimulated by the Plaza Agreement (e.g. Cooper 1989, Frankel 1989, Eichengreen and Uzan 1993) points to the obstacles that must be overcome for international macroeconomic policy coordination to occur. That literature highlights three potential obstacles: interpretative disagreements, distributional conflicts, and a shortage of adequate policy instruments. This section considers them in turn.²²

Interpretive Disagreements. A substantial literature, summarized in Frankel (1989), suggests that interpretive disagreements can be an obstacle to policy coordination. Clearly there is no shortage of interpretive disagreements in the current context.

There is disagreement about the causes of the present constellation of global imbalances.²³

There is disagreement about the current position of the economies concerned. If U.S. economic growth remains robust, then the kind of tax increases and expenditure reductions described in the previous section can contribute to the correction of the country's twin deficits without damaging the prospects for continued growth. But if the odds of recession are high—due to the advanced stage of the expansion, higher energy prices, the weakening housing market and rising levels of consumer indebtedness—then tax increases are the last thing that the economy needs. Similarly, if the Chinese economy is at risk of overheating, then monetary tightening and currency appreciation will work to sustain rather than damage growth. If, on the other hand, current rates of economic growth are sustainable and there is minimal danger of overheating, then the contractionary effects of monetary tightening cum currency appreciation should be offset by expansionary fiscal policy.

There is disagreement about future prospects: about how rapidly the U.S. and Chinese economies can grow, about how quickly the two countries will move away from their current growth models, and about for how long the dollar will retain its “exorbitant privilege” as the leading international currency.

Finally, there is disagreement about the magnitude and even the sign of cross-border spillovers.

The standard analysis motivating calls for policy coordination points to inadequate saving in the United States and excessive saving in the rest of the world as root causes of the imbalance. U.S. gross national saving has fallen to 13.6 per cent of GDP on the IMF's measure, down by 3.3 percentage points from the 1983-2000 average and barely half the levels prevailing in the rest of the world.²⁴ Authors like Roubini and Setser (2004) and Frankel (2006) blame the decline in U.S. savings rates on fiscal policy. They observe that a decline in public saving like that which occurred in the U.S. since 2001, a period that has seen a swing in the fiscal balance from +2.5 per cent of GDP to -3.5 per cent of GDP, will lead to a matching decline in national saving and a matching deterioration in the country's current account balance, other things equal. They attribute the growth of budget deficits to a combination of tax cuts (with the share of federal revenues in GDP falling from 22 per cent to 19 per cent under the Bush Administration) and to increases in outlays.²⁵ They observe the coincidence in time of the decline in gross saving and the rise in the U.S. current account deficit,

²² Although not all at the same length. Disparities in how much space I devote to these four potential obstacles reflects how much attention has been devoted to the surrounding issues in the previous literature.

²³ Previous enumerations the alternative interpretations include Roubini and Setser (2004), Eichengreen (2006a,b) and Frankel (2006).

²⁴ The estimates of savings rates in this and subsequent paragraphs are from BIS (2005).

²⁵ On defense, homeland security, Medicare and Medicaid, and a variety of other domestic programs.

the implication being that the “other-things-equal” assumption, two sentences back, is not a bad approximation to reality.²⁶ In particular, there has been no rise in private savings to offset the decline in public savings, as predicted by the theory of Ricardian equivalence and the advocates of the Bush Administration’s tax cuts; to the contrary, household saving has fallen to the point where it is now in negative territory. National saving remains positive only as a result of strong corporate profitability and high corporate saving rates.

In the world as a whole, meanwhile, gross savings rates rose by 1.7 percent of GDP between 1991 and 2004. With the U.S. accounting for a quarter of the world economy, the corresponding rise in non-U.S. savings as a share of GDP is 2.5 per cent. The rise in savings rates is most dramatic in developing Asia, where it amounted to 9.5 per cent of GDP over the period, and in China in particular, where it came to 9.6 per cent.²⁷ This rise in saving has no single cause, but the dominant factor is probably faster economic growth and the absence recently of disruptive crises.²⁸ This rise in foreign saving in turn suggests that policy adjustments in the United States cannot by themselves bring about a smooth resolution of global imbalances—insofar as the explosive growth of the U.S. current account deficit has taken place in a period of exceptionally low interest rates. If a decline in U.S. saving was all that was going on, after all, one would expect to see unusually high U.S. and global interest rates, not unusually low ones as has been the case in recent years (Bernanke 2005).

Were this universally agreed, a consensus on the nature of desirable adjustments—encourage saving in the U.S. and spending abroad—would not be hard to achieve. In fact, however, there exist alternative views with different implications. To start, there are perspectives attributing global imbalances to investment rather than savings behavior. In this view, capital has flowed toward the United States because the flexibility of the country’s markets and its facility with new technologies render it an attractive place to invest. The country’s flexible labor markets, market-based financial system and lightly regulated economy, which facilitates the entry and exit of firms, have contributed to its leading role in the development and adoption of internet-related (and now biotech- and nanotech-related) technologies. Since the mid-1990s U.S. productivity growth has accelerated, reflecting the country’s facility in the development and utilization of new technologies. While productivity growth has been fastest in the computer-producing sector, new technologies have also delivered efficiencies in the service sector (with, *inter alia*, the advent of big-box stores utilizing just-in-time inventory control and the reorganization of back-office functions in financial institutions).²⁹

The implication, drawn by authors like Bachus and Lambert (2005), Cooper (2004), Clarida (2005), Levy (2005), Mandel (2006) and Plosser (2005), is that the U.S. international economic position

²⁶ Others, starting with Bernanke (2005), will disagree.

²⁷ In Europe and Japan, in contrast, savings rates have fallen, which is a reminder that the problem of global imbalances is first and foremost a problem between the United States and Asia *ex Japan*.

²⁸ Simple life cycle theory would suggest a negative relationship—that households expecting higher future incomes would borrow against those higher future incomes now. In part, evidence of the opposite is explicable by cohort effects: young people in the labor force who save do so out of higher incomes than old people who dissave out of wealth accumulated from what were previously lower incomes. This was famously demonstrated by Modigliani (1970). In addition, in countries like China imperfect financial markets and credit constraints may play a role. The young would like to borrow against higher future incomes in order to, *inter alia*, purchase consumer durables but cannot owing to imperfect markets; hence savings rates are higher than would be the case otherwise. Chamon and Prasad (2005) show that if credit constraints are severe they can produce a positive correlation between the growth rate and the savings rate. For China this suggests that savings rates will decline both as growth falls from the double digits to more normal levels and as financial markets develop.

²⁹ That the productivity effects have not been limited to the computer-producing segment of the economy is important to the argument, given that computer production accounts for only 6 per cent of U.S. GDP.

is, in fact, entirely sustainable. The country's debt/GDP and debt/export ratios will not explode because the rapid productivity, output, and export growth made possible by high levels of capacity expansion, financed in part by foreign investors, will grow the denominators of these ratios. American observers subscribing to these arguments see higher taxes designed to choke off private spending as unnecessary on the grounds that the country's residents, who benefit from this faster productivity growth, have higher personal incomes (Cooper 2006). They will see higher interest rates designed to limit the excess of investment over saving as counterproductive.

But calculations like those of Timmer et al. (2003) suggest at most a ½ per cent economy-wide productivity differential between the U.S. and Europe between 1995 and 2001.³⁰ This would seem to be too small to drive a 6-per-cent-of-GDP swing in the U.S. current account.³¹ And, of course, productivity has been growing even faster in other places, such as China. Moreover, the fact that an increasing share of foreign finance for U.S. current account deficits has been provided in recent years by foreign central banks rather than private investors is hard to square with the notion that the trans-Pacific imbalance reflects the incentive for foreigners seeking high returns to invest in the United States. Assuming that the purchase and construction of actual production facilities is the form of foreign investment that is most responsive to productivity differentials, there is also the uncomfortable fact that FDI is flowing out of the country on net; maybe this means that other parts of the world are not so disadvantaged from the point of view of take-up of new technologies after all. Finally there is the fact that U.S. investment rates have risen only slightly over the period. For some, these are compelling objections to the interpretation of global imbalances as driven by the attractiveness of investment in the United States. But they have not convinced everyone.

Rajan (2006) has developed the intellectual complement to this story, arguing that the growth of the trans-Pacific imbalance also reflects the weakness of investment in Asia ex China. In Japan, investment has been depressed since the mid-1990s by the bursting of the bubble economy and the country's decade-long slump. In the crisis countries of East Asia, investment collapsed in 1997-8, and governments have been concerned to insure against renewed instability by accumulating international reserves, something they have achieved by running their economies under less pressure of demand. For Asia ex China and Japan, investment rates fell by 8.7 per cent of GDP between 1996 and 2004.³²

If this decline in investment demand is permanent, then more global savings will presumably be available indefinitely to finance U.S. investment. By itself, this does not ensure the sustainability of the U.S. deficit, but it makes adjustment less urgent. Those who see some of the investment in the pre-crisis period as inefficient, reflecting industrial policy makers' fixation on high levels of capital formation, presumably subscribe to this view. Even if investment in emerging East Asia now begins to recover, along with investment in Japan, this may be offset by declining investment rates in China, it being doubtful that the country can efficiently invest 50 per cent of its GDP for the foreseeable future. The more widely this perspective is held, the less pressure policy makers feel to negotiate and implement policy adjustments.

30 And at least of some of that may have been temporary, reflecting a larger contribution of capital formation in the United States in the Internet-Bubble years ending in 2000, together with the negative effects on European investment of fiscal consolidation in the run-up to the creation of the continent's monetary union.

31 Subsequent data suggest a further acceleration in U.S. output per hour in the nonfarm business sector, although that acceleration may have petered out after 2005, and recent data revisions suggest a somewhat smaller acceleration relative to the late 1990s.

32 See Macfarlane (2005) and Rajan (2005).

While the definition of the current account as the difference between investment and savings makes the aforementioned arguments an obvious place to start, they by no means exhaust the range of alternative interpretations. In addition there is a cluster of arguments focusing not on aggregate rates of saving and investment but on the tendency for U.S. foreign investments to earn a higher return than U.S. foreign liabilities and for the country's stock of net foreign liabilities to rise less quickly in value than the sum of its current account deficits. U.S. deficits are sustainable in this view because the resulting debts are small and inexpensive to service. There being no problem of sustainability, there is no need for policy adjustments, coordinated or otherwise. Again, the currency of this view complicates the prospects for a "grand bargain."

Gourinchas and Rey (2005) show that compositional effects explain part of observed rate of return differentials: U.S. foreign assets are skewed toward high-return FDI, while U.S. foreign liabilities are more heavily composed of low-return debt securities.³³ In this view, the U.S. current account reflects the greater risk tolerance of American foreign investors, higher yields on U.S. foreign assets being compensation for the greater risk of equity investments.³⁴ Kitchen (2006) shows that part of the differential is also explained by the fact that America's direct foreign investments outperform direct foreign investments in the United States.³⁵ Lane and Milesi-Ferretti (2005) show that these historical rate-of-return differentials have been reflected in expected ways in increases in the value of U.S. foreign investments and relative to the value of the investments of residents of other countries in the United States.³⁶

Kitchen (2006) lays out the scenario in which historical rate of return relationships continue to hold and the U.S. also continues to enjoy the same tendency for its foreign investments to appreciate in value, while foreigners suffer capital losses on their more poorly chosen investments in the United States. He shows that it will then cost the United States less than one per cent of GDP to finance a net external debt of 50 per cent of GDP. Indeed, even if the current account does not adjust, the fact that foreigners continue to incur capital losses on their investments in the United States (relative to valuation changes for U.S. investments abroad) implies that the ratio of net foreign debt to GDP stabilizes in the neighborhood of 75 per cent, lower than the levels implied by the standard analysis.³⁷ It will still cost the United States less than 2 per cent of GDP to service this net external debt, since U.S. investments abroad are much more remunerative than foreign investments in the United States.

The question is whether one should expect these patterns to persist. There is no guarantee that U.S. FDI abroad will continue to outperform FDI by other countries in the United States. Investors learn from their mistakes, and anecdotal evidence like the performance and profitability of Japanese automobile factories in the United States compared to that of U.S. automobile companies' operations abroad does not suggest that American FDI abroad is always and everywhere superior. U.S. net interest payments on the debt securities in which foreigners invest have been depressed by the Greenspan Conundrum (the unusually low level

³³ Note the caveat in the text that this is only part of the story, the remainder being explained by exchange rate movements. I return to this below.

³⁴ Debt being serviced before dividends are paid.

³⁵ One thinks here of the golf courses and high-rise office buildings purchased by Japanese investors in the United States in the 1980s and 1990s.

³⁶ An investment that yields a higher rate of return will have a higher capitalized income stream; hence the capital gains on U.S. investments abroad relative to foreign investments in the United States.

³⁷ According to the standard analysis (Mussa 2004, Roubini and Setser 2004, Yoshitomi 2006), the indefinite maintenance of a current account deficit of 7 ½ per cent of GDP by a country whose rate of nominal GDP growth is 5 per cent (3 per cent real growth plus 2 per cent inflation) implies an eventual ratio of net external debt to GDP of 150 per cent.

of interest rates), which will not last forever.³⁸ It is revealing in this connection that the average return on foreign investment in the United States fell from 3.6 per cent in 2000 to 2.4 per cent in 2003, just when U.S. interest rates were declining.³⁹ With foreign living standards converging toward American living standards and wealthier individuals having more scope for bearing risk, there should be a tendency for historical differences in the composition of national foreign investment portfolios to diminish. And now that the higher yield on U.S. foreign investments is attracting attention, residents of other countries will presumably revise their allocation decisions so as not to be consistently outperformed by their American counterparts. These arguments all paint a gloomier picture of the sustainability of the U.S. current account and support the case for early adjustment.

Similarly, Lane and Milesi-Ferreti show that the valuation effects they detect are explained mainly by exchange rate fluctuations. With U.S. foreign liabilities, such as treasury and agency securities, denominated in dollars while U.S. foreign assets are primarily denominated in foreign currencies, dollar depreciation has strengthened the U.S. net foreign investment position. As some authors put it, the U.S. has regularly fooled foreign investors into holding about-to-be-devalued claims (Roubini and Setser 2004, Frankel 2006). The obvious question is whether it can keep doing so. Those of a skeptical persuasion suggest that a shift away from dollar-denominated claims on the United States to claims on countries with stronger currencies is inevitable. Such a shift would make financing the U.S. deficit more difficult. It could precipitate a sharp fall in the dollar and financial distress if it occurred suddenly.

The most provocative variant of the argument is that of Hausmann and Sturzenegger (2006). The authors suggest that since U.S. net interest income from abroad remained positive (at some \$30 billion) in 2005, U.S. foreign investments, valued to reflect their income-generating capacity, must exceed U.S. foreign investors' claims on the United States, similarly measured so as to reflect their true economic value.⁴⁰ Moreover, since U.S. net interest income did not decline significantly in the 25 years through 2005, neither did the value of the country's net foreign investments in a meaningful economic sense. In turn this must mean that the U.S. has not actually been running current account deficits.

To explain the discrepancy the authors suggest that the official accounting must be failing to capture U.S. exports of reputation (the brand value of companies like Disney and Coca Cola, and the reputation of the U.S. government for preserving the value of its debts) that are packaged together with U.S. exports of observable goods and services. Three categories of U.S. exports must be under-recorded: U.S. liquidity services (seignorage), U.S. insurance services (secure investments), and U.S. knowledge services (organizational knowledge and brand recognition) because they were bundled with three types of financial instruments: U.S. currency held by foreigners, U.S. treasury bonds held by foreigners, and U.S.-originated FDI.

The objection to this analysis is that there is no reason to take the official figures on net income from abroad as accurate while dismissing those for the current account as meaningless.⁴¹ There is ample room in practice for misstating income by using transfer pricing to shift profits between national subsidiaries—and

38 Already we have begun to see some normalization of the relevant interest rates. U.S. rates are still anomalously low, although whether this reflects the persistence of the Conundrum or expectations of weakening economic activity (the inverted yield curve that traditionally signals recession) remains to be seen.

39 See Setser (2006).

40 The 5 per cent interest rate they use to capitalize income streams has been attacked as arbitrary, but their essential point would still follow for any constant positive interest rate.

41 As Hausmann and Sturzenegger do. Further objections are catalogued in Buiters (2006).

considerable incentive for doing so to minimize tax liabilities.⁴² Gros (2006), for one, argues that foreign companies have been understating the profits of their U.S. subsidiaries in order to avoid taxes.

The most plausible form of under-recorded U.S. exports is probably U.S. liquidity services, reflecting the reserve-currency role of the dollar. The U.S. treasury market is the world's deepest and most liquid financial market. Foreign central banks seeking to accumulate reserves have naturally preferred to accumulate dollars. Because U.S. treasuries are so liquid, foreigners are willing to hold them despite their relatively low pecuniary yields, and this "exorbitant privilege" contributes to the observed yield differential on U.S. foreign assets and liabilities. Although foreign financial markets have gained liquidity over time, liquid liabilities (defined as the sum of debt, trade credit and bank loans) still account for a remarkably high 60 per cent of all U.S. foreign liabilities.⁴³

The value of this exorbitant privilege is not easy to measure. Gourinchas and Rey estimate that the U.S. has paid roughly 300 basis points less on liquid liabilities placed with foreign investors than foreigners have paid to place liquid liabilities with American investors. U.S. liquid assets abroad come to roughly 25 per cent of U.S. GDP. By this measure, the exorbitant privilege is worth $\frac{3}{4}$ of one per cent (25 per cent times 0.03) of U.S. GDP per year.⁴⁴

This benefit is not inconsequential. It is roughly equivalent to a quarter's worth of economic growth. At the same time it reduces the amount of foreign funding needed to finance a U.S. current account deficit currently approaching 7 per cent of U.S. GDP by little more than a tenth.

Moreover, there are reasons to doubt that the U.S. will monopolize the global market in liquidity services to the same extent in the future. The third quarter of the 20th century, when only the United States possessed deep and liquid financial markets easily accessible to foreign investors, was an anomaly. With the liberalization and development of their financial systems, other countries and regions have enhanced the liquidity of their financial markets. Most dramatically, the advent of Europe's single currency has stimulated the development of a continental market in euro-denominated government bonds. With the removal of capital controls, foreign investors have gained easier access. For all these reasons, there is reason to anticipate that the dollar will face more intense competition from other currencies. If network externalities are important, one can imagine that the dollar will remain dominant until a tipping point is reached, at which point foreign central banks will shift en masse into another currency such as the euro (Chinn and Frankel 2005). If one doubts the importance of network externalities, then the development of liquid debt markets in other countries suggests that there will instead be more gradual diversification out of the dollar and that, in the future, several reserve currencies will coexist (Eichengreen 2005). Either way the dollar's exorbitant privilege will do less to relieve pressure on the country's balance of payment than has been the case in prior years.⁴⁵

⁴² Hung and Mascaro (2005) note that this view is supported by the fact that the rate of return on U.S. owned FDI in Ireland was triple that on overall U.S. FDI between 1999 and 2003, while that on U.S. FDI in Bermuda was double the overall average.

⁴³ As of 2004, according to Gourinchas and Rey (2005). Caballero, Farhis and Gourinchas (2006) generalize this argument, hypothesizing that the U.S. has a comparative advantage in generating financial assets that the residents of other countries wish to hold. Here the relevant denominator for calculations of the contribution of this "industry" to the U.S. balance of payments would take as its basis not just U.S. debt securities held by foreigners but all financial claims (debt plus equity) held by foreigners.

⁴⁴ Note that this figure would be smaller were it calculated on the basis of debt securities alone and not all liquid liabilities to foreigners.

⁴⁵ In the Caballero, Farhis and Gourinchas variant, one can similarly question whether other countries, as they develop more sophisticated financial markets and institutions, will continue lagging the United States in their ability to generate financial claims that others will wish to hold.

A final reason that some observers question the need for current account adjustment is the “Bretton Woods II” or “Global Co-dependency” view (see e.g. Dooley, Folkerts-Landau and Garber 2003, Mann 2004) that emerging markets are willing to continue financing the U.S. current account for an extended period, questions about its ultimate sustainability or not. The most influential argument along these lines is that emerging markets—above all China, but extending to the rest of Asia and other regions—benefit from maintaining exchange rates that are pegged at low levels against the dollar and exporting their way to faster growth. Japan pioneered this strategy in the 1950s and 1960s, and virtually every emerging market that has sustained high growth for an extended period subsequently has emulated its example.⁴⁶ The export sector is the locus of learning and productivity spillovers; a stable, competitively valued currency that boosts the growth of exports also makes a country a more attractive destination for inward FDI and portfolio capital flows. Thus, even if the dollar ultimately stands to lose value against other currencies, Asian governments and central banks will be reluctant to curtail the foreign exchange market intervention that keeps their currencies from appreciating and results in their massive accumulation of international reserves, for fear of disrupting this process of export-led growth. If the consequence is capital losses on dollar reserves, then this is an acceptable price to pay for prosperity.

The appeal of this model is its consistency with the observation that foreign central banks and not private investors have been providing much of the finance for the U.S. deficit in recent years. It helps to explain the bond market “conundrum” insofar as foreign central banks are the marginal purchasers of U.S. treasury bonds, as well as the coexistence of U.S. deficits with low interest rates.

But note that the argument is not that the current constellation of imbalances is sustainable indefinitely. Ultimately emerging markets, in Asia and elsewhere, will exit the stage of export-led growth and allow their currencies to appreciate, as Japan did in the 1970s and 1980s (Obstfeld 2006). Like Japan before it, China cannot suppress the growth of the service sector forever. Nor will it wish to do so insofar as the service sector and not just industry can be a locus of knowledge spillovers and learning by doing. China cannot keep on running savings rates of nearly 50 per cent of GDP and current account surpluses forever; sooner or later it will want to graduate from a growth model based on exports of merchandise to one based on a better balance of domestic and foreign demand and between the industrial and service sectors (Eichengreen 2006d).

The problem for policy coordination is that this transition is not without risks.⁴⁷ China and other Asian countries are understandably reluctant to tamper with success. And even if it is in the collective interest of Asian countries to keep the dollar up and, by implication, their currencies down, it is in their individual interest to curtail their purchases of dollar-denominated assets and diversify their reserves into other currencies in order to avoid capital losses; thus, maintaining the present situation also poses a problem of collective action (Eichengreen 2004).

⁴⁶ A clear statement of this view is Sachs (1985).

⁴⁷ Japan’s experience with currency appreciation was not entirely happy: growth slowed significantly in the 1970s, following the country’s exit from its 360-yen-to-the-dollar peg, and some observers (viz. McKinnon and Schnabl 2003) blame pressure on the Bank of Japan for the bubble economy of the 1980s and the slump of the 1990s. In their view, it would be better for Asian countries, China in particular, to resist calls for currency appreciation as part of an internationally coordinated package of adjustments.

These are reasons for thinking that the current constellation of global imbalances will not persist indefinitely.⁴⁸ That said, there is uncertainty about how soon it will begin to disintegrate and how disorderly the adjustment will be.⁴⁹ This uncertainty in turn complicates efforts to develop a consensus in favor of adjustment.

Thus, essentially all the analytical obstacles to macroeconomic policy coordination pointed to in Frankel (1989) arise in the current context. There is uncertainty about the initial position of the economies involved: is the U.S. on the verge of a recession, creating the danger that tax increases would push it over the edge? Is or is not China at risk of overheating? There is disagreement about the causes of the current position—about exactly why the U.S. is in deficit and other countries, Asian countries in particular, are in surplus. There is uncertainty about future prospects: there are different perspectives on the danger of explosive growth of U.S. debt/export and debt/GDP ratios that derive from different views on the economy's sustainable rate of growth; and there are different views of how currency appreciation would affect the export-dependent Asian economies. There is disagreement about the domestic effects of policy adjustments: will exiting from its dollar peg allow China to smoothly graduate from export-led growth to a domestic-demand-led growth model, or will it consign the country to a deflationary spiral? Would fiscal stimulus to offset the demand-reducing effects of a tighter monetary policy be productive or counterproductive? What would be the change in the current account balance resulting from a \$1 reduction in the fiscal balance?⁵⁰ Finally, there is uncertainty about nature of the cross-border spillovers: would tax increases in the United States depress economic growth abroad by reducing U.S. import demands, or would they stimulate growth abroad by limiting the upward pressure on global interest rates imparted by U.S. financing needs?

These interpretive disagreements may not be insurmountable obstacles to achieving on a coordinated response to global imbalances (as described in Section 4), but neither will they be easy to overcome.

Resistance from interest groups. Different constituencies—exporters versus producers of home goods, high- versus low-income households, capital versus labor—are affected differently by the same macroeconomic policy adjustments. Even when there is agreement that a coordinated set of national policy adjustments is good for each country overall—that it raises the present value of expected future national incomes—it may work to the disadvantage of a subset of residents. And, in the absence of mechanisms for compensating the losers, they will resist implementation.

In the United States, for example, the construction industry and other sectors producing nontraded goods have self-interested reasons to oppose a weaker dollar that would shift resources into traded goods production. The direct beneficiaries of the tax cuts of the last six years—high-income Americans by most

⁴⁸ As even the founders of the Bretton Woods II school have acknowledged (Dooley and Garber 2005). There are additional grounds on which the accuracy of this interpretation can be questioned, as noted elsewhere. For example, the argument that a stable, competitively valued exchange rate is desirable to promote exports does not provide an adequate rationale for pegging to the dollar in particular, when only a minority of the exports of the countries in question go to the United States, or for that matter to the United States and other dollar peggers. The idea that Asian countries benefit from the maintenance of high levels of exports is not the same as arguing that they should be running chronic current account surpluses; they may wish high levels of imports as well. To explain this the proponents of the Bretton Woods II view must add another element, such as the idea that the accumulation of reserves serves as collateral that renders emerging markets a more attractive destination for FDI (Dooley, Folkerts-Landau and Garber 2004).

⁴⁹ Thus, to support their view that the adjustment will be relatively benign, Dooley, Folkerts-Landau and Garber (2005) argue that even if Asian central banks sell the dollar en masse, the European Central Bank will buy it to prevent the euro from appreciating excessively and further damaging European economic growth.

⁵⁰ There is a wide range of empirical estimates of this elasticity; see U.S. Treasury (2006).

calculations—have a self interest in resisting calls to reverse out or sunset those measures. Cuts in capital gains taxation, estate taxation, and top marginal rates disproportionately benefit high-income households. Thus, even if it is accepted that cutting the budget deficit and therefore the current account deficit is good for the country as a whole, whether unilaterally or in conjunction with complementary policy adjustments abroad, interest groups within the country may prevent these policies from being implemented.

In China's case, it is less obvious that the central government in Beijing is constrained by special-interest politics. But it must work in harmony with local governments, many of which are substantial exporters through their Town-and-Village Enterprises and thus have reason to resist significant current appreciation. The governments of the coastal regions that benefit disproportionately from the current export-based development model (owing to their location) would similarly resist a change in the policy mix that shifted demand toward nontraded goods.

Stakeholders in state-owned enterprises that would not be viable in the face of higher labor costs would similarly resist any policy that results in real appreciation. The government also seeks to encourage private manufacturing enterprise and to attract foreign direct investment into the export sector. When it hears potential foreign investors warning that renminbi appreciation will make them more reluctant to commit to new projects, it has an understandable tendency to think twice.

Of course, pressure from special interests can also strengthen the hand of those seeking to engineer coordinated policy adjustments. Thus, at the time of the 1985 Plaza Agreement, U.S. manufacturers and their workers, especially those concentrated in the so-called "rust belt" states of the Midwest, were disproportionately impacted by the rise in the dollar and consequently supported an initiative to push the currency down. Importers who feared a protectionist backlash similarly saw merit in a coordinated response. In the present context, U.S. exporters would presumably favor a weaker dollar.⁵¹ Chinese importers and producers of services would presumably support a stronger renminbi. The Chinese government clearly pays attention to spontaneous demonstrations and other manifestations of rural unrest; thus, a growth model based on exports and a low exchange rate that disproportionately benefit coastal regions at the expense of the rural interior may be seen as less attractive on distributional grounds.

For those convinced that coordinated policy adjustments would be a global welfare improvement, the issue then becomes how to mobilize the special interests who stand to benefit from the direct effects, and how to compensate the losers.

Absence of adequate policy tools. In the literature on coordinated adjustments to correct the problem of global imbalances, one often hears calls for the United States to boost private savings rates. It is easier to present this request than for policy makers to implement it. In practice, we know relatively little about how the standard policy variables affect household saving, the component of private saving that has fallen most dramatically in recent years. To put the point another way, we have at best a limited understanding of why savings rates vary so dramatically. The determinants of savings rates pointed to by standard approaches like the life-cycle model (Modigliani 1970), interest rates for example, explain only a small part of observed variations. As noted above, the predictions of the Ricardian model, which suggest that private savings should move inversely with the aggregate fiscal balance, are contradicted by the recent behavior of household savings

⁵¹ One might make the same argument about the future generations of Americans who will bear the burden of servicing U.S. debts, although in fact this example points up the opposite problem, that the interests of future generations are underrepresented in current political debate.

in the United States. If monetary policy, which shapes the evolution of interest rates, and fiscal policy, which helps to determine the budget balance, have little systematic impact on household savings behavior, then there may be little that macroeconomic policy makers, who are the principals in policy coordination discussions, can do to reliably influence private savings.

Other factors may matter more for private saving, but these may themselves be more difficult to control. Carroll and Summers (1990) analyzed savings rates in the U.S. and Canada, two economies with many macroeconomic, institutional and geographic similarities but very different savings rates. U.S. and Canadian savings rates diverged in the early 1980s (U.S. savings fell, Canadian savings rose) after having moved in tandem for 25 years. Carroll and Summers attribute this to divergences in the behavior of asset prices (on the grounds that capital gains that raise household wealth reduce household saving) and tax structures (pointing to differences in the tax treatment of interest payments on household debt). Unfortunately for policy, asset prices can have a mind of their own. Whether or not a rise in interest rates will prick a bubble and, more generally, how it will affect asset valuations is uncertain. The literature on whether monetary policy should respond to asset prices, much of which emphasizes these uncertainties, points to the problematic nature targeting asset prices. Targeting asset prices in order to influence private savings rates is only a specific instance of the general point.

It is also problematic to advocate changes in the structure of taxation as part of a policy coordination exercise. The structure of taxes is, if anything, even more politically contentious than the level; cutting some people's taxes has even more visible distributional consequences than cutting everyone's taxes. Changes in the tax code are difficult to push through parliament or congress in the time frame relevant to policy coordination exercises. The effects are uncertain: the capital gains and estate tax cuts of the Bush Administration did not result in higher private savings rates, as their proponents predicted. If the most important thing the U.S. can do to raise household savings is to eliminate the tax deductibility of mortgage interest payments, then it is hard to imagine a more politically contentious proposal.

The upshot is that macroeconomic policy makers face a shortage of instruments suitable for implementing calls to raise U.S. private savings rates.

What is To be Done?

The preceding analysis points in turn to steps that governments and the international policy community can take to encourage coordinated responses to the problem of global imbalances.

Develop a consensus on common goals through international consultations with outside mediation. There is unlikely to be international action to address global imbalances absent agreement that those imbalances are a problem. Agreement on goals is more likely when there is sharing of information and analysis and when there exists an outside body to impartially adjudicate disputes. The obvious analogy is with marriage counseling: just as a husband and wife may be better able to air their differences and agree on common goals and desirable behavioral changes in a neutral forum with impartial mediation, governments may similarly be able to agree on macroeconomic policy changes in such a setting.

This is the idea behind the multilateral consultations inaugurated by the International Monetary Fund in the spring of 2006. According to IMF (2006), these consultations will provide a "forum for debate" among parties to a common economic issue. The aim is to enable the Fund and its members to agree on policy actions to address vulnerabilities affecting both individual countries and the global financial system.

Members will exchange information and views, with the IMF acting as honest broker. The first such consultation, the managing director announced on 5 June 2006, will focus on global imbalances and involve the United States, the Euro Area, Japan, China and Saudi Arabia. Its focus, appropriately, is to be on “spillovers and linkages among these and other economies, rather than on domestic economic issues.” Bilateral consultations with the five parties, as the first stage, will then be followed with multilateral meetings, out of which, it is hoped, will develop agreement on a package of mutually-beneficial policy adjustments.

To be sure, there is no shortage of other venues, including some of long standing, for discussion and debate among national policy makers. There is the IMF Executive Board, where results from the Fund’s multicountry simulation model are discussed twice annually in conjunction with board discussions of the *World Economic Outlook* (WEO). There is the International Monetary and Financial Committee, the IMF’s steering committee, made up of finance ministers and central bank governors from the same 24 countries represented on the Executive Board, where the same issues are discussed. There are the Groups of 5, 7, 8, 10, 15, 20, 24, 30 and 77. There is the Committee of Central Bank Governors and the Financial Stability Forum that meet under the umbrella of the Bank for International Settlements. Some of these clubs are more active than others, and some are more suitable for addressing macroeconomic and financial vulnerabilities. But it is hard to argue that there is a shortage of relevant venues.

The strongest argument for a new mechanism and for the premise that consultations with outside mediation can make a difference is that none of these other groups is appropriately constituted for the problem at hand. In the case of global imbalances, the G5, 7, 8 and 10 do not include an important emerging market like China or an oil exporting state like Saudi Arabia. The larger groupings, for their part, are too unwieldy for productive discussion and debate.⁵² An advantage of the new mechanism is that it can be appropriately constituted to address the problem at hand. It possesses the flexibility needed to address new issues and, at the same time, should have more legitimacy than purely ad hoc consultations.

Enhance the context for mediation and the perceived legitimacy of the mediator. Marriage counseling will not succeed when the parties involved have irreconcilable differences. It will not work when ill will arising out of past disagreements poisons the atmosphere. It will not work when the parties to these consultations have other disagreements, over inter alia foreign policy and geopolitical affairs, complicating efforts to cooperate on economic and monetary affairs.

This is not to say that all other disagreements must be resolved for there to be progress on global imbalances. But there must be a willingness to acknowledge the existence of global interdependencies and a willingness to work through international institutions to achieve a cooperative solution. Thus, agreement on coordinated policy adjustments that work to everyone’s advantage is likely to be easier to reach against a backdrop of progress on other global political and security issues, reached through deliberations in the UN Security Council and other venues. For example, one can imagine that the United States and China will find it easier to agree on mutually advantageous adjustments in exchange rates and domestic policies if they reach at least a de facto understanding on the future of Taiwan.

In addition, mediation is unlikely work when there are doubts about the impartiality of the mediator. In the present context there is the problem that the IMF is a creature of its shareholders and that two of the parties to the first multilateral consultation, the United States and the Euro Area, have more votes

⁵² Buira and Abeles (2006) suggest making the G20 the venue for negotiating a coordinated set of policy adjustments, but there is reason for thinking that this group is too largely and unwieldy.

and leverage in the Fund than the other three participants. Thus, reforming governance and representation in the IMF, so that seats in the Executive Board and votes in the Fund better reflect 21st century realities, is critical for enhancing the legitimacy of the Fund's mediation in the longer run.⁵³ A first step in this direction was taken at the annual meetings of the IMF and World Bank in Singapore, where it was agreed to increase quotas and votes for four particularly underrepresented countries (China, Korea, Turkey and Mexico) and to raise the number of basic votes cast by every country (regardless of size) as a way of enhancing the voice of poor countries. But more comprehensive governance reform is still required. There is the need for agreement on a new quota formula so that other rapidly growing countries see that their problem of underrepresentation is addressed—and that such problems will continue to be addressed over time. There is the need to update the composition of the Executive Board, where largely for historical reasons European countries occupy as many as 9 of the 24 seats (depending on whether Spain holds the chair of its largely Latin American constituency at any particular moment). There is the need to reform leadership selection, to ensure that the managing director and, indeed, the entire management team are chosen on the basis of their qualifications rather than as a matter of national prerogative. Finally, there is the need for greater independence for management and staff to reassure all members that IMF advice is not unduly affected by political pressure for particular shareholders. All this will ultimately be needed to enhance the legitimacy of the multilateral consultations process.

Reduce policy uncertainty through comparative model analysis. Perhaps most fundamentally, there are deep-seated disagreements over the severity of the vulnerabilities created by global imbalances—with the United States viewing the risks to itself and the global financial system as less serious than its counterparts—that discussion, debate and mediation on their own may do little to overcome. Moreover, having agreed on goals, governments must still agree on policies to achieve them. As we have seen, uncertainty about whether a particular package of policies will end up moving them closer or further from those goals may impart a status quo bias. Thus, as part of its process of multilateral consultation, the IMF can bring to the table model simulations of the effects of alternative policy packages on national and global macroeconomic aggregates. It can provide its own estimates of key elasticities, such as the impact of changes in the fiscal balance on the trade balance. If these estimates and simulations are regarded as definitive, they will help to overcome the aforementioned status quo bias.

Of course, the IMF already brings its model simulations to the table as part of the WEO exercise. Not everyone will necessarily agree that its modeling is definitive. Some competing global simulation models point to rather different conclusions. The resulting uncertainty allows officials reluctant to acknowledge the need for change to dismiss assessments of vulnerability based on simulations of the IMF's in-house model as less than convincing.

In the 1980s, in response to an earlier flurry of interest in international policy coordination, there was a private sector effort to overcome these problems by undertaking policy coordination simulations using a host of different national and global models and analyzing, among other things, which results were robust to changes in model selection and specification (see Bryant et al. 1989). One can imagine how these could help to cultivate agreement on the “meta-model.” Disagreement on how alternative policies will affect global imbalances and the macroeconomic performance of the major economies might be resolved, at least in part, by another such comparative modeling exercise.⁵⁴

⁵³ Although it is questionable whether fundamental reform of seats, votes and quotas can be completed in a time frame relevant to the orderly resolution of global imbalance.

⁵⁴ That said, it is not obvious that the analogous disagreements were resolved the last time around.

Address commitment problems by issuing multi-year schedules for policy adjustments. There are two ways of reassuring financial markets that excessive budget deficits leading to excessive current account deficits will be eliminated: eliminating them immediately and completely, and eliminating them gradually over time. The gradual approach is preferable in that it avoids shocking the economy with a large change in fiscal policy all at once. But investors will only be reassured if the commitment to continued adjustment is credible. A down payment on adjustment may not do much to reduce financial vulnerabilities if the markets doubt that governments will not follow up with additional installments. If a government is unconvinced of the need for adjustment, it may agree to token adjustments to get off the hook with its foreign partners with no intention of following up subsequently. In addition, officials find it difficult to commit their successors. Governments change; treasury and finance ministers change; parliaments and congresses can pass new legislation watering down or overturning previous legislation.

Perfect solutions to politically-grounded commitment problems do not exist in democratic societies. But a partial solution is to publish a multi-year schedule for adjustment. Announcing specific targets, in the form of a schedule, and then missing them has costs in terms of reputation. So does specifying a series of policy actions and then failing to implement them. As Frankel (1989) puts it, commitments in order to be credible must be attainable and readily monitored, which requires that they should be explicit, measurable and public.⁵⁵

Governments already pre-specify schedules of actions in an effort to enhance the perception of commitment. The Bush Administration has declared its commitment to cutting the U.S. budget deficit as a share of GNP in half by 2009. The United States Congress has established a Congressional Budget Office charged with issuing nonpartisan multi-year projections and analyses of whether current policies will succeed in achieving such goals and, if not, what policy adjustments are needed. Members of the European Union are required to submit annually a multi-year (generally, five year) Stability Program (in the case of members of its monetary union) or a Convergence Program (in the case of countries that are not yet members of the Euro Area). These programs are then vetted by the European Commission and by the Ecofin Council of economics and finance ministers.

One can imagine similar schedules emanating from IMF's consultations. The "deliverable" from the consultations process (the "multilateral letter of intent") should be a sequence of policy adjustments tied to a specific schedule, to be made public at the end of the multilateral round.

That said, it is not obvious that the costs of renegeing on those commitments subsequently would be as great as in the EU context. The IMF and the economic policy community generally lack leverage over the United States and China comparable to that possessed by the EU over countries submitting Convergence Programs. These countries can be denied membership in the monetary union if they fail to follow through on their commitments. The IMF possesses comparable leverage only over countries in a lending program—which is not the case of any of the five countries that are party to its imbalances consultations. More generally, EU member states have constructed a dense web of interlocking bargains. A country that reneges on commitments in its Stability or Convergence Report runs the risk of jeopardizing these other bargains. There is a difference in extent, if not in kind, in the commitments that exist among parties to discussions of the resolution of global imbalances.

⁵⁵ It is perhaps revealing in this context that the first time G5 finance ministers and central bank governors released an official public statement following one of their summits was in 1985, with the intensification of policy coordination efforts.

All this finesses the question of exactly what variables should be subject to these commitments. The longer the list, the more difficult it will be to monitor compliance.⁵⁶ Moreover, a laundry list of targets will not be credible if the number of target variables exceeds the number of available instruments. Thus, it is important that multilateral letter of intent focus on a limited number of targets—reconciling the correction of external imbalances with the maintenance of growth and price stability at home—and verify that the number of instruments (the number of policy instruments for which settings will be modified) at least equal the number of targets (without exceeding their number to such an extent that monitoring compliance becomes problematic).

Conclusion

That the imbalance between the United States and the principal surplus economies arises out of policies and conditions in all the countries concerned makes it unlikely that any one government would be prepared to bear the costs of the policy initiatives needed to correct that imbalance on its own. That the deficits of one set of countries are the surpluses of the rest of the world means that measures by either group to reduce the imbalance also reduce the imbalance of the other—in other words there are cross-border spillovers that accrue as an externality. And when there are effects external to a country, national policy makers operating in isolation will not have an incentive to implement the globally optimal policies. Together these observations point to the desirability of coordinating the response. Ideally, that response would combine measures to reduce the growth of spending in the United States (through policies of revenue enhancement to narrow the government budget deficit together with tax reforms designed to encourage household saving) with measures to stimulate the growth of spending in other countries (by boosting public expenditure in Asia and loosening monetary policy in Europe, insofar as there is room for pursuing these policies without aggravating debt and inflation problems, as well as by pushing ahead with structural reform). Reducing the growth of U.S. spending relative to the growth of spending in the rest of the world will require some adjustment of relative prices; as part of this coordinated response, governments will also have to permit adjustment of the exchange rate between the dollar and other currencies, including Asian currencies

But actually implementing this response will be easier said than done. There is less than complete consensus on risks posed by the current constellation of global imbalances. Even those governments that agree that adjustments are necessary do not agree on their urgency. Governments are uncertain about the initial position of their economies. They are uncertain about how policy initiatives will affect the current account and about how their own economies will be affected by policy initiatives abroad. Even were they to agree on a desirable package of coordinated policy adjustments, they would still face resistance from domestic interest groups that stand to be adversely affected, notwithstanding the prospect of global welfare improvements. Governments also face a commitment problem, in that they would prefer that other countries bear the brunt of the adjustment; they may be reluctant to follow through on their part of the bargain. An effective resolution of existing imbalances requires sustained action over time, and governments often find it difficult to credibly commit themselves, much less their successors in office.

⁵⁶ This was a problem in the 1980s: in the wake of the Plaza Agreement, G5 finance ministers meetings were regularized by expanding them to include Canada and Italy and holding them under the aegis of the G7; the G7 then agreed on a list of ten “objective indicators” on which the policy coordination process would focus. It was not credible that governments would adjust fiscal and monetary policies to achieve such a long list of targets. Monitoring compliance was difficult. Thus, officials were able to blame a shortage of available instruments where in fact missing a target could really reflect a lack of commitment.

Theory and experience point to steps that can help in overcoming these obstacles. Exchanging information and analysis through frank discussions in a neutral venue with impartial mediation can foster a consensus on the nature and sources of the problem. Here initiating multilateral consultations under the stewardship of the IMF is a step in the right direction. This initiative provides the flexibility needed to constitute an appropriate grouping, not too large but at the same time comprised of the countries that have played the most prominent role in the development of the imbalance and that can do the most to bring about its orderly resolution. The IMF can provide a neutral venue and impartial mediation; making this first consultation on global imbalances part of an ongoing initiative, in which different issues involving global interdependencies are discussed at different points in time, lends the process more legitimacy and structure than a purely ad hoc approach. The IMF can provide systematic analysis, in the form of model simulations, of both the risks and the effects of policy adjustments.

More ambitiously, the IMF can encourage countries to commit to a multi-year schedule of current account targets and policy adjustments. In the same way that announcing an inflation target and an inflation forecast can lend credibility to the anti-inflationary policies of a central bank, making public an agreed sequence of current account targets and describing the models designed to achieve them can lend credibility to the commitment to bring about an orderly resolution of global imbalances. Announcing an explicit schedule can also help to address the time-consistency problem—the temptation for countries to renege on their part of the bargain insofar as they prefer to see their foreign partners bear the brunt of the costs of adjusting policies, and the resulting reluctance of anyone to adjust.

To be sure, current account outcomes are harder to observe than inflation outcomes: current account data becomes available with longer lags and can be subject to larger revisions. The association between current account outcomes and domestic policies is more complex and disputable than the association between monetary policies and inflation outcomes. Hence markets may be less capable of holding governments to their commitments and effectively sanctions those that deviate. This creates an argument for a multilateral body like the IMF to monitor compliance with commitments and make strong public statements if governments fail to adhere.

The IMF will be effective in this role if its statements don't mince words and its advice is regarded as legitimate. Thus, the Fund's role in the resolution of global imbalances points up, yet again, the urgency of reforming the structure and governance of the institution. Making the IMF more independent of governments, as suggested by De Gregorio et al. (1999) and King (2006), will better enable it to issue clear and forceful evaluations of country policies in the course of multilateral surveillance. Comprehensive quota reform, something that was begun at the September 2006 annual meetings in Singapore, and revising the country composition of the International Monetary and Financial Committee to give more voice and representation to rapidly-growing emerging markets that are currently on the surplus side of the imbalances equation will invest the Fund's advice and recommendations with more legitimacy; traditionally underrepresented countries (like China) will be more inclined to cooperate insofar as they are confident that their views are reflected in the strategies of the institution. Multilateral institutions like the IMF can effectively contribute to the orderly resolution of global imbalances only if representation in and the operation of those institutions is updated to reflect the realities of the 21st century.

This emphasis on the need for more fundamental reform of the multilateral financial institutions is a specific instance of the general point that deeper reform of the global monetary and financial system may be required to prevent similar problems from arising again the future. The current pattern of global imbalances

emerged, in part, because developing countries, following the financial crises of the 1990s, saw it necessary to accumulate international reserves as protection against renewed instability. Since the dollar was the leading reserve currency, this meant accumulating dollars, which in turn meant providing easy finance for the U.S. current account. Now that developing countries have augmented their dollar balances, they are reluctant to alter their reserve portfolios or the policies that facilitated the emergence of the U.S. deficit for fear of precipitating a fall in the dollar and inflicting capital losses upon themselves. This “balance of financial terror” (Summers 2004) allows the U.S. deficit to persist and the country’s foreign indebtedness to grow until some inevitable point at which doubts about the sustainability of its debts precipitate reserve diversification and other policy adjustments by one creditor country and others scramble out of dollars in order to avoid being left holding the bag.

This is an intrinsic problem with a system in which a single national currency is used as international reserves, as Keynes emphasized in the negotiations that led to the creation of the Bretton Woods System and Robert Triffin analyzed in his writings predicting its demise.⁵⁷ Rapidly growing countries require additional reserves, which allows the more slowly growing reserve-currency country to run balance-of-payments deficits for a time. Eventually, however, the fact that the external obligations of the reserve-currency country grow faster than its economy puts the sustainability of its external position into doubt. And when those doubts reach a critical mass, there can be a scramble out of that currency, causing its exchange rate to come crashing down.

Over time, there may develop a market solution to this problem. If there exist a number of competing reserve currencies, each of which accounts for a significant share of foreign reserve portfolios, it will be easier for central banks to alter the composition of their reserves continuously over time and avoid situations where serious doubt arise about the value of a specific reserve currency and the sustainability of the obligations of its issuer. Some authors have argued that the day of multiple reserve currencies may already be at hand.⁵⁸ They suggest that the post-World War II period was exceptional; because of a unique set of historical circumstances, only the United States had both deep and internationally-open financial markets, making the dollar the dominant reserve currency of the day. Now, in contrast, there are a growing number of other economies (the euro area and Japan, for example) whose financial markets are both liquid and open to foreign financial investment. Moreover, the network effects that made a single national money so attractive and economical as the vehicle for international transactions (international investment in particular) operate less powerfully in a world where there exists a proliferation of financial instruments to facilitate transactions in different currencies. If so, the dilemma identified by Keynes and Triffin may be less corrosive to the stability of the international monetary and financial system in the future than in the past.

Alternatively, the development of a multiple reserve currency world may take longer than the optimists suppose. If so, there may be an argument for revisiting Keynes’ case for the creation of a reserve asset that does not take the form of a national money, precisely in order to avoid a repeat of recent problems.⁵⁹

57 See Triffin (1947, 1960).

58 See Eichengreen (2005).

59 There is a long history of such proposals, the most recent of which is Stiglitz (2006).

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